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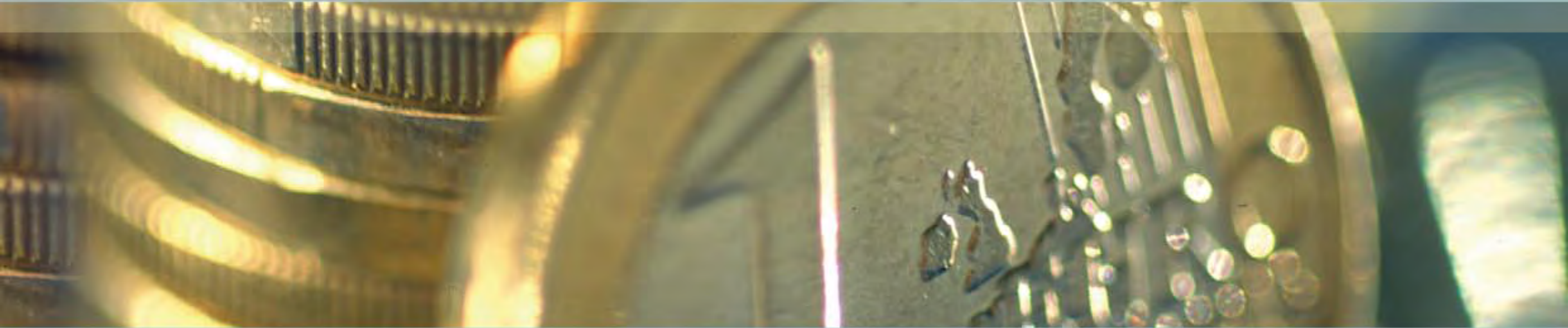

2009 Pre-Accession Economic Programmes of candidate countries:

EU Commission's assessments

Directorate-General for Economic and Financial Affairs

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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 Pre-accession Economic Programmes of the candidate countries (Croatia, the former Yugoslav Republic of Macedonia and Turkey).

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

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

The three countries have published their 2009 programmes, which can be found on the web under following addresses:

Croatia	http://www.mfin.hr/adminmax/docs/2008_PEP%20eng.pdf
The former Yugoslav Republic of Macedonia	http://www.finance.gov.mk/files/u9/PEP_Macedonia_2009-2011.pdf
Turkey	http://www.dpt.gov.tr/PortalDesign/PortalControls/WebIcerikGosterim.aspx?IcerikRef=4022&WorkArea=ctl38

These assessments were prepared in the Directorate-General for Economic and Financial Affairs under the guidance and coordination of Christophe Pavret de la Rochefordière. The principal authors were Uwe Stamm (Croatia), Bernhard Böhm (the former Yugoslav Republic of Macedonia) and Dirk Verbeken (Turkey).

The programmes and this assessment were discussed at experts' level in two multilateral meetings held in Brussels on 15 and 20 April 2009 and at ministerial level during the ECOFIN Council on 5 May. Representatives from EU Member States, the ECB, the Commission and the candidate countries attended this meeting.

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1. OVERVIEW

1.1. SUMMARY AND CONCLUSIONS

Croatia, the former Yugoslav Republic of Macedonia and Turkey were invited to submit by 31 January 2009 their annual *Pre-accession Economic Programmes* (PEPs) covering the period 2009-2011. The preparation, assessment and discussion of these programmes serve to strengthen economic planning capacity in the countries as such and to prepare them for their eventual participation in the economic policy co-ordination and budgetary surveillance mechanisms of Economic and Monetary Union (EMU). In the present crisis context, such programmes appear even more important as the crisis unfolding calls for a fresh re-assessment of each country's policy mix.

Croatia and the former Yugoslav Republic of Macedonia submitted their programme end of January, while Turkey was at that time still in discussions with the IMF, and requested a delay in order to align the programme assumptions with the outcome of the negotiations. While it did not conclude these discussions with the IMF, Turkey submitted its programme in early April. The submitted programmes contain overviews of economic policy plans over a broad range of issues until 2011. In particular they show the governments' intentions to advance structural reforms, productivity gains and alignment with the EU *acquis* and EU best practices that will allow sufficiently high growth in order to catch up with, and prepare for membership in, the European Union. However, the degree of ambition and precision in policy implementation across the programmes is not uniform.

This exercise of submitting, assessing and discussing annual PEPs will continue to support the countries in their preparation for accession. The EU provides an important anchor in this effort. A further integration of pre-accession economic and fiscal surveillance with other instruments of pre-accession economic policy formulation, in particular the economic chapters of the Progress Reports and Accession Partnerships and the bilateral economic dialogues with the countries, can increase the EU's effectiveness in this respect. Technical assistance to candidate countries in the area of economic policy planning and implementation has proven powerful and should be continued.

1.2. BACKGROUND

The ECOFIN Council of 26/27 November 2000 requested the Commission to invite candidate countries to submit an annual PEP and an annual fiscal notification. This initiative resulted in the so-called Pre-Accession Fiscal Surveillance Procedure, which aims at preparing countries for the participation in the multilateral surveillance and economic policy co-ordination procedures currently in place in the EU as part of the Economic and Monetary Union (EMU). The PEPs are part of this procedure. Since 2001, acceding and candidate countries have submitted such annual medium-term PEPs, comprising a macro-economic scenario, a fiscal framework, a structural reform agenda and supplementary information.

The assessment of these programmes complements the policy messages given by the Commission in its annual Enlargement Package. While the economic chapters of the latter assess only past developments in the countries, the assessments of the PEPs are forward looking. They analyse government medium-term plans, crucial for eventual full compliance with the Copenhagen economic criteria for accession.

The PEPs have developed into increasingly important platforms for the authorities to develop and communicate consistent 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. Consequently, the timing,

scope and methodology of the PEPs follow closely reporting obligations of Member States participating in EMU. The PEPs and their assessments are therefore discussed in a multilateral policy framework with Member States and candidate countries, ending with the annual policy dialogue of the ECOFIN Council with candidate countries. 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 experience with the PEPs has shown that the positive results in terms of building up administrative and policy planning capacity and of designing conducive and consistent policies are powerful, but that they take time to accumulate and to materialise.

1.2.1. The 2009 Programmes

Countries were requested to submit their programmes by 31 January 2009. Croatia and the former Yugoslav Republic of Macedonia complied with this deadline, while Turkey submitted its programme with a delay due to its on-going discussions with the IMF. All three programmes have been made public.[1]

In the case of the assessment of the 2009 PEPs one important caveat has to be made:

- When analysing the programmes, the EU Commission assesses whether the provided information is in line with the required standards and whether the programme's overall scenario is plausible and consistent at the time of submission. In the case of the assessment of the 2009 programmes, the global economic environment departed quite significantly from what appeared plausible at the time of drafting the programmes of Croatia and of the former Yugoslav Republic of Macedonia. In the meantime the global environment had changed dramatically, with a sharp decline in global demand and major turbulences and uncertainties on the financial markets. As a result, when commission services assessed them, these two programmes appeared to be fairly optimistic. In the case of Turkey, the main macro-economic assumptions of the programme were deemed as broadly realistic, also given the late submission which allowed for a more accurate assessment of the fall-out from the international crisis.

With this limitation in mind, the main elements of the assessment are the following:

- the programmes present overall consistent and partly ambitious policy frameworks for economic stabilisation, fiscal prudence and structural reforms. Their methodology and presentation has further improved in some areas compared to previous submissions. However, in all programmes there is still room for further improvement, in particular in view of presenting more explicitly the link between the discussed reforms and the country's EU accession process. Overall, countries appear committed to strengthen administrative capacities and to prepare for eventually joining the Economic and Monetary Union.

- the programmes are based on – in principle – consistent macroeconomic and fiscal frameworks. However, in the meantime, the rapidly changing international environment has rendered most of the programmes' economic set-up outdated. At the time of submission, Croatia and the former Yugoslav Republic of Macedonia expected a rather moderate growth slowdown in 2009 and a clear recovery in 2010 and 2011. Croatia envisaged a deceleration from 2.5% in 2008 to 2.0% in 2009 and an acceleration by about one percentage point in each of the following years. The former

[1] Croatia: http://www.mfin.hr/adminmax/docs/2008_PEP%20eng.pdf
The former Yugoslav Republic of Macedonia: http://www.finance.gov.mk/files/u9/PEP_Macedonia_2009-2011.pdf
Turkey: http://www.dpt.gov.tr/PortalDesign/PortalControls/WebIcerikGosterim.aspx?IcerikRef=4022&WorkArea=ctl38

Yugoslav Republic of Macedonia expected a deceleration from 6% in 2008 to 5.5% in 2009 and a growth acceleration to 6% and 7% in 2010 and 2011. These assumptions –at the time of submission and even more so at present – appear overly optimistic for both countries and will have to be revisited. Partly due to Turkey's later submission, the programme was able to include more recent information, suggesting a stronger GDP decline, by 3.6% in 2009. For the remaining programme period, the Turkish programme was also rather optimistic, expecting a recovery of 3.3% in 2010 and a further acceleration to 4.5% growth in 2011.

- the economic frameworks for Croatia and the former Yugoslav Republic of Macedonia foresee a mild slowdown, while the overall trend of capital deepening and efficiency improvements is seen to continue. From the demand side, a strengthening domestic demand – in particular solid consumption and investment – will support growth, which is expected to mitigate consequences from the worsening external environment. However, risks to the programmes are much more elevated than last year, in particular with respect to external demand and capital inflows, notably tourist revenues, workers remittances, FDI and portfolio investment. In Croatia, and in particular in the case of the former Yugoslav Republic of Macedonia, the presented macroeconomic framework probably was too optimistic for being used as a realistic planning tool. A more detailed analysis of the at that time already substantial downward risks would therefore have been welcome.

- the fiscal frameworks foresee for Croatia a gradual narrowing of the deficit, while the former Yugoslav Republic of Macedonia envisages a significant rise in the deficit. In Croatia, the general government accounts are projected to improve from a deficit of -1.3% of GDP in 2008 to a balanced budget in 2011, which is less ambitious than last year's submission. The former Yugoslav Republic of Macedonia plans a significant increase in the deficit from -1.0% of GDP in 2007 to -2.8% of GDP during the whole programme period, reflecting a lowering of the tax burden while increasing capital investment. In the case of Turkey, the programme expects a rise in the fiscal deficit from 1.4% of GDP in 2008 to 4.6% in 2009. In 2010 and 2011, the deficits are expected to narrow to 3.2% of GDP and 2.8%, respectively. The achievement of such objectives under conditions of likely revenue shortfalls and increased social expenditure is likely to require vigorous budget rebalancing measures. In the case of the former Yugoslav Republic of Macedonia, while the lower level of public debt leaves a marginally larger fiscal space than in the case of Croatia, the wider current account deficit nevertheless leaves limited scope for the foreseen expansionary fiscal stance that may exacerbate the country's external imbalances. In the case of Turkey, the fiscal relaxation in 2009 may affect the quality of public spending, while fiscal risks are significant over the programme period, given the rather optimistic revenues projections.

- the structural reform agendas, as presented in the 2009 PEPs, cover a broad range of policies and reveal a varying degree of ambition. Croatia's emphasis is put on economic restructuring, and reform of labour markets, agriculture and the health system. The programme of the former Yugoslav Republic of Macedonia focuses on improving the transport and communication, agriculture, business environment, and regional development. In the case of Turkey, the emphasis of structural reforms is to increase the efficiency in the private sector and of public administration and to strengthen the functioning of the market economy, also by continuing the ambitious privatisation agenda in the energy sector. Often, however, the PEPs are very detailed when describing past developments and rather vague when explaining intended reform measures. Furthermore, the links between the structural reforms outlined and the macroeconomic and fiscal frameworks would have benefitted from a more explicit discussion. Overall, the full and determined implementation of those reforms should strengthen their economies, in particular in view of their increasing EU integration.

Table I.1.1:

Pre-Accession Economic Programmes 2009-11 : Key indicators

	2007	2008	2009	2010	2011
Real GDP growth (% change)					
Croatia	5.6	2.5	2.0	3.2	4.0
The former Yugoslav Republic of Macedonia	5.9	6.0	5.5	6.0	7.0
Turkey	4.7	1.1	-3.6	3.3	4.5
Unemployment rate (%, LFS)					
Croatia	9.6	8.7	8.5	8.0	7.4
The former Yugoslav Republic of Macedonia	34.9	33.7	33.5	33.0	32.4
Turkey	9.9	10.6	13.5	13.9	13.9
Current account balance (% of GDP)					
Croatia	-8.6	-10.5	-7.8	-6.9	-6.4
The former Yugoslav Republic of Macedonia	-7.2	-11.3	-11.1	-10.2	-10.1
Turkey	-5.9	-5.7	-1.9	-3.0	-4.0
Inflation (CPI, annual % change)					
Croatia	2.9	6.1	3.5	3.2	3.0
The former Yugoslav Republic of Macedonia	2.3	8.3	3.5	2.8	2.8
Turkey	8.4	9.6	7.1	6.5	5.6
General government balance (% of GDP)					
Croatia	-1.6	-1.3	-0.9	-0.6	0.0
The former Yugoslav Republic of Macedonia	-0.8	-1.5	-2.8	-2.8	-2.8
Turkey	-0.2	-1.4	-4.6	-3.2	-2.8
General government gross debt (% of GDP)					
Croatia	37.8	36.1	35.1	33.8	31.8
The former Yugoslav Republic of Macedonia	24.7	21.4	22.7	24.7	25.8
Turkey		39.5	43.1	44.1	43.4

Source: PEP 2009

1.2.2. Crisis related policy issues

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

- Given the relatively small size of their economies – even Turkey's economy is roughly of a size between the economy of Belgium and of the Netherlands - and their high degree of trade openness, the design of counter-cyclical measures in the present crisis context need to take into account that a number of traditional demand stimulating measures tend to have a rather limited impact on the local economy and may rather exacerbate external imbalances.

- The financing of substantial spending plans might not be possible through tax revenues, at times of decelerating output and declining inflation. Credit financing on the domestic sector risks to crowd out domestic investors, while tapping international financial markets could be rather difficult and expensive, given the current scarcity on financial markets. In particular in the case of Croatia, increasing the stock of foreign debt appears rather challenging as well as its roll-over, with sizeable maturities falling due in 2009.

- Furthermore, rapidly increasing external indebtedness could erode confidence of financial markets in the countries' solvency, which could lead to tensions in the countries' foreign exchange markets, requiring further increases in interest rates. Even Turkey that went through a drastic fiscal consolidation between 2002 and 2008, could see some of its benefits jeopardized.

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 is approved, it 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.

1.2.3. The PEPs and pre-accession strategy

The programmes lay out policy strategies which are to a large degree compatible with and conducive to the economic priorities of the Accession Partnerships and, more widely, to the general objective of meeting the Copenhagen economic criteria for accession, i.e. establishing a functioning market economy and raising competitiveness to a level which would allow the countries to meet competitive pressure within the European Union[1]. In some cases, though, clearer and more convincing information on the specific implementation of these objectives would have been useful.

Technical assistance to candidate countries in the area of economic policy planning and implementation has proven powerful and should be continued.

1.2.4. Follow-up

The programmes and their assessments by the Commission services were discussed within multilateral policy dialogues between Member States and candidate countries. A special meeting of the Alternates of the Economic and Financial Committee with representatives of candidate countries took place on 15 April 2009 and discussed and assessed the individual programmes of Croatia and the former Yugoslav Republic of Macedonia. As Turkey had submitted its programme only a few days before the meeting, only a very general discussion took place on Turkey's programme. On 20-21 April, a High-level meeting between the EFC and representatives of the candidate countries was held and the draft conclusions prepared at the Alternates level were endorsed. The Ministerial Meeting between the ECOFIN and their counterparts from the candidate countries took place on 5 May 2009. The Council's presidency adopted and published the conclusions of the two countries which had submitted their programmes in time.

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

([1]) So far, the Commission considers Turkey and Croatia to have achieved the status of a fully functioning market economy, while the former Yugoslav Republic of Macedonia is seen to be well advanced as regards meeting the economic criteria and to have moved closer towards becoming a functioning market economy.

1. CROATIA

1.1. EXECUTIVE SUMMARY

Croatia's fifth Pre-Accession Economic Programme ("PEP 2009-2011"), submitted in February 2009 presents a sufficiently comprehensive and broadly consistent macroeconomic and fiscal framework which is however based on overly optimistic macroeconomic projections, undermining the usefulness of the document as a basis for economic policy making. The programme's overarching objectives are: enabling sustainable growth, reducing unemployment and increasing employment levels as well as ensuring social fairness. The document largely complies with the content, form and data requirements and appears consistent with earlier key policy documents and the 2009 budget adopted in December.

Economic performance slowed markedly in 2008 and in early 2009 as a result of the global financial crisis. Tighter financing conditions as well as asset price adjustments have lowered domestic demand and exports to Croatia's main trading partners in the EU declined. Inflation has decelerated from its peak in mid-2008, mainly as a result of lower commodity and energy prices as well as slowing domestic demand, but picked up again in early 2009. The unemployment rate has increased recently and total employment growth has fallen. The current account deficit continued to increase and was more than financed by net capital inflows, despite lower net foreign direct investments. The large stock of external debt and important short-term debt repayment obligations of the government and corporate sector are key challenges against the background of much tighter financing conditions and a possible slowdown in capital inflows. At the same time, a comfortable stock of international reserves and banking sector foreign assets will serve as a cushion in the event of lower external financing. The financial sector remained stable with the mostly foreign-owned banking sector still benefiting from earlier recapitalisations.

The PEP's GDP growth and employment projections appeared overly optimistic at the time of submission, against the background of the growth slowdown in Croatia's major EU trading partners. Moreover, external financing constraints may limit the scope for corporate sector investment. The slowdown in private consumption growth could be stronger than projected, resulting from lower employment and disposable income, negative wealth effects from asset price adjustments, tighter borrowing conditions and a general decline in consumer confidence in a situation of heightened uncertainty. Reaching growth rates close to potential, as projected for 2010 and 2011, may require a longer than envisaged adjustment process. The inflation outlook of the programme appears broadly reasonable with limited upside risks. Also, a continuation of the stability-oriented monetary policy framework may help preventing a significant re-acceleration of inflation over the medium term.

The PEP projects a gradual reduction of the current account deficit, which appears plausible. The growth of exports will be significantly affected by lower demand of Croatia's main trading partner, but total imports are likely to have a larger impact on the current account, due to the combined effect of lower prices for energy and commodities and a significant deceleration of domestic consumption and investment. Moreover, external financing constraints, including less scope for FDI inflows, may also lead towards a reduction of external balances. The main risks to the programme are clearly associated with the possibility of more pronounced negative effects of the global financial crisis on the real and financial sector. A long lasting downturn in Croatia's major EU trading partners would certainly affect prospects for an early resumption of growth as projected by the PEP.

The fiscal programme 2009-2011 envisages a gradual improvement of the consolidated general government balance, turning from an expected deficit of 1.3% of GDP in 2008 to a balanced budget

by 2011. This is based on a reduction of total spending by around 2.5 percentage points of GDP over 2008-2011, which does not appear to be fully backed by specific policy measures. Some measures, especially in the social area, imply an increase in spending. The revenue-to-GDP ratio is planned to decline by 1.3 percentage points, however, revenue projections are based on overly optimistic growth assumptions, and revenue shortfalls are very likely to emerge. The general government debt ratio is projected to fall by around 4.3 percentage points, from a projected 36.1% of GDP in 2008 to 31.8% of GDP in 2011, mainly driven by an improvement of the primary balance and an acceleration of nominal GDP growth.

The general direction of continued fiscal adjustment to ensure long-term sustainability of public finances remains appropriate in view of high spending ratios and significant external vulnerabilities emanating from a high level of external debt and large short term debt service obligations. However, the programme contains limited information on key fiscal measures and their respective quantitative effects. Moreover, the envisaged gradual approach of balancing the budget only by 2011 appears less ambitious compared to the previous PEP and earlier government intentions and may not sufficiently reflect much tighter external financing constraints. Fiscal risks are strongly linked to the likelihood of a much weaker growth performance, which will trigger a significant shortfall in revenues. Additional risks may result from a slower than envisaged implementation of reforms which could delay the realisation of budget savings, especially in the area of subsidies and transfers. The authorities may also be confronted with spending pressures as the current unfolding of the financial crisis may lead to calls for an increase of discretionary spending to counterbalance its negative effects on growth and employment. The combined effect of markedly lower fiscal revenues and a higher current spending would seriously undermine the urgently needed fiscal consolidation. Therefore, an appropriate fiscal response under current circumstances would require immediate and bold fiscal measures, including spending cuts and contingency planning, beyond those explained in the programme, in order to bring spending plans in line with emerging revenue shortfalls and tighter financing constraints.

The PEP 2009-2011 covers a broad range of structural reforms related to the enterprise and financial sector, labour market, agricultural sector, public administration, education, health care, judiciary, and environment. The presentation is often backward looking, providing information on past and ongoing reform initiatives with a strong focus on harmonisation with EU requirements. More emphasis could have been given to measures aimed at improving the business environment, given the pertaining administrative obstacles still in place. The programme contains fiscal estimates on some measures, but the link between the structural reform agenda and the implementation of the fiscal strategy could be further strengthened. The full implementation of the structural reform agenda would in some cases require the establishment of time bound action plans and the definition of concrete measures and clear targets. On such a basis, reforms would be conducive to meeting the objectives of the Lisbon agenda concerning product, labour and capital markets and the establishment of a knowledge based economy. Intensified efforts to speed up the implementation of reforms, in particular in the areas of enterprise restructuring, education and labour markets would be supportive to the fulfilment of the second Copenhagen economic criteria over the medium term. The structural reform agenda largely reflects the main accession-related policy requirements, but falls somewhat short in fully addressing the economic priorities of the Accession Partnership of February 2008 and the policy challenges identified in the 2008 Progress Report.

1.2. INTRODUCTION

On 1 February 2009, Croatia submitted its fifth Pre-Accession Economic Programme, following government adoption and earlier consultation of social partners. The programme covers the period 2009-2011 and represents an update of the previous years' submission. It builds on earlier policy documents, such as the "Strategic Development Framework for 2006-2013" and the "Economic and Fiscal Policy Guidelines 2009-2011". The document largely complies with the content, form and data

requirements. Comments and suggestions by the Commission made in its last years' PEP assessment have been taken on board and led to technical improvements. The PEP presents a sufficiently comprehensive and broadly consistent macroeconomic framework. However, its growth projections appear overly optimistic at the time of submission, and consequently lead to a rather unrealistic fiscal scenario. The programme's overarching objectives are: enabling sustainable growth, reducing unemployment and increasing employment levels as well as ensuring social fairness. The structural reform agenda puts emphasis on a continuation of enterprise restructuring and social reforms, but falls short in fully addressing the economic priorities of the Accession Partnership and the key challenges identified in the 2008 Progress Report.

Table II.1.1:

2009 Pre-accession Economic Programme: Key indicators

		2007	2008	2009	2010	2011
Real GDP growth (% change)	COM	5.6	3.5	3.0	4.0	n.a.
(% change)	**PEP 2008**	**5.6**	**2.5**	**2.0**	**3.2**	**4.0**
Consumer price inflation (%)	COM	2.9	6.5	4.5	4.0	n.a.
	PEP 2008	**2.9**	**6.1**	**3.5**	**3.2**	**3.0**
General government balance (% of GDP)	COM	-2.8	-2.3	-2.5	-2.4	n.a.
	PEP 2008	**-1.6**	**-1.3**	**-0.9**	**-0.6**	**0.0**
Primary balance (% of GDP)	COM	-0.1	-0.1	-0.1	0.0	n.a.
	PEP 2008	**0.5**	**0.5**	**0.8**	**0.8**	**1.3**
Government gross debt (% of GDP)	COM	37.7	35.8	35.4	34.3	n.a.
	PEP 2008	**37.8**	**36.1**	**35.1**	**33.8**	**31.8**

Source: 2009 PEP, Commission Autumn 2008 forecast

1.3. ECONOMIC DEVELOPMENTS AND CHALLENGES

1.3.1. Recent macroeconomic developments

Economic performance slowed markedly in 2008. Real GDP growth decelerated to 2.4%, down from 5.5% in 2007. The slowdown came on the back of a marked deceleration of household consumption to 0.8% year-on-year, down from 6.2% in 2007, while the growth of total investment accelerated to 8.2%, from 6.5% a year before. The first two months of 2009 saw a further deterioration of economic performance as evidenced by falling industrial production and retail trade as well as an increase in stocks of manufactured goods. In line with slowing domestic demand, inflation continued to decelerate to 2.8% year-on-year in December, from its peak of 8.6% in July, but re-accelerated slightly in early 2009, mainly as a result of administrative price adjustments. Employment increased by around 1% on average in 2008, but recent trends point to declining employment levels and a rise in the unemployment rate. A tightened monetary policy helped stabilising domestic credit expansion to the non-banking sector, which decelerated from 15% in 2007 to 10.5% in 2008. The current account deficit increased to 9.5% of GDP, up from 7.6% in 2007, largely driven by lower net exports and a higher deficit of the income balance, also reflecting higher debt servicing costs. The current account balance was more than financed by net capital inflows, despite lower net inflows of foreign direct investments which amounted to 5.9% of GDP. Overall, the impact of the financial crisis has contributed largely to the marked slowdown of the Croatian economy. Tighter financing conditions as well as asset price adjustments have lowered domestic demand while foreign demand suffered from declining exports to Croatia's main trading partners in the EU.

The PEP provides a concise and up-to-date overview of recent macroeconomic developments at the time of submission. It provides useful explanations for deviations of actual developments from estimates presented in the previous PEP.

1.3.2. Key policy challenges

Continued fiscal consolidation coupled with productivity enhancing structural reforms should play a key role in the narrowing of the country's savings-investment gap and in reducing the present heavy reliance on foreign savings. A continuation of a prudent monetary policy aimed at stabilising the exchange rate seems essential to anchor market expectations under more severe external financing constraints and to preserve financial sector stability. This policy mix needs to be supported by comprehensive structural reforms, particularly in areas which have a direct effect on public finance and its long-term sustainability. Notably, reforms should be directed in rendering current spending more effective, in particular in the area of health care and social benefit spending. A particular challenge will be to reduce the heavy reliance of the shipbuilding and railway sector on state subsides through an acceleration of sector restructuring. Progress in reforms has been slow over recent years and more determination seems necessary if the key objectives of the PEP were to be met.

The PEP 2009-2011 presents a comprehensive medium-term macroeconomic programme with projections for key economic variables, covering real sector, employment, wage, inflation as well as external developments. The growth projections have been significantly revised downwards from last year's PEP scenario, taking into account a much less favourable external environment. However, the macroeconomic scenario still appears overly optimistic, especially with respect to growth and employment projections in 2009 and 2010. The PEP does not explicitly discuss alternative scenarios. In the present context the programme could usefully have presented a more detailed assessment of risks related to the financial crisis and the recession in the EU and its possible effects on the macroeconomic programme.

The external assumptions of the PEP 2009-2011 have markedly changed in line with a considerably less benign external outlook, but appear still optimistic. For 2009, the programme assumes world and EU 27 real growth rates of 2.9% and 0.2%, respectively, two percentage points lower than in last year's PEP. The volume of world imports is assumed to grow by 2.2%, down from 8.2% in the previous PEP. Oil prices in 2009 are projected at 68 US-$ per barrel, which is 7 US-$ lower.

Table II.1.2:

Comparison of macroeconomic developments and forecasts

	2007		2008		2009		2010		2011	
	COM	**PEP**	COM	**PEP**	COM	**PEP**	COM	**PEP**	COM	**PEP**
Real GDP (% change)	5.6	**5.6**	3.5	**2.5**	3.0	**2.0**	4.0	**3.2**	n.a.	**4.0**
Contributions:										
- Final domestic demand	6.4	**6.4**	4.3	**3.9**	3.6	**0.6**	4.6	**2.2**	n.a.	**3.2**
- Change in inventories	0.0	**0.0**	0.0	**1.0**	0.2	**-1.0**	-0.1	**0.1**	n.a.	**0.2**
- External balance of goods and services	-0.8	**-0.8**	-0.9	**-2.5**	-0.7	**2.4**	-0.6	**0.9**	n.a.	**0.6**
Employment (% change)	1.8	**1.8**	1.0	**1.2**	0.7	**0.4**	1.0	**0.9**	n.a.	**1.2**
Unemployment rate (%)	9.6	**9.6**	9.2	**8.7**	9.0	**8.5**	8.7	**8.0**	n.a.	**7.4**
GDP deflator (% change)	4.0	**4.0**	7.1	**6.2**	4.2	**3.7**	4.7	**3.5**	n.a.	**3.2**
CPI inflation (%)	2.9	**2.9**	6.5	**6.1**	4.5	**3.5**	4.0	**3.2**	n.a.	**3.0**
Current account balance (% of GDP)	-8.6	**-8.6**	-10.5	**-10.5**	-10.2	**-7.8**	-9.4	**-6.9**	n.a.	**-6.4**

Sources: Pre-Accession Economic Programme 2009; Commission Spring Forecast

Real sector

The PEP projects a further mild slowdown of real growth to 2% in 2009, down from an expected 2.5% in 2008, before it accelerates to 3.2% in 2010 and to 4% in 2011 on the assumption of a gradual recovery of the world economy. The temporary growth slowdown in 2009 is primarily the result of slowing domestic demand. Private and public consumption growth rates are projected to decelerate to around 1% each, and investment growth to turn slightly negative, to -1.1% from an expected 8% in 2008. Apart from strong base effects, this decline results from lower government investments as some large infrastructure projects were completed in 2008. It however also reflects a significant reduction of corporate sector investments, reflecting tighter external financing conditions and a slack in business confidence. The growth of exports of goods and services is expected to fall in line with lower foreign demand from the main EU trading partners. However, the contribution of net exports to growth in 2009 is actually projected to turn positive, as the volume of total imports will fall by around 3%. For 2010 and 2011, the PEP projects a strengthening of the economy, supported by an improved business climate and a continuation of productivity enhancing structural reforms. Growth rates of private consumption and of total investments are expected to resume to 2.7% and 4.2%, respectively, by 2011.

Overall, the PEP's growth projections appear overly optimistic at the time of submission, in particular with respect to 2009, given the marked deterioration of the external environment, including a projected growth slowdown in Croatia's major EU trading partners. Moreover, external financing constraints are likely to limit the scope for corporate sector investment and the reduction in total investments could actually be stronger than projected by the PEP. Also, the slowdown in private consumption growth could be much more pronounced in 2009, resulting from lower employment and disposable incomes, negative wealth effects from asset price adjustments, tighter borrowing conditions and a general decline in consumer confidence in a situation of heightened uncertainty. It seems that those effects have been underestimated in the programme. The assumption of a growth recovery in 2010 and 2011 appears reasonable. However, reaching growth rates close to potential growth may require a longer than envisaged adjustment process.

On labour market developments, the PEP projects employment growth to fall to 0.4% in 2009, from 1.2% in 2008, and to slightly accelerate again to 1.2% by 2011. The unemployment rate (ILO) will continue to fall, to 7.4% at the end of the PEP horizon. It is somewhat surprising that the slowdown in growth in 2008 and 2009 does not have stronger effects on employment and unemployment levels. Overall, the programme may underestimate the negative effects of a rapidly slowing economy on labour market dynamics.

Inflation

As a result of higher commodity and energy prices as well as still relatively strong domestic demand, annual inflation increased significantly in the first half 2008, reaching its peak of 8.7% year-on-year in July. Since then, annual inflation has come down to 2.9% in December as energy prices have fallen significantly. As a result of price dynamics, average inflation in 2008 stood at 6.1%, up from 2.9% a year before. The PEP projects a marked reduction in average inflation to 3.5% in 2009, and a further gradual adjustment to 3% at the end of the PEP period. The projection is based on a stable exchange rate of the kuna against the euro, lower food and energy prices on world markets and a marked deceleration of domestic demand. The PEP assumes that cost push pressures will remain limited as the growth of unit labour costs will slow down.

The inflation outlook of the programme appears broadly reasonable, also in the context of the outlined policy mix. However, there a number of risks related both to foreign and domestic factors. On the external front, higher prices for imported raw material are likely to be translated into higher inflation. Domestically, stronger inflationary pressures could result from stronger wage increases, if public

sector pay increases cannot be contained and spill over to the private sector. Moreover, necessary alignments of indirect taxes (e.g. excises) as well as further adjustments of administrative prices could add to prices increases. At the same time it is reasonable to assume that a continuation of the stability-oriented monetary policy framework will help preventing a significant re-acceleration of inflation over the medium term.

Monetary and exchange rate policy

The present policy framework, which has been in place for many years, is often labelled as a tightly managed floating regime. The primary policy objective is price stability, and the exchange rate has traditionally and successfully been used as a stabilisation devise, conducive to anchoring inflationary expectations. The PEP rightly argues that the choice for such a regime is largely determined by the fact that Croatia is a small, open economy with a large degree of financial euroisation. The latter could imply significant risks due to balance sheets mismatches of the private corporate and non-corporate sector. Under these conditions, exchange rate stabilisation becomes an objective in itself to safeguard financial sector stability. As a consequence, the room for a discretionary monetary policy remains very limited. Administrative and prudential measures were taken over recent years to contain credit growth, domestic demand and inflation and have led to a stronger resilience of the domestic banking sector. More recently, the focus has shifted towards measures aimed at improving foreign exchange liquidity to domestic markets with a view to mitigating the effects of the global financial crisis (see Box 1).

External sector

The PEP projects a marked reduction of the current account deficit in 2009, to 7.8% of GDP from 10.5% in 2008, and a further gradual adjustment to 6.4% of GDP by 2011. These assumptions appear plausible. Although the growth of exports will be significantly affected by lower demand of Croatia's main trading partner, reduced total imports are likely to have a much larger impact on the current account, due to the combined effect of lower prices for energy and commodities and a significant deceleration of domestic consumption and investment. Moreover, a reduction of the current account deficit appears also plausible, given external financing constraints. On this issue, the PEP remains rather vague. It however admits that scope for financing through FDI will be limited in 2009 while some inflows related to greenfield investments are expected after 2009.

Main risks

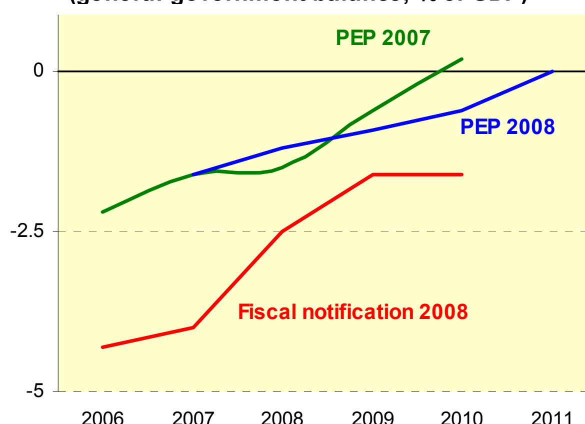
The main risks to the macroeconomic scenario are clearly associated with the possibility of more pronounced negative effects of the global financial crisis on the real and financial sector. A longer lasting downturn in the major EU trading partners will certainly affect prospects for an early resumption of growth as projected by the PEP. Risks are somewhat elevated due to significant external vulnerabilities emanating from a high level of external debt and large debt service obligations coming due, particularly in 2009. The programme would have deserved a more in-depth discussion of those issues, including possible options for matching important external financing requirement.

1.4. PUBLIC FINANCE

The fiscal programme of the PEP 2009-2011 is presented as an integral part of - and supportive to - the overall medium-term economic policy framework, which aims at enabling sustainable growth, reducing unemployment and increasing employment levels as well as ensuring social fairness. The general direction of continued fiscal adjustment to ensure long-term sustainability of public finances remains unchanged and broadly appropriate in view of high spending ratios and significant external vulnerabilities emanating from a high level of external debt and large short term debt service

obligations as well as under conditions of much tighter financing constraints. However, fiscal targets are less ambitious compared to last year's PEP and the envisaged gradual approach of balancing the budget by only 2011 may not sufficiently reflect much tighter external financing constraints. Moreover, there are serious risks that the actual fiscal outcome could be much less comfortable than projected in the programme. The programme contains limited information on key fiscal measures and their respective quantitative effects. A short assessment on the cyclical position of the economy and the cyclically adjusted profile of fiscal policy is provided, but the programme would have benefited from a more in-depth discussion of the working of automatic stabilisers in the context of an economic slowdown. The sensitivity analysis is welcome, but potential fiscal risks appear to be much more elevated than those presented in the various scenarios. The programme makes an attempt to apply ESA 95 standards and fiscal data are broadly consistent with those presented in the recent fiscal notification submitted in April 2008.

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



The fiscal programme envisages a gradual improvement of the consolidated general government balance, turning from an expected deficit of 1.3% of GDP in 2008 to a balanced budget in 2011. The primary surplus will gradually increase from 0.4% of GDP to 2% of GDP. Fiscal consolidation is based on a reduction of the public spending ratio (including net acquisition of non-financial assets) by around 2.5 percentage points of GDP in the three-year period (from 46.9% of GDP in 2008 to 44.4% in 2011). In particular, spending on transfers, subsidies, wages, and investments is, relative to GDP, programmed to be reduced. At the same time, the revenue-to-GDP ratio is planned to decline by 1.3 percentage points over 2008 to 2011. The general government debt ratio is projected to fall by around 4.3 percentage points, from a projected 36.1% of GDP in 2008 to 31.8% of GDP in 2011, mainly driven by an improvement of the primary balance and an acceleration of nominal GDP growth.

1.4.1. Budget implementation in 2008

As for the year 2008, the original budget framework presented in last years' PEP (and adopted in late 2007) foresaw a deficit target for the consolidated general government sector of 1.5% of GDP, down from 1.6% in 2007. In mid-2008, the government proposed and the parliament adopted a revision of the 2008 budget with a slightly lower than originally planned deficit (1.3% of GDP). The budget revision provided for higher than originally projected revenues. Additional budget revenues were, as in previous years, partly used to repay health sector arrears, but also to compensate private households for higher energy prices, and to provide additional funds for regional development as well as for science and education. Unfortunately, the PEP does not provide sufficient information on budget execution in 2008, which is a major shortcoming. Data presented for the first three quarters of 2008 suggest that budget implementation has been broadly in line with the revised plan. Available

preliminary data for the central government point to a underperformance of total revenues by 2 percentage points of GDP for the whole year. This shortfall has been largely matched by an adjustment of current spending. However, official available data are largely cash based, and do not yet fully account for changes in general government arrears, debt assumptions and other factors that in past years have had a significant impact on the deficit as defined under ESA 95, such as so-called pensioners' debt and activities of the State Development Bank (HBOR).

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

The global financial crisis and economic slowdown in Croatia's main trading partners have started to affect the Croatian economy. Growth decelerated markedly, external imbalances widened and economic prospects have become much bleaker. The large stock of external debt and important short-term debt repayment obligations of the government and corporate sector are key challenges against the background of much tighter financing conditions and a possible slowdown in capital inflows. A comfortable stock of international reserves and banking sector foreign assets will serve as a cushion in the event of lower external financing. The financial sector remained stable with the mostly foreign-owned banking sector still benefiting from earlier recapitalisations.

The Croatian authorities adopted a number of measures to mitigate potential shocks that may arise from the financial crisis. In October, the guaranteed amount of household deposits was increased four times (to € 56,000). The majority of measures that were taken in the following months were aimed at improving domestic and foreign exchange liquidity of the banking system under circumstances of tighter external financing conditions and at stabilising the exchange rate.

Monetary Policy – administrative and regulatory measures.

* In October 2008, the Croatian National Bank (CNB) abolished the marginal reserve requirement on bank's foreign borrowing, thereby injecting foreign exchange liquidity of approximately EUR 460 million.
* In November 2008, the CNB reduced the banks' reserve requirement rate from 17% to 14%, thereby releasing an amount of HRK 8.4 billion (around EUR 1.2 billion) additional liquidity to the banking sector, also to facilitate government financing without crowding out private sector activities. This was later (in January 2009) followed by changes in the currency allocation of the reserve requirement with an estimated effect of EUR 780 million.
* In 2009, CNB took several steps to ease tensions and excessive fluctuations in the foreign exchange markets and to discourage speculative activities. In order to mitigate depreciation pressures on the kuna, the CNB intervened twice in the foreign exchange market, by selling EUR 328 million in January and EUR 184 million in February, respectively. In end-February, the CNB intervened again, this time by purchasing EUR 331 million in order to provide domestic currency liquidity following significant increases in inter-bank rates.
* In February 2009, the central bank gradually reduced the rate of the minimum required reserves on foreign currency claims from 28.5% to 20% in two steps, thereby providing a total of above EUR 2 billion in foreign exchange liquidity to the domestic banking sector.

Fiscal policy measures

* The Minister of Finance announced to finance part of the 2009 budget deficit on foreign markets through a bond issue planned for May. Debt obligations which came due in the first quarter, amounting to EUR 750 million, were successfully financed through a syndicated loan from the largest 6 domestic banks.
* In February, the government announced an anti-recession programme consisting of 10 measures, including a planned revision of the state budget, a financial strengthening of the State Development Bank (HBOR), and support for the tourism, SMEs and the real estate market.
* A government's proposal for a budget revision was adopted on 25 March. It reportedly contains a 4% spending cut, which does not fully compensate for the projected loss in revenues, so that the general government budget deficit is set to increase to 1.6% of GDP.

Near- and medium-term budget strategy

For the year 2009 and in line with the budget framework adopted in late 2008, the programme projects a reduction of spending and revenues, as measured as a percentage of GDP, by 0.8 and 0.5 percentage points, respectively. Accordingly, the general government deficit will fall by 0.4 percentage points to 0.9% of GDP. The slowdown in annual revenue growth to 4.6%, from 8.2% in 2008, appears broadly consistent with the projected lowering of GDP growth, assuming that the tax elasticity does not change in the short term. A surprising element is however the one-off increase in property income in 2009 by almost 50% year-on-year which is not explained in the document, but may be related to the transfer of surplus from the CNB to the budget. Moreover, revenue projections are based on growth assumptions, which are likely to be overly optimistic, as outlined earlier below. A more realistic growth scenario would imply a larger shortfall in government revenues. The reduction of the expenditure-to-GDP ratio in 2009 is largely driven by lower investment (by 0.2 percentage points), which appears reasonable as some large infrastructure projects have been completed in 2008. The projected marked reduction of subsidies (by 0.4 percentage points of GDP or by 5.5% year-on-year) seems rather ambitious and is not fully consistent with the attached policy matrix. The latter indicates that the envisaged savings (e.g. a lowering of subsidies to the railway, shipbuilding and agricultural sectors) accounts for less than 0.1% of GDP. Spending on wages is projected to increase in 2009, as a percentage of GDP, probably reflecting the recent 6% public sector wage increase. An increase in spending on social transfers (by 0.4 percentage points of GDP) is only partly explained by the increase in social benefits and family support measures. The reduction of interest payments and of the implicit interest rate on outstanding public debt in 2009 (and beyond) does not appear to be consistent with current expectations about the pricing of Croatia's sovereign debt. Overall, the PEP's fiscal programme for 2009 is being overtaken by a major budget revision, most likely to be adopted in April 2009 (see also BOX).

In 2010, the general government deficit is projected to further decline to 0.6% of GDP, before a balanced budget is reached in 2011. A major part of adjustment over these two years is planned to be realised through a reduction of primary spending with a particularly strong contribution of spending on social benefits (0.6 percentage points), subsidies (0.3 percentage points) and wages (0.6 percentage points). This appears rather ambitious and the programme itself does not elaborate on cost saving measures to support fiscal adjustment and spending contraction over the latter part of the PEP period. It would have particularly benefited from outlining a public sector employment and wage strategy that could back the envisaged reduction of the public sector wage bill.

Fiscal risks are clearly related to the unrealistic growth assumptions of the programme (see below). A stronger cyclical downturn is expected to worsen the fiscal balance. Also, the revenue base is likely to shrink, especially for indirect taxes, as a result of the ongoing dis-inflation. Altogether, a much stronger decline in fiscal revenues than projected in the PEP is likely to materialise. Additional risks may result from a slower than envisaged implementation of reforms which could delay the realisation of budget savings. This refers particular to subsidies and transfers. The authorities may also be confronted with continued spending pressures, especially in the area of wages, as has been repeatedly the case in the past. Finally, the current unfolding of the financial crisis may lead to pressures to increase short-term discretionary spending to counterbalance the negative effects on growth and employment, and to higher costs of servicing outstanding public debt. The resulting combined effect of markedly lower fiscal revenues and pressures for higher current spending would seriously undermine the envisaged fiscal consolidation process. Therefore, an appropriate fiscal response under current circumstances would require bold fiscal measures, including spending cuts and contingency planning, beyond those explained in the programme, in order to bring spending plans in line with emerging financing and revenue constraints.

Structural balance

The PEP 2009-2011 provides a short overview on the cyclical position of the economy and the impact of fiscal policy, using the same methodology in estimating cyclically adjusted primary balances as in last year's submission. On this basis, estimated potential growth exceeds projected real growth in 2009, but falls below projected growth rates in 2010 and 2011. Total output falls below potential in 2009 and 2010, before the output gap turns positive in 2011, resulting from the projected acceleration of growth toward the latter part of the PEP period. The cyclically adjusted primary balance constantly improves over the PEP period, by 0.1 percentage point per year. On this basis, the PEP concludes that fiscal policy has slightly restrictive and pro-cyclical effects in 2009 and 2010, and turns countercyclical in 2011. Given the methodological weaknesses, the statements on the effects of fiscal policy certainly need to be taken with a great deal of caution. There is scope for deepening the analysis in future submissions.

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

	2007	2008	2009	2010	2011	Change: 2008-11
Revenues	46.0	45.7	45.2	44.8	44.4	-1.3
- Taxes and social security contributions	39.8	40.6	39.8	39.7	39.6	-1.0
- Other (residual)	6.2	5.1	5.4	5.1	4.8	-0.3
Expenditure	47.6	46.9	46.1	45.4	44.4	-2.5
- Primary expenditure	45.6	45.1	44.5	43.9	43.1	-2.0
of which:						
Gross fixed capital formation	4.3	2.9	2.7	2.7	2.6	-0.3
Consumption	17.1	17.2	17.3	16.8	16.7	-0.5
Transfers & subsidies	20.2	20.5	20.5	20.4	19.9	-0.6
Other (residual)	4.0	4.5	4.0	4.0	3.9	-0.6
- Interest payments	2.0	1.8	1.6	1.5	1.3	-0.5
Budget balance	-1.6	-1.3	-0.9	-0.6	0.0	1.3
- Cyclically adjusted	0.5	0.1	-0.4	-0.2	0.4	0.3
Primary balance	0.5	0.5	0.8	0.8	1.3	0.8
Gross debt level	37.8	36.1	35.1	33.8	31.8	-4.3

Sources: Pre-Accession Economic Programme 2009-2011, ECFIN calculations

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

The PEP 2009-2011 projects a baseline scenario of a gradual reduction of general government debt from 36.1% of GDP in 2008 to 31.8% of GDP in 2011. Projections on the decomposition of changes in the debt ratio appear largely comprehensive and consistent with the macro-economic and fiscal assumptions. The nominal GDP effect and the projected improvement of the primary balance over the PEP period have a marked effect on the reduction of the debt ratio. This effect is partially offset by interest payments which are projected to slightly fall from 1.6% to 1.3% of GDP. Interestingly, stock-flow adjustments are projected to have only a minor impact on the debt ratio. In particular, the presented debt dynamics do not project any receipts from privatisation which is not entirely in line with the stated objectives in the economic policy matrix of the programme. It remains unclear why the intended acceleration in the sale of state assets would not yield any net revenues. The public debt sensitivity analysis presented in the PEP shows that the public debt ratio is particularly sensitive to a depreciation of the kuna-euro exchange rate, as around 80% of outstanding public debt is denominated in foreign currency. Also, a slightly more expansionary fiscal stance[1] as well as an increase in contingent liabilities by 10% of GDP would lead to an increase in the debt-to-GDP ratio. The analysis undertaken in the PEP is useful and confirms the need for continued fiscal discipline in order to ensure public debt sustainability.

[1] Defined as keeping primary deficits in 2009 and 2010 at historical level minus two standard deviations

1.4.2. Budgetary implications of major structural reforms

As required, the programme (in its Annex) presents some estimates of the fiscal impact of reforms envisaged over the PEP horizon, which is a useful complement. A summary overview is presented in table 5 (under Chapter 5) of this assessment. It shows that structural reforms will have an important impact on the country's fiscal position. Namely, net spending is estimated to increase by 0.7% of GDP on average per year over the period 2009-2011. Some of the estimates presented and explicitly referred to in the PEP, notably on subsidy reduction to the enterprise sector do not appear to be entirely consistent with the medium-term budget scenario outlined in the fiscal programme.

Table II.1.4:
Composition of debt dynamics (in % of GDP)

	2007	2008	2009	2010	2011
Gross debt ratio (1)	**37.8**	**36.1**	**35.1**	**33.8**	**31.8**
Change in the ratio	-3.0	-1.7	-1.0	-1.4	-2.0
Contributions (2):					
1. Primary balance	**-0.5**	**-0.5**	**-0.8**	**-0.8**	**-1.3**
2. "Snow-ball" effect (2)	**-1.5**	**-1.3**	**-0.3**	**-0.8**	**-1.0**
Of which:					
Interest expenditure	2.0	1.8	1.6	1.5	1.3
Growth effect	-2.1	-0.9	-0.7	-1.1	-1.3
Inflation effect	-1.5	-2.2	-1.3	-1.2	-1.0
3. Stock-flow adjustment	**-0.9**	**0.1**	**0.1**	**0.3**	**0.3**

(1) End of period.

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

Source:Pre-Accession Economic Programme(PEP); Commission services' calculations

1.4.3. Sensitivity analysis and comparison with previous programme

The PEP 2009-2011 includes an update of the sensitivity analysis presented in last year's submission. The first scenario assumes lower real growth rates, namely a zero growth in 2009 and a 50% lower growth rate in 2010. This leads to a deterioration of the fiscal balance, by 1.1 percentage points on average per year. The second scenario assumes a 50% lower revenue growth in 2009 and 2010, while real GDP growth rates are left unchanged. This would result in even stronger deviations from baseline fiscal balances, by around 1.8 percentage point per year on average. Finally, the third scenario assumes a one-off increase in current spending by one billion kuna in 2009, leading to slightly higher fiscal deficits by around 0.3 percentage points on average over the reference period. The analysis is useful in demonstrating the sensitivity of the fiscal balance to changes in real growth, revenues and spending. However, deviations from the baseline scenario appear rather moderate and may not fully cover the magnitude of possible shocks, especially against the background of an already slowing economy and a much riskier external environment. Therefore, it would have been more appropriate to base the analysis on a set of more severe shocks to growth, revenues and spending. Also, a combination of lower growth, revenue underperformance and spending overrun cannot be excluded and could have even more serious effects on the fiscal balance. The PEP does not elaborate on possible counterbalancing measures to be taken in the event of risk occurrence. It thus remains unclear how the fiscal strategy could respond in the short term in case significant deviations from the outlined fiscal path occur.

1.4.4. Quality of public finance and institutional features

The PEP 2009-2011 refers in a very general way to recent and ongoing institutional changes and policies which are seen to improve the quality of public finances over the medium term. It emphasises improvements in budget management, revenue collection and expenditure control as well as the

adoption of a new public procurement system in line with EU practice and a new legal framework for public-private partnerships. On tax policy, the programme puts emphasis on further technical alignment with EU requirements. Changes to the tax-benefit system are not foreseen. The simplification of the tax system is – contrary to last year's submission – not mentioned as a policy objective. As in last year's PEP, public finances are expected to contribute to creating a knowledge-based society through investments in science and education. Also, a more balanced development across all regions of the country remains a priority. Overall, the programme expresses intentions to shift the composition of the budget toward growth-enhancing expenditure, but does not present medium-term spending targets in this respect.

1.4.5. Sustainability of public finance

The PEP 2009-2011 contains a short analysis of the long-term sustainability of public finances with a focus on pension, health and interest expenditure. Assumptions on long-term population trends as well as on participation rates have not been changed compared to last year's PEP. Differences to last year's scenario result primarily from the significant downward revision of GDP growth over the PEP period and slightly different fiscal balances. Total expenditures are projected to increase from 45.4% of GDP in 2010 to close to 50% in 2050, compared to 43.5% in last year's PEP. Total revenues are set to stay at 44.4% during this period, also somewhat higher than in last year's submission (41.7%). Spending on old-age pensions is also expected to decline from 9.2% of GDP in 2010 to 7% in 2050, as a larger share of pensions is expected to be paid by the second pillar. Pension contributions would stay at around 6.3% of GDP in 2050. Health care spending is set to increase markedly from 7.4% in 2010 to 13.7% of GDP in 2050, mainly as a result of an ageing population. Interestingly, despite an unchanged population trend, the projected share of health spending in GDP turns out to be higher compared to last year's PEP, by around 2 percentage points in 2010 and 3.5 percentage points in 2050. The document explains this also as a result of new health care measures adopted in late 2008. Those were primarily directed at tapping additional sources of financing, thus allowing for higher public health spending, rather than at structural changes to the system conducive to ensuring the long-term sustainability of the system.

Like last year's submission, the programme does not foresee additional reforms in the area of pension, health care or labour markets which would improve the long term sustainability of public finance. The obvious challenges arising from demographic pressures remain significant, also in view of an already relatively high public debt ratio and a very low participation rate. Moreover, long-term sustainability could be further eroded, if growth and productivity trends turned out to be less comfortable and if participation rates fell below levels assumed under the programme. Given the risks and magnitude of challenges, the programme would have benefited from outlining a somewhat more thorough policy response to the challenges of an ageing society.

1.5. STRUCTURAL REFORMS

The PEP 2009-2011 covers a broad range of structural reforms related to the enterprise and financial sector, labour market, agricultural sector, public administration, education, health care, judiciary, and environment. The presentation is often backward looking, providing information on past and ongoing reform initiatives with a strong emphasis on harmonisation with EU requirements. More emphasis could have been given to measures aimed at improving the business environment, given the pertaining administrative obstacles still in place. The programme contains fiscal estimates on some measures, but the link between the structural reform agenda and the implementation of the fiscal strategy could be further strengthened. The full implementation of the structural reform agenda would in some cases require the establishment of time bound action plans and the definition of concrete measures and clear targets. On such a basis, it would be conducive to meeting the objectives of the Lisbon agenda concerning product, labour and capital markets and the establishment of a knowledge based economy.

Intensified efforts to speed up the implementation of reforms, in particular in the areas of enterprise restructuring, education and labour markets would be supportive to the fulfilment of the second Copenhagen economic criteria over the medium term.

1.5.1. Product and capital markets

The PEP 2009-2011 touches upon the following main reform areas related to the functioning of product markets: strengthening of competition policy and state aid control, privatisation, enterprise restructuring (railway sector, shipbuilding) and SME development. Further progress has been achieved in the area of competition policy and state aid control. The PEP envisages a continuation of measures aimed at a strengthening of the legal and institutional framework and a further harmonisation with EU requirements, which is welcome. The process of privatisation of state assets held in the Privatisation Fund has made only very limited progress in the past. In September 2008, the fund's portfolio still comprised 890 companies, in 96 of which the state is a majority owner. The acceleration of privatisation remains a declared economic policy objective. However, the programme does not provide a time-bound plan for selling or liquidating state assets, with the exception of the privatisation of the six loss-making shipyards, scheduled to be completed by end-2009. Significant efforts are still required with respect to the restructuring of shipyards in order to fully comply with EU requirements and the programme should have put more emphasis on outlining the government's strategy in this respect. It also remains unclear why and in which way the ongoing or planned institutional reforms, notably the transformation of the Privatisation Fund as well as the creation of investment funds would improve the prospects for privatisation. The restructuring of the loss-making railway sector has made very limited progress and the railways continue to absorb high levels of budget support (above 1% of GDP). Low productivity and high unit labour costs continue to undermine their long-term viability, but wages and staff levels have nonetheless increased recently. Against this background, it is appropriate that railway restructuring remains an important policy priority, also with a view to ensuring the sector's viability and competitiveness once the full liberalisation of passenger and freight markets take place. The programme would however have benefited from providing specific restructuring objectives to be achieved beyond 2008, in terms of operating ratios and staff levels. As it stands now, the programme remains rather declarative. The SME sector is likely to continue to benefit from various incentive schemes at different government levels. As further improvements in the overall business environment remain an important challenge, the programme should have also addressed measures to improve the regulatory framework and to address inefficiencies in public administration.

The programme gives a thorough overview of recent and planned measures aimed to align the financial sector legislation and in particular prudential regulations with EU requirements. This process appears to be well on track. Moreover, the banking sector has become more resilient as a result of a number of specific supervisory measures that have been taken to address potential macro-financial vulnerabilities. Additional capital requirements were imposed on fast-growing banks, and risk weights on un-hedged foreign currency loans were increased. Banks' capital adequacy, asset quality and profitability have remained at comfortable levels. One would have expected the programme to discuss in more detail the new challenges for domestic financial and capital markets in the context of the global financial crisis and the possible policy responses to mitigate risks for financial sector stability.

1.5.2. Labour market

Despite a recent trend decline in unemployment levels and moderate employment growth, the Croatian labour market continues to suffer from unusually low participation and employment rates as well as high rates of youth and long-term unemployment. The policy response of the programme continues to focus on active labour market measures, including qualification of job seekers and temporary employment subsidies for vulnerable groups. However, relying exclusively on active labour market policies does not appear to be sufficient to address the core problems of the Croatian

labour market. A more comprehensive reform approach would need to address incentive structures on the labour supply and demand side. Significant labour supply disincentives appear to be linked to a number of factors, such as a low effective retirement age, built-in incentives for early retirement and generous social welfare benefits for parts of the population, particularly for war veterans. A stronger labour demand is likely hampered by rigid employment protection and collective wage bargaining systems. Overall, the programme does not address the structural deficiencies in a manner which would be conducive to increase the flexibility of the labour market. On a more positive note, the new law on the restructuring of unemployment benefits, which leads to higher replacement rates in the first three months followed by a gradual decrease thereafter, as well as the provision of financial incentives for unemployed to participate in educational measures are steps in the right direction to fight long-term unemployment.

1.5.3. Other reform areas

In the area of social security, the PEP 2009-2011 envisages to improve the financial situation of low income groups, pensioners, families, and students, on the basis of already adopted legislation. The establishment of a social benefit registry as well as a personal identification number are seen as important elements to render the social benefit system more effective, notably to reduce an "accumulation" of benefits. However, the PEP remains vague on the precise steps to be taken to further streamline the social benefit system. On the reform of health care financing, the PEP refers to a new health reform package adopted last December. It introduced new sources of financing, such as higher co-payments, higher contributions from some pensioners and unemployed persons, as well as new mandatory allocations from other revenue sources (32% of excises, 10% of paid car insurance premium). In particular, the reform seeks to stabilise the financing of hospitals through larger transfers from the health budget. However, a strategy whose primary focus is on strengthening the revenue base of the system without tackling its structural weaknesses may not be sufficient to ensure its long-term financial sustainability. This weakness is to some extent mitigated by the fact that the health reform contains some measures aimed at strengthening the role of primary health care as a gatekeeper to the system and improving the productivity of hospitals. With respect to the agricultural sector, the programme envisages the adoption of new state aid principles, and the overall state aid is projected to slightly decline as a percentage of GDP while the share of horizontal support in total aid will increase. Moreover, the privatisation of a large agricultural and food processing company is programmed for 2009, but the PEP does not provide any revenue estimates. The continuation of education reform on the basis of an Educational System Development Plan (2005-2010) is welcome and should be supportive of the development of a knowledge-based economy. On agriculture, the PEP envisages a new State Aid Act. As part of the preparations for the Common Agricultural Policy, considerable changes are indeed needed to adjust the current largely production-based support system. As in the previous PEP, emphasis on judicial reform is appropriate and the successful implementation of envisaged measures could be conducive to improving the overall business environment, which remains an important challenge.

Table II.1.5:

Net direct budgetary impact of key reform commitments (in EUR million)

	2008	**2009**	**2010**	**2011**
Enterprise restructuring and state aid	-149.44	-14.23	-128.85	-115.93
Labour market reforms	-58.59	-92.56	-25.29	-23.07
Agriculture sector reform	-136.24	-2.80	28.51	21.85
Health reforms	0.00	-240.85	-281.25	-17.66
Other reforms	-136.26	44.73	-24.88	-125.62
Total impact on the budget	-480.53	-305.71	-431.78	-260.43
Total impact on the budget (% of GDP)	***-1.17***	***-0.70***	***-0.93***	***-0.52***

Source: Pre-accession Economic Programme 2009-2011, own calculations

Table II.1.6:

Annex: Structural indicators

	CROATIA					EU 27				
	2004	2005	2006	2007	2008	2004	2005	2006	2007	2008
General economic background										
Real GDP [1]	4.2	4.3	4.8	5.6	3.5	2.5	2.0	3.1	2.9	1.4
Labour productivity [2]	64.8	61.6	63.8	71.7	71.4	100	100	100	100	100
Real unit labour cost [3]	-3.2	7.5	-4.7	-8.7	-1.1	-1.4	-0.6	-1.1	-0.8	-1.6
Real effective exchange rate [4]	n.a.	n.a.	n.a.	n.a.	n.a.	101.2	107.5	106.4	107.9	114.0
Inflation rate [5]	2.0	3.3	3.2	2.9	6.1	2.0	2.2	2.2	2.3	3.7
Unemployment rate [6]	13.7	12.7	11.2	9.6	8.5	9.0	8.9	8.2	7.1	7.0
Employment										
Employment rate [7]	54.7	55.0	55.6	57.1	n.a.	63.0	63.6	64.5	65.4	n.a.
Employment rate - females [8]	47.8	48.6	49.4	50.0	n.a.	55.5	56.3	57.3	58.3	n.a.
Employment rate of older workers [9]	30.1	32.6	34.3	35.8	n.a.	40.7	42.3	43.5	44.7	n.a.
Long term unemployment [10]	7.4	7.4	6.7	5.9	n.a.	4.2	4.1	3.7	3.0	n.a.
Product market reforms										
Relative price levels [11]	66.5	68.7	69.8	70.1	n.a.	100	100	100	100	100
Total trade-to-GDP ratio [12]	34.7	35.1	36.9	37.1	n.a.	9.0	9.8	10.7	10.7	n.a.
Net FDI [13]	2.0	2.6	4.2	9.3	n.a.	0.9	1.7	2.2	3.4	n.a.
Market share electricity [14]	86.0	87.0	83.0	84.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Sectoral and ad-hoc state aid [15]	n.a.	n.a.	n.a.	n.a.	n.a.	0.6	0.6	n.a.	n.a.	n.a.
Business investment [16]	29.1	29.0	30.8	30.0	n.a.	17.2	17.7	18.2	18.7	n.a.
Knowledge based economy										
Tertiary graduates [17]	5.4	5.7	6.0	n.a.	n.a.	12.5	13.2	13.0	n.a.	n.a.
Spending on human resources [18]	4.5	4.6	n.a.	n.a.	n.a.	5.1	5.0	n.a.	n.a.	n.a.
Educational attainment [19]	93.5	93.8	94.6	95.3	n.a.	77.1	77.5	77.9	78.1	n.a.
R&D expenditure [20]	1.1	1.0	0.9	0.9	n.a.	1.8	1.8	1.8	1.8	n.a.
Broadband penetration rate (EU25) [21]	n.a.	n.a.	n.a.	n.a.	n.a.	6.5	10.6	14.8	19.0	n.a.

1. Growth rate of real GDP in %. 2. Labour productivity per person employed - GDP in PPS per person employed relative to EU-25 (EU-25=100). 3. Growth rate of the ratio: compensation per employee in current prices divided by GDP (in current prices) per total employment. 4. Vs IC36 (1995 = 100), current year's values are based on Commission's forecast deflator figures, nominal unit labour cost deflator. 5. Annual average rate of change in Interim Harmonized Indices of Consumer Prices (HICPs), Croatia = CPI. 6. Unemployed persons as a share of the total active population. 7. Employed persons aged 15-64 in % of total population of the same age group. 8. Employed women aged 15-64 in % of total female population of the same age group. 9. Employed persons aged 55-64 (EU25) or 50-64 (Croatia) in % of total population of the same age group. 10. Long-term unemployed (over 12 months) in % of total active population aged 15-64. 11. comparative price levels of final consumption by private households including indirect taxes (EU-25=100). 12. Trade integration - Average value of imports and exports of goods divided by GDP. 13. Average value of inward and outward FDIs flows in % of GDP. 14. Market share of the largest generator (% of total net generation). 15. In % of GDP. 16. Gross fixed capital formation by the private sector in % of GDP. 17.Total tertiary graduates in science and technology per 1000 of population aged 20-29. 18. Public expenditure on education in % of GDP. 19. Percentage of the population aged 20 to 24 having completed at least upper secondary education. 20. GERD (Gross domestic expenditure on R&D) - in % of GDP. 21. Percentage of households who have Broadband access at home.

f: forecast, e: estimated value, p: provisional value, b: break in series, s: Eurostat estimate, r: revised value, q: estimated from quarterly values.

Source: Commission services, Croatia's Central Bureau of Statistics

2. THE FORMER YUGOSLAV REPUBLIC OF MACEDONIA

2.1. EXECUTIVE SUMMARY

The Pre-Accession Economic Programme for 2009 - 2011 (the "2009 PEP") of the former Yugoslav Republic of Macedonia is a comprehensive economic policy document, which is however based on a rather optimistic economic scenario. The fiscal strategy appears very ambitious and is in line with the budget for 2009 and the country's fiscal strategy for the period 2009-2011. The description of structural reforms is rather broad but lacks a discussion of policy priorities and the link to the EU accession process. Concerning content, form and data, the programme partly complies with the requested standard.

The recent economic performance has been characterised by strong growth during 2007 and the first half of 2008, but started to decelerate in the second half of the year. The current account deficit rose significantly, while the fiscal balance turned from a slight surplus in 2007 into a deficit of about 1½% of GDP in 2008. The reduction in the public debt ratio came to a halt. Inflationary pressures subsided towards the end of the year.

The programme is based on strong economic growth of 5½% to 7% during 2009-2011, which even at the time of submission at the end of January was optimistic in view of the ongoing sharp deterioration in the international environment. In the meantime, this scenario has become increasingly unrealistic. The programme's expectations concerning inflation are more in line with the country's track record. However, public finances are planned to register deficits of close to 3%, mainly through higher capital investment in order to raise the country's growth potential. The presentation suffers from a lack of reliable and consistent statistical data, impeding the analysis of the country's position in the business cycle and of the assessment of reform measures. Furthermore, the provided data in the main body of the document are not always consistent with information provided in the data annex. Overall, the macroeconomic scenario appears to be too optimistic to serve as a realistic planning tool. In addition, the programme would have benefitted from a more extensive analysis of the substantial downward risks, already very present at the time of submission.

The fiscal performance during the last year was characterised by a significant fiscal surplus during most of the year (some 2% of GDP by October 2008), which during the last 2 months of 2008 turned into a central government deficit of about 1% of GDP. The main reason for the surpluses was stronger than expected tax revenues, while public capital spending remained below targets. In the last two months of 2008, revenues were below expectations, while spending for capital investment and in particular for transfers rose sharply.

The programme's fiscal framework for 2009-2011 is geared towards fostering economic growth through a more active fiscal policy, by lowering the tax burden while increasing public spending, in particular with respect to capital investment. In 2009, the deficit is expected to increase from 1.5% of GDP in 2008 to 2.8% of GDP, mainly as a result of decline in total revenues by nearly 2 percentage points of GDP. In 2010 and 2011, both revenue and expenditure are estimated to continue declining as a share of GDP, reflecting the impact of the crisis on revenues and a reduction of public spending. However, public revenues estimates appear to be poorly linked to the macroeconomic framework, while the presentation of expenditure reducing measures is very parsimonious. The main strategy seems to be to increase spending at a lower rate than nominal GDP, while only public consumption is planned to be reduced in absolute terms. However, there is only vague information on how this spending reduction will be achieved. In general, the PEP would have benefitted from more clarifications on contingency plans and priorities and on ways to increase revenues or to reduce

spending, given the risk of a decelerating revenue performance, the shallow domestic credit markets which impede to raise funds domestically and the increasing difficulties in financing the planned deficits on international markets. Furthermore, more information on measures to improve the quality of public finances would have been welcome.

The country's structural reform programme aims to support the establishment of a functioning market economy, particularly by improving the business climate and strengthening the competitiveness of the country's enterprises. However, the connection between the reform measures and the government priorities are not sufficiently spelled out and the link to accession related priorities is rather weak.

Overall, the programme's reform agenda is broadly consistent with the fiscal scenario. However, the programme would have benefited from a closer alignment with the reform requirements in view of the country's EU accession perspectives, for example as spelled out in the latest Progress Report and the European Partnership. Furthermore, the programme does not yet sufficiently take into account the economic and fiscal impact of the global crisis on the country's economy It would also have gained from devoting more attention to key challenges to the economy, such as the very ill-performing labour market.

2.2. INTRODUCTION

The former Yugoslav Republic of Macedonia submitted its third PEP on 30th January 2009, covering the period 2008-2011. The programme has been adopted by the government. It is a joint document with contributions of a large number of line ministries and the Central Bank, under the coordination of the Ministry of Finance. Social Partners were not included in the drafting of the document. The programme is a new document and takes into account the 2009 budget and other national programmes, such as the National Development Plan, the fiscal strategy for 2007-2009 and the National Plan for the Adoption of the Acquis (NPAA). However, the link to the country's accession process, such as the European Partnership priorities and the Commission's assessment in the Progress Report is weak.

Table II.2.1:

Comparison of key macroeconomic and budgetary projections

		2007	2008	2009	2010	2011
Real GDP growth (% change)	COM	5.9	5.5	4.6	5.0	n. a.
	PEP 2009	**5.9**	**6.0**	**5.5**	**6.0**	**7.0**
Consumer price inflation (%)	COM	2.3	7.0	3.5	2.7	n. a.
	PEP 2009	**2.3**	**8.3**	**3.5**	**2.8**	**2.8**
General government balance (% of GDP)	COM	-0.8	-1.0	-2.7	-2.4	n. a.
	PEP 2009	**0.7**	**-1.5**	**-2.8**	**-2.8**	**-2.8**
Primary balance (% of GDP)	COM	0.2	0.0	-1.9	-1.7	n. a.
	PEP 2009	**1.5**	**-0.7**	**-2.0**	**-1.9**	**-1.8**
Government gross debt (% of GDP)	COM	24.7	23.2	23.0	22.8	n. a.
	PEP 2009	**21.7**	**18.7**	**20.8**	**22.7**	**23.5**

Sources: Pre-Accession Economic Programme (PEP), Commission autumn 2008 forecast

The document partly complies with the content, form and data required for this exercise, as specified in the outline. It contains a general overview of recent economic developments and presents a parsimonious macroeconomic framework. The document describes key medium-term fiscal and other policy objectives and provides an overall presentation of structural reforms of product and capital markets in the light of EU-integration. Concerning the form, the 2009 PEP follows the structure of the outline and represents a stand-alone document, providing required information on the macroeconomic and fiscal framework and on structural reforms. The document also includes the quantitative information required. However, the completeness and consistency of the provided data

leaves significant room for improvement. Furthermore, a significant share of the data, in particular the fiscal data, is not yet in line with ESA 95 requirements. The programme also presents several alternative scenarios and briefly analyses their fiscal impact.

2.3. ECONOMIC DEVELOPMENTS AND CHALLENGES

2.3.1. Recent macroeconomic developments

After years of subdued growth, economic activity has been relatively strong in 2007, reaching real GDP growth of about 6% and decelerated during 2008, reaching output growth of 5% in 2008. The acceleration in economic activity in 2007 and early 2008 was mainly based on stronger domestic demand, in particular private consumption and investment. The labour market situation continued to improve marginally, with a decline in unemployment from 34.7% end of 2007 to 33.5% at the end of 2008. Employment rose by some 2½% during 2008. However, youth unemployment, which accounts for some 20% of the unemployed, stayed at 56% of the labour force in this age group. Consumer price inflation started to decelerate by mid-2008, after higher food and energy prices had brought inflation close to 10% in the first half of 2008. By the end of the year, 12-month inflation had come down to 4.1%, resulting in an annual inflation rate of 8.3% for 2008.

The current account started to deteriorate by the end of 2007, reaching a deficit of 7% of GDP over 2007 and of 12% of GDP by December 2008. The main factors for this strong increase in imports were higher expenditures for energy and machinery. FDI rose sharply during the last year, reaching nearly 7% of GDP by end -2008. A considerable part of these capital inflows was related to investment of foreign banks in private local banks. In the last two months of 2008, the economic performance deteriorated markedly as the impact of lower external demand feeding through to the domestic economy. .

Overall, the programme presents a clear and concise picture of past economic developments and covers all relevant data available at the time of submission.

2.3.2. Key policy challenges

The economic developments during the last months of 2008 point to a number of important policy challenges: mitigating the impact of the global financial crisis and maintaining the sustainability of the country's external balances while using the fiscal space in an efficient and prudent way. Addressing the very high unemployment in general, and among the young in particular, remains another important medium-term issue.

With respect to the country's accession perspective, important challenges are to improve its administrative capacities, to strengthen regulatory and supervisory agencies and to improve the rule of law and contract enforcement.

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

Due to the low degree of internationalisation of the country's financial sector and the relatively small size of this sector, the immediate direct impact of the global financial crisis has remained limited so far. During January 2009, the stock market index has further declined, albeit at a slower pace, bringing the stock market capitalisation to below 35% of GDP. In the last months of 2008 and in early 2009, foreign exchange reserves dropped, partly as a result of a one-off dividend payment to a foreign investor, but also because of increased foreign exchange purchases of households and enterprises, possibly reflecting declining confidence in the stability of the national currency. The Central Bank intervened in order to keep the exchange rate stable. However, this situation seems to have stabilised during February.

In November 2008, the authorities presented ten measures to alleviate the impact of the global crisis, claiming an effect of 5-6% of GDP. However, the majority of those measures (some 3-4% of GDP) appear to have no impact on the deficit, as they consist of rebates and write-offs of unpaid social security contributions, which the authorities had not included in their 2009 revenue estimates. The remaining part (about 2% of GDP) consists mainly of a further lowering of taxes on profits and agricultural incomes. Those measures, however, have not been included in the 2009 budget, due to the already advanced stage of the budgetary discussions in parliament. The authorities intend to finance this package through international loans and a Eurobond issue.

2.3.3. Medium-term macroeconomic scenario

The programme presents an – in principle – coherent macroeconomic framework, albeit based on assumptions which at the time of submission were already very optimistic and which have become increasingly unlikely in the meantime. However, in contrast to last years' submission, the programme includes several alternative scenarios, including a significant reduction in economic growth, a much lower than expected revenue performance and a one-off expenditure shock of 2 % of GDP. Given the current situation, the low growth scenario appears more appropriate, assuming a drop in GDP growth to half of the baseline scenario.

Compared to last year, the programme expects GDP growth to be 1 percentage point lower, while inflation is 1 percentage point higher than assumed last year. The main justification for this revision is the impact of the global financial crisis.

The overall thrust of the programme is much in line with last year's submission. Compared to the Commission's autumn forecast, the PEP continues to be significantly more optimistic with respect to economic growth and employment growth, while being more downbeat with respect to the unemployment rate and the current account deficit.

Real sector

The macroeconomic scenario assumes a rather moderate slowdown in economic activity, with real GDP growth decelerating from 6% in 2007 to 5.5% in 2009, while accelerating to 6% and 7% in the following two years. The main driving forces for this favourable development are private consumption, supported by high employment growth and strong investment, benefitting from an improved business environment which is expected to boost domestic and foreign investment. On the supply side, the service sector will be the main contributor to growth. The authorities expect the country's de facto fixed exchange rate regime to keep inflationary pressures close to EU levels, with

consumer price inflation coming down to 2.8% in 2010 and 2011. Given that the external environment had already deteriorated further at the time of submission, the programme probably was already then based on too optimistic assumptions for serving as a realistic tool for policy planning.

The general government deficit is expected to deteriorate from close to balance in the past to 1% of GDP in 2008 and 2.8% during 2009-2011. The level of public debt is seen to continue declining. Early debt repayments during 2007 brought down the debt ratio to about 25% of GDP by the end of 2007. In 2008, the debt ratio declined further to 21% of GDP. However, higher deficits will lead to an increase in the debt ratio during the remaining programme period. The current account deficit is expected to deteriorate to about 11% of GDP in 2009 and to improve marginally in 2010 and 2011 to around 10% of GDP. Substantial inflows of FDI are expected to support the financing of imports. Overall, the programme's growth projections appear to have been calculated before the sharp deterioration in the global economic outlook.

The programme presents the fiscal impact of three alternative scenarios. One scenario assumes growth to drop to half of the baseline scenario; the other assumes revenues to increase by only ¼ of the programme rates and the third one calculates the impact of a one-off increase in spending by 2 percentage points. In all three scenarios, the deficit increases by about 1 percentage point in 2009. However, in case of the lower growth scenario, the fiscal imbalance increases by another ½ percentage point in 2010, to 4½ % of GDP, but improves by 1 percentage point in 2011, reaching a deficit of 3½ % of GDP. In the case of the revenue-shortfall scenario and the expenditure shock scenario the fiscal deterioration continues. Given the current global slowdown, the first scenario appears to be more likely, expecting GDP growth of some 2¾% in 2009 and an acceleration to 3% and 3½% in 2010 and 2011. In that case, the fiscal deficit would be close to 4% of GDP in 2009, increase to 4½% in 2010, but improve to 3½% of GDP in 2011. However, it would have been interesting to look also at a combination of shocks, such as lower growth and lower revenue growth. In view of the substantial downward risks at the time of submission, the programme would have benefitted from a more detailed discussion of those alternative scenarios, included in the document for the first time.

Table II.2.2:

Comparison of macroeconomic developments and forecasts

	2007		**2008**		**2009**		**2010**		**2011**	
	COM	**PEP**	COM	**PEP**	COM	**PEP**	COM	**PEP**	COM	**PEP**
Real GDP (% change)	5.9	**5.9**	5.5	**6.0**	4.6	**5.5**	5.0	**6.0**	n.a.	**7.0**
Contributions:										
- Final domestic demand	6.8	**6.8**	13.1	**6.1**	5.5	**5.4**	6.4	**4.5**	n.a.	**4.8**
- Change in inventories	1.2	**1.2**	0.0	**0.6**	0.0	**0.5**	0.0	**0.0**	n.a.	**0.5**
- External balance of goods and services	-4.1	**-4.1**	-7.6	**-3.0**	-0.8	**-2.5**	-1.3	**-0.9**	n.a.	**-1.2**
Employment (% change)	4.0	**4.0**	3.3	**4.0**	3.2	**4.0**	3.5	**4.0**	n.a.	**4.0**
Unemployment rate (%)	34.9	**34.9**	33.3	**33.7**	32.3	**33.5**	31.0	**33.0**	n.a.	**32.4**
GDP deflator (% change)	7.4	**7.4**	4.1	**8.0**	4.1	**3.5**	2.9	**2.8**	n.a.	**2.8**
CPI inflation (%)	2.3	**2.3**	7.0	**8.3**	3.5	**3.5**	2.7	**2.8**	n.a.	**2.8**
Current account balance (% of GDP)	-7.2	**-7.2**	-12.1	**-11.3**	-10.0	**-11.1**	-8.4	**-10.2**	n.a.	**-10.1**

Sources: Pre-Accession Economic Programme (PEP); Commission Autumn 2008 forecasts (COM)

Inflation

After a sharp rise in inflation in 2008, declining energy prices and lower external and domestic demand are expected to result in lower inflation, reaching some 3.5% in 2009 and 2.8% in 2010 and

2011. However, this outlook appears rather benign, taking into account relatively high nominal wage growth in 2008 and the expectation of GDP growth above potential.

Monetary and exchange rate policy

The monetary framework continues to consider price stability as the overarching monetary policy objective. To this end, the central bank maintains a de-facto fixed peg of the denar towards the euro. In view of the high share of euro-denominated imports (some 60% of total imports) this helps to contain price pressures through imports. As a result of the recent strength of the euro, the nominal effective exchange rate slightly appreciated during the last years. No changes to the current exchange rate regime are envisaged. The central bank has continued to upgrade the institution's analytical and forward-looking capacities. Overall, the monetary framework is in line with the programme's supply side approach to stimulate economic growth by improving the business environment and reducing the tax burden.

External sector

The programme expects a deceleration of global demand, which will lead to a deceleration of export growth. FDI inflows are expected to remain on a much higher level than in the past, benefitting from improved attractiveness to foreign investors. However, in view of the current sharp deterioration in international environment, those FDI assumptions appear too optimistic. Private transfers in the form of workers remittances and cash exchanges at foreign exchange offices are expected to remain on their relatively high level. Here too, the expectation of rather stable private transfers appears rather optimistic, given weak economic developments in the host countries of migrant workers, such as Germany.

The 2009 PEP expects a marked widening of the current account deficit from 7% of GDP in 2007 to 11% of GDP in 2009, mainly as a result of a decrease of export growth to less exceptional levels. In the following 2 years, decelerating import growth should contribute to stabilise the current account deficit at some 10% of GDP. The main driving force behind the sharp deterioration is the increase in the trade deficit in 2008, which however is expected to decline from 26.7% of GDP in 2008 to 24.6% in 2011. Furthermore, current transfers are predicted to decline, from 16% in 2008 to 14.8% in 2011.

Concerning the financial account, FDI inflows are expected to continue to play an important role. However, in percent of GDP, a moderate decline is foreseen, with a decline from 8.1% of GDP in 2008 to 7.5% in 2011. This is about twice the level of FDI inflows registered during recent years. Foreign exchange reserves increased by 0.8% of GDP in 2008. However, in the remaining programme period, foreign exchange reserves are seen to decline, by about 2% of GDP in 2009 and some 5.4% and 5.1% in 2010 and 2011, respectively.

In view of the programme's macroeconomic profile of accelerating growth, the expected improvement in the trade account would have deserved a more detailed explanation. In particular, the relatively slow growth of imports appears difficult to reconcile with the expected central role of import-intensive investment for economic growth in the programme period. With respect to sector balances, the programme envisages increased net lending of the households and corporate private sector, financing the deficits of the public sector and the current account deficit. Compared to last year's submission, the authorities expect significantly higher public sector and external deficits. However, the programme is rather short on plans as how to finance those deficits.

Overall, the chapter on external developments would have benefitted from explaining in greater details the main factors underpinning the authorities' external outlook. The framework is subject to substantial risks, in particular with respect to its assumptions on capital inflows in form of FDI and

private transfers. Furthermore, the expected export growth appears to be on the optimistic side, especially given the current rapid deterioration in global demand.

2.4. PUBLIC FINANCE

The fiscal framework refers to the overall policy objective of fostering economic growth by lowering the tax burden and of supporting investment by improving the business environment and lowering profit taxation. However, overall, the link to the macroeconomic framework and accession related requirements is rather weak. The framework itself appears to be largely coherent, albeit with a strong focus on describing past developments, while being very short and too general when discussing the forward looking part of the programming period. Compliance with ESA 95 seems to be rather weak and unfortunately the programme does not specify a concrete timeframe for aligning the data presentation with ESA 95. Furthermore, the data deviate from data presented in the fiscal notification without specifying the reasons for the deviation.

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

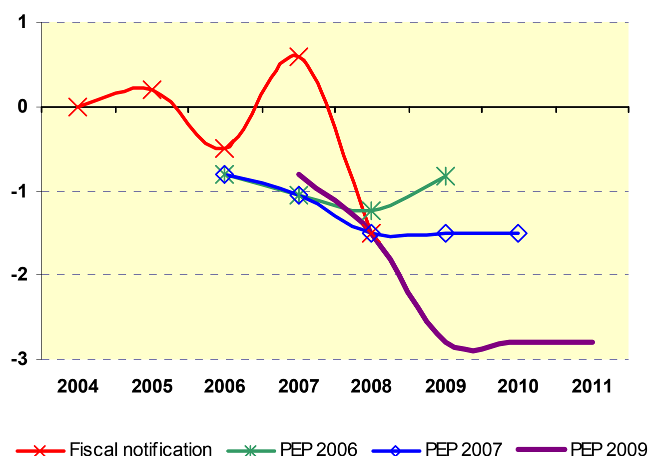
	2007	2008	2009	2010	2011	Change: 2008-11
Revenues	35.6	40.7	38.9	34.8	32.2	-8.5
- Taxes and social security contributions	30.2	31.8	30.6	26.9	25.6	-6.2
- Other (residual)	5.4	8.9	8.3	7.9	6.6	-2.3
Expenditure	34.9	42.2	41.7	37.6	35.0	-7.2
- Primary expenditure	34.1	41.4	40.9	36.7	34.0	-7.4
of which:						
Gross fixed capital formation	4.1	5.7	8.0	7.7	7.2	1.5
Consumption	11.4	14.8	15.6	13.2	11.9	-2.9
Transfers & subsidies	18.6	17.3	17.3	15.7	15.0	-2.3
Other (residual)	0.0	3.6	0.0	0.1	-0.1	-3.7
- Interest payments	0.8	0.8	0.8	0.9	1.0	0.2
Budget balance	0.7	-1.5	-2.8	-2.8	-2.8	-1.3
- Cyclically adjusted	-1.2	-2.5	-2.7	-3.0	n.a.	-0.5
Primary balance	1.5	-0.7	-2.0	-1.9	-1.8	-1.1
Gross debt level	21.7	18.7	20.8	22.7	23.5	4.8

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

The programme is very parsimonious when it comes to quantifying the various planned revenue and expenditure measures. The programme expects the economy to grow above potential in 2010 and 2011, which brings the cyclically adjusted deficit to 4.5% of GDP in 2011. In this context, the country's fiscal policy appears to be rather pro-cyclical in 2010 and 2011. Furthermore, the planned deficits lead to an increase in the debt ratio, which deteriorates the country's so far favourable situation with respect to public debt.

Assessing the fiscal strategy is also impeded by data inconsistencies, both between the descriptive part and the annex tables but also within the annex tables. The main element of the fiscal strategy seems to be a sharp increase in capital expenditure in 2009, while in 2010 and 2011 lower spending for public consumption and social transfers should compensate for the expected decline in revenues (from 39% of GDP in 2009 to 30.6% in 2010). The main source for financing the increased deficits will be foreign loans, increasing from 1.7% of GDP in 2009 to 3.4% of GDP in 2011. As a result, the debt ratio is expected to increase by some 4½ percentage points of GDP, from 21.4% of GDP in 2008 to 25.8% in 2011, a still rather moderate level.

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



2.4.1. Budget implementation in 2008

Central government accounts registered significant surpluses during most of 2008, which however turned into a deficit of close to 1 % of GDP at the end of year. The main reasons for this deterioration were declining revenues and a sharp increase in spending during the last 2 months of the year. In June and October, the parliament adopted supplementary budgets, envisaging additional expenditures amounting to some 2½% of GDP. The additional funds were supposed to be used to cover losses of the state-owned electricity generation, for additional social and labour market related measures and for construction and renovation. The public sector debt ratio[1] declined from 39% of GDP at the end of 2006 to some 22% at the end 2008. This drop was mainly due to early debt repayments.

The end-year fiscal deficit of 1.5% of GDP was close to the fiscal target. However, during most of 2008, public sector accounts registered significant surpluses, which turned into a deficit only in the last few months of the year. This profile points to significant administrative weaknesses in both, revenue estimation but also expenditure implementation. A considerable part of the additional spending at the end of the year was not planned investment, but transfers in the form of subsidies. As a result, the quality and focus of public spending appears not to be very high. Revenue collection benefitted not only from higher inflation, but also improved tax collection as a result of institutional reforms of tax collection.

2.4.2. Near-term and medium-term budget strategy

The programme envisages a general government deficit of 2.8% of GDP in 2009, which is in line with the 2009 budget for the central government, adopted in December 2008. Total general government revenues are expected to decline from 40.7% of GDP in 2008 to 39%, while total expenditures are planned to decline from 42.2% of GDP in 2008 to 41.7% in 2009.

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[1] The authorities' concept of general government is based on GFS 1981, which is fully in line with ESA 95. For example, debt of state enterprises is not included in the debt concept of the authorities' general government. The concept of public debt thus appears to be a better approximation to the concept of general government according to ESA 95.

In the descriptive part of the programme, the authorities refer to a decline in total revenues, from 40.7% of GDP in 2008 to 39.0% of GDP in 2009, resulting from measures to reduce the tax burden on profits and income and to lower social contributions. Unfortunately, the programme only indicates that profit taxes, VAT and social security contributions will be the main factors for this decline, but does not quantify the impact of those various revenue categories. No major privatisation revenues are mentioned. With respect to expenditures, the programme seems to envisage a marked increase in capital spending by 2.3 percentage points of GDP. Another important additional spending category is public consumption, increasing by 0.8 percentage points of GDP.

In the past, the country had a track record of prudent fiscal policies, underestimating tax revenues and budgeting optimistic spending targets. However, the authorities have repeatedly announced their intention to move to a more active fiscal policy. The assumptions on tax revenues appear to be significantly more optimistic than in the past. Furthermore, the 2009 budget does not yet contain the fiscal impact of a first anti-crisis package, which could reduce revenues by another 2% of GDP. As a result, revenue estimates appear far too optimistic. The envisaged sharp increase in capital spending in 2009 is rather unprecedented while the reduction in public consumption in 2010 and 2011 is rather ambitious. More background information on these core expenditure measures would have been helpful.

The programme envisages for 2010 and 2011 a significant drop in revenues by 6.7% of GDP, from 39% of GDP in 2009 to 32.3% in 2011). This decline is partly explained by the government policy to reduce the tax burden and to lower social security contributions. However, another important contribution to the revenue decline probably reflects the impact of the crisis on the domestic economy. The main expenditure side measures to balance this revenue loss seem to be reductions in public consumption (by 3.7% of GDP in 2010 and 2011), and social transfers (by 2.3% of GDP in 2010 and 2011). As a result, expenditures are planned to drop by 6.6% of GDP, from 41.7% of GDP in 2010 to 35.1% in 2011. While in general the strategy for lowering the share of public spending seems to be to increase spending at a lower rate than nominal GDP growth, public consumption is envisaged to decline in absolute terms. Unfortunately the programme does not provide details as to how the authorities intend to lower public consumption, while at the same time embarking on a strategy of raising salaries in the public sector.

Regrettably the programme limited its analysis of fiscal risks to the general sensitivity analysis in the macroeconomic framework. Undoubtedly, the programme would have benefitted from a more extended risk analysis, also covering risks of additional spending, for example related to the notorious financial needs of the state owned electricity producer, the probably increased financial needs of the health and pension insurance sector in view of the costs of the social security reform; and the risk of decelerating employment as a result of the crisis.

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

	2007	2008	2009	2010	2011
Gross debt ratio [1]	**21.7**	**18.7**	**20.8**	**22.7**	**23.5**
Change in the ratio	-5.0	-3.0	2.1	1.9	0.8
Contributions [2]:					
1. Primary balance	**-0.3**	**-0.2**	**0.6**	**0.5**	**-0.1**
2. "Snow-ball" effect	**-2.0**	**-1.0**	**0.7**	**0.6**	**0.9**
Of which:					
Interest expenditure	1.1	1.7	2.2	2.3	2.9
Growth effect	-1.4	-1.1	-0.9	-1.1	-1.4
Inflation effect	-1.7	-1.5	-0.6	-0.5	-0.6
3. Stock-flow	**-2.5**	**-1.8**	**0.9**	**0.8**	**0.0**

Notes:

[1] End of period.

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

Source: Pre-Accession Economic Programme(PEP); Commission services' calculations

Structural balance (cyclical component of deficit, one-off measures and temporary measures, fiscal stance)

With the exception of 2009, the programme expects the economy to grow above potential. The potential growth rate is estimated to increase from 5% in 2007 to 6.6% in 2011, which appears to be on the optimistic side. Over the same period, real GDP growth is seen to increase from 5.9% in 2007 to 7% in 2011. Given the fiscal expansion during the programme period, the fact of above potential growth led to an even higher cyclically adjusted fiscal deficit, reaching some 4.5% of GDP in 2010. As a result, the fiscal stance can be seen as being pro-cyclical over the end of the programme period, which would warrant a less expansionary approach.

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

According to the submitted data, the current level of total public debt was 34.4% of GDP at the end of 2007 and dropped further to 28.2% at the end of 2008.[1] The main factors for the decline have been early debt repayments, but also primary surpluses. During the programme period, the debt ratio is expected to increase to 34.7% of GDP, reflecting increased budgetary and extra-budgetary spending for infrastructure, education and electricity generation. The majority of this spending is planned to be financed through external sources, which would bring the external public debt from around 57% of total public debt (16% of GDP) in late 2008 to about 87% of public debt (30% of GDP). Unless large amounts can be borrowed from international financial institutions (IFIs) this may turn out to be optimistic assumptions given the current financial markets unfavourable situation.

[1] Table 4 in the annex provides data on the consolidated general government sector, as submitted in the PEP. However, this aggregate is not in line with the ESA 95 concept and does not to include debt of public enterprises, amounting to about 10% of GDP. The present assessment therefore uses data on public debt, which seems to be more in line with ESA 95.

In order to improve debt management, the Ministry of Finance established a central public debt management department in 2005 and adopted a medium-term public debt strategy, currently covering the years 2008-2010. This debt strategy envisages a limit to the increase in public debt ratio to 40% of GDP.

About 77% of the total public debt is denominated in foreign currency, with a dominant share of the euro of about 55%. The interest rate structure is characterised by 54% of the debt with fixed interest rates and 46% with floating rates. The average maturity of external public debt is relatively long (about 8½ years), which is related to the high share of IFIs in the debt portfolio. Domestic debt has an average maturity of some 2¼ years only. Debt servicing costs are expected to remain at around 1% of GDP by 2011. Despite the relatively sound debt situation, the programme's intention to substantially increase foreign denominated public debt increases the country's exposure to exchange rate risks.

2.4.3. Budgetary implications of "major structural reforms"

The PEP provides a broad and comprehensive overview of the country's structural reform agenda. The document contains a detailed and comprehensive matrix of policy commitments, with quantitative information on the impact of various reform measures on budgetary expenditures and revenues. The presentation also contains information on the time schedule of the various measures. However, as in the last submission, the presentation would have benefited from a more explicit description of the government's policy priorities and the policy mix which results from its priorities. The policy mix contains measures which are in line with the Lisbon agenda and the priorities derived from the Commission's Progress Report and spelled out as economic priorities in the European Partnership. However, when looking at the fiscal commitments, the policy mix is highly focused on a few areas, such as strengthening infrastructure, supporting the agricultural sector and education, while the financial commitments related to other policy objectives, such as direct measures to address the labour market imbalances and improving the efficiency of public administration, are still very limited. The overall estimated level of reform oriented spending has been increased significantly compared to last year's submission, to around 4½% of GDP during the programme period.

Overall, the main structural reforms should have an important impact on the country's fiscal position, with a net effect of around 5% of GDP. The measures related to infrastructure and education address important structural weaknesses and are therefore likely to add to the country's growth potential.

2.4.4. Sensitivity analysis and comparison with previous PEP

In contrast to last year's submission, the programme presents an analysis of the impact of various alternative scenarios on the budget deficit. The first assumes real GDP to grow only at half of the baseline rate, a second scenario looks at the implications of revenue growth of only ¼ of the baseline scenario and the third scenario assesses a one-off expenditure shock of 2% of GDP. In all three cases, the initial impact on the fiscal deficit is about 1% of GDP. In the low growth scenario the deficit deteriorates by another ½ percentage point of GDP further in 2010, to 4½% of GDP, but improves by 1 percentage point in 2011, reaching a deficit of 3½% of GDP. In the case of the revenue-shortfall scenario and the expenditure shock scenario the fiscal deterioration continues. Given the current global slowdown, the first scenario appears to be more likely, expecting GDP growth to slow down to some 2¾% in 2009 and an acceleration to 3% and 3½% in 2010 and 2011. In that case, the deficit would be close to 4% of GDP in 2009, increase to 4½% in 2010, but improve to 3 % of GDP in 2011. Although this impact appears to be rather modest, the programme does not present any contingency measures for the case of fiscal slippage. However, the document provides information on the size of contingent liabilities, which appear to be rather low with respect to GDP.

2.4.5. Quality of public finances and institutional features

The country embarked in May 2000 on a major reform of public administration, which – with support from the IFIs – intended to reduce the public sector to its core activities and to improve the transparency and efficiency of public administration in general. Another impulse for public sector reform is based on the Ohrid framework agreement from 2001. In line with this agreement, the authorities endorsed a major programme of administrative decentralisation, which envisages transferring the competence and the financial means in a number of communal areas (such as education, health, local cultural institutions, urban planning and construction, fire brigades, etc.) to the local communities. So far, mainly the responsibilities have been transferred, while financial competences are more gradually transferred. Overall, the institutional and legal changes over the last years appear to lead to a strengthening of the country's capacities to administrate public finances.

The government's implementation of a flat tax on corporate profits and income will have an important impact on the level and composition of public revenues. The lowering of direct taxes might help to stimulate consumption and investment. But at the same time, it might shift the tax burden to lower income households. During 2008, the authorities have started to reduce the tax wedge on labour, which should increase the incentives for official employment. Furthermore, the authorities have started to implement a switch to a gross salary concept, which should improve the transparency of social security system.

2.4.6. Sustainability of public finances

The programme contains a table with long-term (2000-2050) estimates on the sustainability of public finances. Based on an economic scenario with a decelerating trend in growth (from 6.5% in 2010 to 4.5% in 2050) and a rather moderate decline in unemployment (from 37% in 2005 to 12% by 2050), the programme expects revenues and expenditures to remain constant as share in GDP, at 33% and 32%, respectively. However, in contrast to last year's submission, expenditures for pensions are expected to increase relative to GDP, from 5.3% in 2005 to 7.5% of GDP in 2050. Health expenditures are also set to relatively decline, from 5.5% of GDP in 2005 to 4 in 2050. Spending for education is seen to increase, from 4.7% of GDP in 2005 to 6.4% in 2050.

Overall, there appear to be no major and immediate threats to the long-term sustainability of the country's public finances, in particular in view of the country's relatively low debt level. Demographic pressures seem to pose no major threats, although a continued reform of the social security system appears to be necessary to keep public sector health spending under control. Provided that the current public sector reform agenda is fully implemented, the former Yugoslav Republic of Macedonia seems to be relatively well placed to meet the costs of an aging population. Nevertheless, costs in relation to the reform of the pension and health-care systems should be monitored carefully.

2.5. STRUCTURAL REFORMS

The 2009 PEP provides a broad and comprehensive overview of the country's structural reform agenda. The document also contains a detailed and comprehensive matrix of policy commitments, with quantitative information on the impact of the various reform measures on budgetary expenditures and revenues. The presentation also includes information on the time schedule of the various measures. However, as last year, the presentation would have benefited from a more explicit discussion of the government's policy priorities and the policy mix which results from its priorities. The policy mix contains measures, which are in line with the Lisbon agenda and the priorities derived from the Commission's Progress Report and spelled out as economic priorities in the European Partnership.

However, in contrast to last year's submission, the level of fiscal commitments for structural reforms has been more than doubled, to some 4½% of GDP during the programme period. According to spending plans, the main emphasis of structural reforms seems to be on road construction, education and agriculture. However, investment in road and railway infrastructure usually is not considered to be a structural reform in the strict sense which would reduce the country's spending volume for structural reforms by about one third. Surprisingly, spending for active labour market policies is rather low, especially when taking into account the current unemployment level of some 33% of the labour force.

Table II.2.5:
Net direct budgetary impact of key reform commitments (in EUR million)

	2009	2010	2011
Road infrastructure	-93.8	-106.4	-125.0
Education	-91.4	-93.8	-94.6
Agriculture and rural sector	-37.5	-40.8	-45.7
Railway infrastructure and introduction of system for	-14.9	-14.7	-14.9
Business environment	-12.6	-11.5	-12.7
Electronic communication	-12.2	-12.2	-12.2
Other reforms (public administration, knowledge-based society, judiciary, envrionment, public procurement etc)	-72.6	-67.9	-111.7
Total impact on the budget	-335.1	-347.3	-416.8
Total impact on the budget (in % of GDP)	-4.6	-4.4	-4.8

Source: 2009 Pre-accession Economic Programme (PEP), own calculations

2.5.1. Product and capital markets

Like the previous submission, the 2009 PEP contains a long and comprehensive description of a large number of structural reform areas targeted to improve the efficiency of product and capital markets. The main reform areas mentioned in the document are supporting the agricultural sector, strengthening infrastructure, strengthening the competitiveness of the industrial sector, strengthening competition policy and state aid control, promoting industrial clusters, improving the business environment, supporting SMEs and liberalising network industries (energy, telecommunication, transport). With respect to financial commitments, the focus appears to be on agriculture, infrastructure and education.

Overall, the pace of structural reforms appears to be relatively moderate in the programme, which allocates a limited amount of budgetary resources to promote structural reforms. Furthermore, a considerable share of the available funds seems to be devoted to areas which in view of meeting the Copenhagen criteria might not be the most effective ones, such as agriculture, while improved funding for addressing education and labour market rigidities might have been more in line with accession related priorities. With respect to the timing of reforms, the programme presents a back-loaded approach with respect to improving infrastructure, while the support for agriculture is more concentrated towards the immediate future.

With respect to the reform of capital markets, the programme envisages a further alignment with the EU acquis and a further strengthening of the regulatory and supervisory institutions. In contrast to the product market reforms, the information provided in this respect is more concrete and operational.

2.5.2. Labour market

The document contains information on recent labour market reforms and in particular on administrative measures, but however, the information on policy objectives for the remaining programme period in very limited.

2.5.3. Other reform areas

Concerning other reform areas, the most noteworthy additional reform projects are related to the judiciary system, health and education, public administration, including a reform of the financial system and the decentralisation of competences from the central government to the local administrations, IT, environment and regional development. Overall, the presentations tend to devote much emphasis on past developments and often remain relatively vague with respect to concrete plans for the programme period. Like in the other reform areas, the conceptual link to the EU accession process, notably the European Partnership, is rather limited.

Table II.2.6:
Annex: Structural indicators

	The former Yugoslav Republic of Macedonia					EU 27				
	2004	2005	2006	2007	2008	2004	2005	2006	2007	2008
General economic background										
Real GDP [1]	4.1	4.1	4.0	5.9	5.0	2.5	2.0	3.1	2.9	1.4
Labour productivity [2]	n.a.	n.a.	n.a.	n.a.	n.a.	100	100	100	100	100
Real unit labour cost [3]	n.a.	n.a.	n.a.	n.a.	n.a.	-1.4	-0.6	-1.1	-0.8	-1.6
Real effective exchange rate [4]	n.a.	n.a.	n.a.	n.a.	n.a.	101.2	107.5	106.4	107.9	114.0
Inflation rate [5]	-0.4	0.5	3.2	2.3	8.3	2.0	2.2	2.2	2.3	3.7
Unemployment rate [6]	37.2	37.3	36.0	34.9	33.5	9.0	8.9	8.2	7.1	7.0
Employment										
Employment rate [7]	33.8	34.1	35.2	36.2	37.3	63.0	63.6	64.5	65.4	n.a.
Employment rate - females [8]	25.7	25.4	27.0	28.0	28.2	55.5	56.3	57.3	58.3	n.a.
Employment rate of older workers [9]	21.9	23.2	n.a.	n.a.	n.a.	40.7	42.3	43.5	44.7	n.a.
Long term unemployment [10]	n.a.	n.a.	n.a.	n.a.	n.a.	4.2	4.1	3.7	3.0	n.a.
Product market reforms										
Relative price levels [11]	44.4	42.2	43.3	43.3	n.a.	100	100	100	100	100
Total trade-to-GDP ratio [12]	n.a.	n.a.	n.a.	n.a.	n.a.	9.0	9.8	10.7	10.7	n.a.
Net FDI [13]	6.0	1.6	6.8	4.3	6.7	0.9	1.7	2.2	3.4	n.a.
Sectoral and ad-hoc state aid [15]	n.a.	n.a.	n.a.	n.a.	n.a.	0.6	0.6	n.a.	n.a.	n.a.
Business investment [16]	10.9	3.0	4.0	n.a.	n.a.	17.2	17.7	18.2	18.7	n.a.
Knowledge based economy										
Tertiary graduates [17]	3.7	4.0	4.3	n.a.	n.a.	12.5	13.2	13.0	n.a.	n.a.
Spending on human resources [18]	n.a.	n.a.	n.a.	n.a.	n.a.	5.1	5.0	n.a.	n.a.	n.a.
Educational attainment [19]	n.a.	n.a.	n.a.	n.a.	n.a.	77.1	77.5	77.9	78.1	n.a.
R&D expenditure [20]	n.a.	n.a.	n.a.	n.a.	n.a.	1.8	1.8	1.8	1.8	n.a.
Broadband penetration rate (EU25) [21]	n.a.	n.a.	n.a.	n.a.	n.a.	6.5	10.6	14.8	19.0	n.a.

1. Growth rate of real GDP in %. 2. Labour productivity per person employed - GDP in PPS per person employed relative to EU-25 (EU-25=100). 3. Growth rate of the ratio: compensation per employee in current prices divided by GDP (in current prices) per total employment. 4. Vs IC36 (1995 = 100), current year's values are based on Commission's forecast deflator figures, nominal unit labour cost deflator. 5. Annual average rate of change in Interim Harmonized Indices of Consumer Prices (HICPs), tFYRoM = CPI. 6. Unemployed persons as a share of the total active population. 7. Employed persons aged 15-64 in % of total population of the same age group. 8. Employed women aged 15-64 in % of total female population of the same age group. 9. Employed persons aged 55-64 (EU27) or 50-64 (tFYRoM)) in % of total population of the same age group. 10. Long-term unemployed (over 12 months) in % of total active population aged 15-64. 11. comparative price levels of final consumption by private households including indirect taxes (EU-25=100). 12. Trade integration - Average value of imports and exports of goods divided by GDP.

13. Average value of inward and outward FDIs flows in % of GDP. 14. Market share of the largest generator (% of total net generation). 15. In % of GDP. 16. Gross fixed capital formation by the private sector in % of GDP. 17.Total tertiary graduates in science and technology per 1000 of population aged 20-29. 18. Public expenditure on education in % of GDP. 19. Percentage of the population aged 20 to 24 having completed at least upper secondary education. 20. GERD (Gross domestic expenditure on R&D) - in % of GDP. 21. Percentage of households with broadband at home.

f: forecast, e: estimated value, p: provisional value, b: break in series, s: Eurostat estimate, r: revised value,

Source: Commission services, national sources

3. TURKEY

3.1. EXECUTIVE SUMMARY

Turkey submitted the eighth Pre-accession Economic Programme (PEP) in early April 2009, after the submission deadline set for January 31. The delay was caused by the need to adjust short and medium-term macroeconomic and fiscal projections to the IMF programme under discussion. The PEP covers 2009-2011 and has been prepared under the coordination of the Undersecretariat of State Planning Organization with contributions of relevant ministries and institutions. It has been adopted by the decision of the High Planning Council.

The PEP presents a comprehensive and largely consistent macroeconomic and fiscal framework which is based on broadly realistic macroeconomic projections. The programme's overarching objectives are to minimize negative effects of the global crisis on growth, to continue the disinflation policies, to create an environment conducive to economic growth through implementing fiscal and income policies in a way to contribute to macroeconomic stability. Priorities related to growth, employment and inflation were tentatively taken into consideration within the constraints of the global business cycle. The document largely complies with the content, form and data requirements and appears consistent with earlier key policy documents, including the 2008 National Programme, and the 2009 budget.

The PEP has been prepared in a challenging economic environment. The economic crisis originated in the financial markets of developed countries, started to impact Turkey more seriously as of mid-2008 and brought about a sharp fall in economic activity, as well as major uncertainties. In the light of these developments, the PEP envisages that the Turkish economy will contract significantly, by 3.6%, in 2009. The economy will begin to recover starting from 2010 growing by 3.3% and will converge to a level close to its potential growth – 4.5% – by 2011. These assumptions largely concur with the European Commission's spring 2009 forecast as regards 2009. However, reaching the growth rates projected for 2010 and 2011, may require a longer than envisaged adjustment process. The inflation outlook of the programme appears broadly reasonable, maybe even too conservative given the recent acceleration of the disinflation process.

The tight fiscal policy implemented since the 2001 crisis based on yielding large primary surpluses in order to reduce the public debt stock is being relaxed in the context of the economic crisis, as the primary surplus targets are significantly reduced. The document does not describe in great detail how the new targets will be achieved as the fiscal policies are not always clear and adequately quantified. In addition, fiscal risks are significant given a rather optimistic projection of revenues for 2009-2010 and the downside risks to growth, in particular for 2010-2011. The authorities have also initiated in April 2009 a consistent fiscal stimulus package (amounting to about €27 billion or about 5.1% of GDP over the programme period) in order to mitigate adverse effects of the crisis on growth and employment. While the fiscal response aims at being strongly countercyclical, the relaxation of current spending ahead of the 2009 local elections and the unbalanced composition of the anti-crisis weaken the quality of public spending and its overall impact on the country's growth potential. In 2009, the fiscal relaxation to the tune of around 3% of GDP is largely accounted for by increased current transfers and interest payments. Therefore, a more appropriate fiscal response is deemed necessary in particular by restraining current spending and maintaining public investment at previous levels as a share of GDP in order to mitigate the effects of the crisis. In addition, the size of the fiscal response should carefully calibrated, in order to avoid a crowding-out of private investment and a deterioration of investor confidence also given the already high cost of debt roll-over. A strong and

binding fiscal rule, as spelled out in the PEP, may be very helpful in this respect, especially if introduced before 2011 since markets tend to penalise uncertainty.

The basic objective of the monetary policy is to ensure price stability. The monetary policy will be implemented within the framework of explicit inflation targeting, as in the 2008 PEP period. The Central Bank will continue to use short term interest rates as the basic policy instrument. In the upcoming period, the Central Bank will focus on the medium-term inflation outlook and set the monetary policy decisions in line with this outlook, which may lead to further easing after base rates were cut by 750 basis points between November 2008 and May 2009. In addition, the floating exchange rate regime will also be maintained. Foreign exchange rates will be determined by supply and demand conditions in the market as in the previous years, and the Central Bank will not set any target for exchange rates. However, the Central Bank may directly intervene in the foreign exchange market via FX buying or FX selling interventions on its own initiative, in order to prevent actual and potential excess volatility in the foreign exchange rates, as it did in early 2009.

A significant reduction of the current account deficit, as projected in the PEP, seems realistic. Exports are to be significantly affected by lower global demand, and imports are affected by the lower energy and commodity prices and depressed domestic demand. The PEP scenario is fairly conservative in projecting capital inflows and the stock of foreign reserves especially if the recent large and unrecorded capital inflows are taken into account. Despite large capital inflows to Turkey in recent years, it is indeed realistic to assume the occurrence of capital outflows over the program period, in particular of a net outflow in 2009, albeit not to the extent that financing is severely put at risk. In this regard, the authorities' adherence to prudent policies and measures to anchor the credibility of markets and investors are important.

Structural reforms have been implemented with determination in previous years and will be continued in the 2009-2011 period. They aim at strengthening the market mechanisms, increase competitiveness, reduce the share of the public sector in the economy through privatization, strengthen the functions of regulatory and supervisory agencies, develop the intermediary capacity of the financial sector to meet funding requirements needs of the enterprise sector. Besides, the PEP stresses the importance of improving labour qualifications according to market demands and of strengthening the link between the labour market and the education system. The programme also refers to the important role of improving the effectiveness of public services, eliminating the deficiencies in health and social security systems, increasing R&D activities and innovative capacity, improving transportation and energy infrastructure, ensuring regional development and increasing productivity in agriculture. Taking into account the ongoing negative developments in the world economy, the programme's objectives of sustaining the dynamics of structural reforms is commendable and the right approach for minimizing the impact of the crisis in the short and medium-term. However, recent global developments put the privatization scenario at risk and have already started creating larger imbalances in the labour market than foreseen in the PEP.

3.2. INTRODUCTION

Turkey submitted its eighth Pre-accession Economic Programme, following government adoption on 4 April 2009, after the submission deadline set for January 31. The delay was caused by the need to adjust short and medium term macroeconomic and fiscal projections to the IMF programme under discussion. The programme covers the period 2009-2011 and represents an update of the previous years' submission. It builds on earlier policy documents, such as the "National Programme 2008", adopted in December 2008 and the "Medium Term Fiscal Framework and Medium Term Economic Programmes adopted in 2008. The document broadly complies with the content, form and data requirements. Comments and suggestions by the Commission made in its last years' PEP assessment have been taken on board and led to technical improvements. In particular, the information related to

the ongoing crisis appears highly relevant and useful. The PEP is supported by a sufficiently comprehensive and broadly consistent macroeconomic framework. However, the fiscal and labour market scenarios appear rather optimistic in the current crisis context. The programme's overarching objectives are: to minimize negative effects of the global crisis on growth, to continue the disinflation policies and to create an environment conducive to economic growth through implementing fiscal and income policies in a way to contribute to macroeconomic stability. Priorities related to inflation, growth and employment were tentatively taken into consideration within the constraints of the needs of the economy and the restrictions of the global business cycle, and adequately address most of the economic priorities of the Accession Partnership and the key challenges spelled out in the 2008 Progress Report.

Table II.3.1:

Comparison of key macroeconomic and budgetary projections

		2007	2008	2009	2010	2011
Real GDP growth (% change)	COM	4.7	1.1	-3.7	2.2	n. a.
	PEP	**4.7**	**1.1**	**-3.6**	**3.3**	**4.5**
Consumer price inflation (%	COM	8.4	10.4	7.3	6.3	n. a.
	PEP	**8.4**	**9.6**	**7.1**	**6.5**	**5.6**
General government balance (% of GDP) (*)	COM	-0.2	-2.1	-4.6	-4.1	n. a.
	PEP	**-0.2**	**-1.5**	**-4.6**	**-3.2**	**-2.8**
Primary balance (% of GDP) (*)	COM	n. a.	n. a.	n. a.	n. a.	n. a.
	PEP	**5.7**	**4.1**	**1.7**	**2.6**	**2.6**
Government gross debt (% of GDP) (*)	COM	39.4	39.5	42.7	43.4	n. a.
	PEP	**n. a.**	**39.5**	**43.1**	**44.1**	**43.4**

Source: PEP 2009, Commission autumn 2008 forecasts

3.3. ECONOMIC DEVELOPMENTS AND CHALLENGES

3.3.1. Recent macroeconomic developments

Economic activity slowed down sharply since mid-2008, and GDP contracted significantly in the final quarter of the year. Since the beginning of 2009, business and consumer confidence indicators started to improve, albeit from very poor levels. Nonetheless economic activity may have contracted at a double-digit rate in the first quarter of 2009, according to the central bank. Industrial output fell by over 20% in the year to April 2009, and exports shrunk in tandem by around 25%. In the period between November 2008 and May 2009, the central bank started a monetary easing cycle, whereby key rates were cut by a cumulative 750 bps to 9.25%. The local banking system appears relatively sound, but credit conditions became stricter and the ratio of non-performing loans slowly increased to rates above 4% by the end of the first quarter. In parallel with the decline in economic activity, the roll-over of external debt by the private sector receded, albeit not dramatically. The current account deficit is shrinking fast as a result of decelerating domestic demand and the favourable impact of oil and commodity prices, and is expected to narrow to 1-2% of GDP in 2009 from 5.7% of GDP in 2008. This reduces the external financing needs of the country and somewhat eases the pressure on the currency.

The PEP provides a concise and up-to-date overview of recent macroeconomic developments at the time of submission. It provides useful explanations for deviations of actual developments from estimates presented in the previous PEP.

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

The global financial crisis and economic slowdown in Turkey's main trading partners has adversely affected the Turkish economy. Growth decelerated markedly and economic prospects have become much bleaker. The large stock and important short-term debt repayment obligations, in particular of the corporate sector, are key challenges against the background of much tighter external financing conditions and increased market uncertainty. A comfortable stock of international reserves and private sector foreign assets may serve as a cushion in the event of lower external financing. The financial sector remained relatively stable still benefiting from the major restructuring and the improved regulation and supervision implemented after the 2001 financial crisis.

The Turkish authorities adopted a number of measures to mitigate potential shocks that may arise from the financial crisis. In total, stimulus measures amount to about € 27 billion (TRL 54 billion) in 2008-2010, or about 5.1% of GDP, of which about € 20 billion will be have a direct budgetary impact.

Monetary Policy

Monetary policy easing was initiated in November 2008, and the central bank cut base lending rates by a cumulative 750 basis points by May. The central bank justifies the strong easing on the economic slowdown and the decline in inflation, but spill-over effects on the exchange rate are likely. In addition, the central bank took measures to increase FX liquidity on the inter-bank market and occasionally sold a daily amount of USD 50 million in order to prevent excess volatility of the exchange rate.

Fiscal policy measures

The government has adopted several stimulus packages, including the provision of zero-interest loans for SMEs, a tax break for local investors in equities, and inducements for Turks to repatriate savings held offshore. A crisis package adopted in mid-March supports domestic demand by cutting taxes on the sale of cars, office furniture, IT, houses and machinery used by SMEs for a period of three months. The government intends to establish a Credit Guarantee Fund, in order to facilitate SME-lending.

3.3.2. Key policy challenges

The key policy challenge at this juncture appears to be the calibration of the fiscal response to the crisis both in terms of its size and composition. The authorities need to avoid a fiscal relaxation that would put at risk the macro-economic stability achieved so far or would weaken the long-term growth-potential of the economy. Coupled with productivity enhancing structural reforms this should play a key role in the narrowing of the country's savings-investment gap and in reducing the present heavy reliance on foreign savings. A continuation of a prudent monetary policy aimed at stabilising the exchange rate seems essential to anchor market expectations under more severe external financing constraints and to preserve financial sector stability. This policy mix needs to be supported by comprehensive structural reforms, particularly in areas which have a direct effect on the quality and sustainability of public finances. Notably, reforms should be directed at reigning in the significant increase in current spending envisaged for 2009. Progress in reforms has been somewhat slowing down in recent years and more determination seems necessary if the key objectives of the PEP were to be met in a difficult external environment.

3.4. MEDIUM-TERM MACROECONOMIC SCENARIO

The PEP 2009-2011 presents a comprehensive medium-term macroeconomic scenario with projections for key economic variables, covering real sector, employment, wage, inflation as well as external developments. The growth projections have been significantly revised downward from last year's PEP scenario, taking into account a much less favourable external environment. As a result the macroeconomic scenario appears as broadly realistic. However, the projections of real GDP growth in 2010 and 2011 are surrounded by significant downside risks and employment assumptions over the programme period appear as overly optimistic. The PEP does not explicitly discuss alternative scenarios. In the present context the programme could usefully have presented a more detailed assessment of risks related to the financial crisis and the recession in the EU and its possible effects on the macroeconomic programme.

The external assumptions of the PEP 2009-2011 have markedly changed in line with a considerably less benign external outlook, but downside risks appear to prevail. For 2009, the programme assumes euro area real growth rates of -4.1% and 0.2%, respectively. The volume of world imports is assumed to shrink by 13.2%. Oil prices in 2009 are projected at 50 US-$ per barrel. All of these assumptions appeared plausible at the time of submission.

Real sector

The PEP projects a further slowdown of real growth to -3.6% in 2009, down from an expected growth of 1.1% in 2008, before it accelerates to 3.3% in 2010 and to 4.5% in 2011 on the assumption of a gradual recovery of the world economy. The temporary output decline in 2009 is primarily the result of slowing domestic demand, in particular gross fixed capital formation, by over 13%. The private consumption growth is projected to decelerate to a negative 3.1%, while public consumption growth is expected to increase above 3% from 1.8% in 2008. Apart from strong base effects, this increase results from the announced fiscal stimulus, including some large infrastructure projects stimulus and the increase in current public spending which took place around the local elections in early 2009. The large fall in domestic investment primarily stems from a significant reduction of corporate sector investments, tighter external financing conditions and weak business confidence. The growth of exports of goods and services is expected to fall in line with lower foreign demand from the main EU trading partners. The contribution of net exports to growth turned positive in 2008, and it is projected to remain broadly constant in 2009, as the volume of total imports will fall by around 15.5% compared with 11% for total exports. For 2010 and 2011, the PEP projects a strengthening of the economy, supported by an improved business climate and a continuation of productivity enhancing structural reforms. Growth rates of private consumption and of total investments are expected to resume to 4.3% and 8.5%, respectively, by 2011.

Overall, the PEP's growth projections for 2009 appear realistic at the time of submission, given the marked deterioration of the external environment, including a projected growth slowdown in Turkey's major EU trading partners. Moreover, external financing constraints are likely to limit the scope for corporate sector investment and the reduction in total investments could actually be stronger than projected by the PEP. However, the increase in private consumption growth could be much more subdued in 2010, resulting from lower employment and disposable incomes, negative wealth effects from asset price adjustments, tighter borrowing conditions and weak consumer confidence in a situation of high uncertainty. It seems that those effects may have been underestimated in the programme. The assumption of a growth recovery in 2010 and 2011 therefore appears optimistic. Reaching growth rates close to potential growth may require a longer than envisaged adjustment period.

On labour market developments, the PEP projects employment growth to fall to 1% in 2009, from 1.8% in 2008, and to slightly accelerate again to 1.5% by 2011. The unemployment rate (ILO) will

continue to rise, to 13.9% at the end of the PEP horizon. It appears unrealistic that the slowdown in growth in 2008 and 2009 does not have stronger effects on employment and unemployment levels, in particular in view of the developments in the first four months of 2009. Overall, the programme may underestimate the negative effects of a rapidly slowing economy on labour market dynamics.

Table II.3.2:

Comparison of macroeconomic developments and forecasts

	2007		2008		2009		2010		2011	
	COM	PEP	COM	PEP	COM	PEP	COM	PEP	COM	PEP
Real GDP (% change)	4.7	**4.7**	1.1	**1.1**	-3.7	**-3.6**	2.2	**3.3**	n. a.	**4.5**
Contributions:										
- Final domestic demand	5.2	**5.2**	-0.7	**-0.8**	-5.3	**-5.0**	2.2	**3.6**	n. a.	**5.1**
- Change in inventories	0.7	**0.7**	0.3	**0.3**	-1.3	**-0.2**	0.6	**0.0**	n. a.	**0.3**
- External balance of goods and services	-0.3	**-0.3**	1.6	**1.6**	2.9	**1.6**	-0.7	**-0.3**	n. a.	**-0.9**
Employment (% change)	1.1	**1.1**	1.8	**1.5**	-2.8	**-1.8**	0.8	**1.0**	n. a.	**1.5**
Unemployment rate (%)	9.9	**9.9**	9.4	**10.6**	13.1	**13.5**	12.9	**13.9**	n. a.	**13.9**
GDP deflator (% change)	6.2	**6.2**	11.4	**11.5**	4.5	**5.5**	5.5	**5.0**	n. a.	**4.5**
CPI inflation (%)	8.4	**8.4**	10.4	**9.6**	7.3	**7.1**	6.3	**6.5**	n. a.	**5.6**
Current account balance (% of GDP)	-5.9	**-5.9**	-5.7	**-5.7**	-1.8	**-1.9**	-2.8	**-3.0**	n. a.	**-4.0**

Sources: Pre-Accession Economic Programme (PEP); Commission services Spring 2009 forecasts (COM)

Inflation

As a result of higher commodity and energy prices as well as still relatively strong domestic demand, end-of period inflation increased in 2008 to 9.6% from 8.4% in 2007. The PEP projects a reduction in inflation to 7.1% in 2009, 6.5% in 2010, and a further gradual adjustment to 5.6% at the end of the PEP period. However, inflation has come down more rapidly than anticipated in the first four months of the year to 6.1%, primarily due to large falls in energy and food prices. The projection is based on a stable exchange rate of the TRL in real effective terms against the euro, lower food and energy prices on world markets and a marked deceleration of domestic demand. The PEP assumes that cost push pressures will remain limited as the growth of unit labour costs will be subdued.

The inflation outlook of the programme appears conservative and it is very likely that inflation will undershoot the Central Bank target in 2009. However, a number of risks stem from both to foreign and domestic factors. Higher prices for imported raw materials are likely to translate into higher inflation. Domestically, stronger inflationary pressures could result from stronger wage increases, if public sector pay increases cannot be contained and spill over to the private sector. Moreover, necessary alignments of indirect taxes (e.g. excises) as well as further adjustments of administrative prices could add to prices increases. At the same time it is reasonable to assume that a continuation of the stability-oriented monetary policy framework will help preventing a significant re-acceleration of inflation in the medium-term.

Monetary and exchange rate policy

The present policy framework, which has been in place for several years, is labelled as an inflation targeting floating exchange rate regime. The primary policy objective is price stability, and the exchange rate has recently successfully been used as a stabilisation devise, conducive to anchoring inflationary expectations. The PEP rightly argues that the choice for such a regime is largely

determined by the fact that the structural transformation in the Turkish economy, the convergence process and the pricing behaviour inherited from the high inflation period warrant a gradual path towards price stability. As the main policy instrument, short-term rates will be primarily determined by considering the medium-term inflation outlook as before. Furthermore, the Central Bank may use instruments such as required reserve ratios or effective liquidity management if necessary. Turkey is a relatively open economy where the euro is widely used for trade invoicing and the dollar still prevails in debt holding. The latter could imply significant risks due to balance sheets mismatches of the private corporate and non-corporate sector. Under these conditions, the avoidance of too high volatility becomes an objective in itself to safeguard financial sector and macroeconomic stability. The central bank stands ready to take additional measures aimed at improving the foreign exchange liquidity in the banking system with a view to mitigating the effects of the global financial crisis (see Box 1 for previous actions to improve the management of FX liquidity).

External sector

The PEP projects a marked reduction of the current account deficit in 2009, to 1.9% of GDP in 2009 from 5.7% in 2008, followed by a widening to 4.0% of GDP by 2011. These assumptions appear plausible. Although the growth of exports will be significantly affected by lower demand of Turkey's main trading partners, reduced total imports are likely to have a much larger impact on the current account, due to the combined effect of lower prices for energy and commodities and a significant deceleration of domestic consumption and investment. Moreover, a reduction of the current account deficit appears also plausible, given the external financing constraints. On the financing side, the PEP remains relatively optimistic on the continuation of FDI flows. Overall, the PEP scenario is fairly conservative in projecting capital inflows and the stock of foreign reserves especially if the recent large and positive unrecorded capital inflows are taken into account. Despite large capital inflows to Turkey in recent years, it is indeed realistic to assume increased volatility of capital flows over the program period, in particular in 2009, albeit not to the extent that financing would be severely put at risk.

Main risks

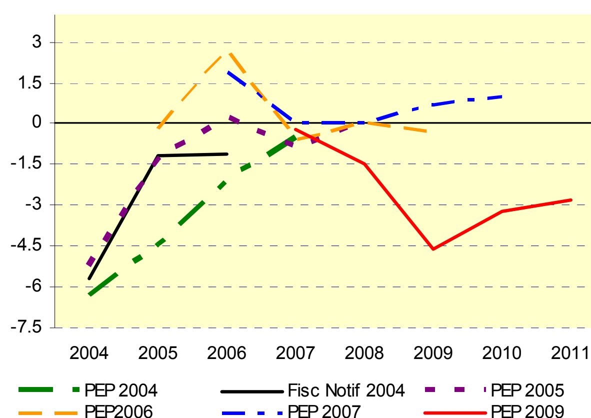
The main risks to the macroeconomic framework are clearly associated with more pronounced adverse effects of the global crisis on Turkey's real economy and financial sector. A longer lasting downturn in the major EU trading partners would certainly affect prospects for a resumption of growth as early as projected by the PEP. Risks are somewhat elevated due to significant external vulnerabilities emanating from the high level of external financing needs and large debt service obligations coming due in the coming years, particularly in the corporate sector. The programme benefits from in-depth assessment of those issues, whereby it concludes that Turkey’s non-banking sector holds a substantial open foreign exchange position, and is therefore sensitive to external shocks, particularly exchange rate fluctuations. However, the concentration of these FX liabilities in large-scale and/or exporting firms with relatively sound balance sheets reduces default risk. Moreover, the fact that about one-third of non-bank firms’ external debt has been borrowed from foreign branches of domestic commercial banks also needs to be considered. Since further declines in domestic and foreign demand are expected in 2009, together with some further tightening in credit conditions, the FX liabilities of the non-banking sector need to be closely monitored to preserve macroeconomic stability.

3.5. PUBLIC FINANCE

The fiscal framework of the PEP 2009-2011 is presented as an integral part of - and supportive to - the overall medium-term economic policy framework, which aims at maintaining debt levels close to 40% of GDP, enabling sustainable growth, reducing unemployment and increasing employment levels. The

general direction of continued fiscal adjustment to ensure long-term sustainability of public finances remains unchanged and broadly appropriate in view of higher public spending and significant external vulnerabilities. However, fiscal targets are less ambitious compared to last year's PEP. The sizeable fiscal relaxation envisaged in 2009 in the context of the economic crisis and prior to the March local elections, combined with the suggested approach of adopting a strong fiscal rule by only 2011 may not sufficiently reflect the much tighter external financing constraints both for the public and the private sectors. Moreover, there are serious risks that the actual fiscal outcome could be even less favourable than projected in the programme, as the revenue projections for 2009 and 2010 appear as overly optimistic given the strong decline of indirect taxes and the temporary tax cuts adopted by the government. The programme contains limited information on key fiscal measures and their respective quantitative effects. An assessment on the cyclical position of the economy and the cyclically adjusted profile of fiscal policy is provided, but the programme would have benefited from a more in-depth assessment of automatic stabilisers in the context of an economic slowdown. The sensitivity analysis is welcome, but potential fiscal risks appear to be much more elevated than those presented in the previous programmes. The programme makes an attempt to apply ESA 95 standards and fiscal data are broadly consistent with those presented in the recent fiscal notification submitted in April 2009.

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



The fiscal programme envisages a worsening of the consolidated general government balance, from an expected deficit of 1.5% of GDP in 2008 to a 4.6% deficit in 2009, before gradually improving to 2.8% of GDP by 2011, largely in line with the growth scenario. The primary surplus will move in parallel, first falling from 4.1% of GDP in 2008 to 1.7% of GDP in 2009 and subsequently increase to 2.6% of GDP in 2010-2011. The public spending ratio increases by almost four percentage points of GDP in 2009, and falls only marginally by 0.5% of GDP by 2011. In particular, spending on social transfers increases significantly by almost 2 percentage points of GDP, together with interest payments and other current spending. At the same time, the revenue-to-GDP ratio is planned to increase by about 1 percentage points over 2008 to 2011, which does not seem realistic in the present crisis context. The general government debt ratio is projected to rise by around 4.5 percentage points in 2008-2010, from a projected 39.5% of GDP in 2008 to 44.1% of GDP in 2010, mainly driven by a worsening of the primary balance and a deceleration of the nominal GDP growth. In view of the above mentioned risks to fiscal revenue, and possible higher deficit outcomes, public debt may increase to substantially higher levels.

Table II.3.3:
Composition of the budgetary adjustment (% of GDP)

	2007	2008	2009	2010	2011	Change: 2008-11
Revenues	33.6	32.8	33.6	34.2	33.9	1.1
- Taxes and social security contributions	30.1	30.1	30.5	31.2	31.0	0.9
- Other (residual)	3.5	2.7	3.1	3.0	2.9	0.2
Expenditure	33.8	34.2	38.2	37.4	36.7	2.5
- Primary expenditure	27.9	28.6	32.0	31.6	31.3	2.7
Gross fixed capital formation	3.2	3.3	2.8	2.8	2.7	-0.6
Consumption	15.0	15.5	16.4	16.2	16.0	0.5
Transfers & subsidies	5.1	4.9	6.8	6.9	7.0	2.1
Other (residual)	4.6	4.9	6.0	5.7	5.6	0.7
- Interest payments	5.9	5.6	6.2	5.8	5.4	-0.2
Budget balance	-0.2	-1.4	-4.6	-3.2	-2.8	-1.4
- Cyclically adjusted	-2.0	-0.6	-1.0	0.0	-0.3	0.3
Primary balance	5.7	4.2	1.6	2.6	2.6	-1.6
Gross debt level	na	39.5	43.1	44.1	43.4	3.9

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

3.5.1. Budget implementation in 2008

As for the year 2008, the original budget framework presented in last years' PEP (and adopted in late 2007) foresaw a broadly balanced budget for the consolidated general government sector of 1.5% of GDP, as in 2007. However, budget revenues performed particularly poorly, and fell by 0.8 percentage points of GDP from 2007, mainly due to a significant fall in indirect taxes. The PEP does not provide sufficient information on the budget execution in 2008, which is a major shortcoming. Data presented for 2008 show the broad picture, but fail to adequately link in a quantitative way the budget performance to the business cycle and/or policy related events. In this respect, some detail and estimates of the budgetary impact of the temporary subsidisation of the social security contributions by the Treasury would have been useful.

3.5.2. Near-term and medium-term budget strategy

For the year 2009 and in line with the budget framework adopted in late 2008, the programme projects an increase in spending of 4% of GDP in tandem with increasing revenues but at a slower pace. Accordingly, the general government deficit will increase by around 3.1 percentage points to 4.6% of GDP. The moderate increase in the share of revenue to GDP appears to be optimistic and inconsistent with the projected fall in GDP growth, assuming that the tax elasticity will not improve in the short-term. The increase of the expenditure-to-GDP ratio in 2009 is largely driven by higher current transfers (up by 3.7 percentage points), which appears to be in part linked to the increasing social spending commitments and social security deficits. The increase in interest payments from 5.6% of GDP in 2008 to 6.2% of GDP in 2009 does not appear to be entirely consistent with current, more optimistic expectations as regards the pricing of Turkey's sovereign debt. Overall, the PEP's fiscal framework for 2009 may become outdated once the announced budget rebalance takes place and Turkey decides on a new Medium-Term Fiscal Framework for 2009-2014.

In 2009, the general government deficit is projected to increase to 4.6% of GDP, before declining gradually to 2.8% of GDP by 2011. A major part of the adjustment over these two years is planned to be realised through a reduction of current transfers, by almost 1 percentage point. Although appropriate, this appears rather ambitious and the programme itself does not elaborate in more detail on these spending adjustments over the latter part of the PEP period.

Fiscal risks are clearly related to the downside risks to growth assumptions of the programme, in particular after 2009. A stronger cyclical downturn is likely to worsen the fiscal balance. Also, the revenue base is likely to shrink, especially for indirect taxes, as a result of the ongoing disinflation process. Altogether, a much stronger decline in fiscal revenues than projected in the PEP is likely to materialise. Additional risks may result from a slower than envisaged implementation of reforms which could delay the realisation of budget savings. This refers in particular to current spending commitments and social transfers. The authorities may also be confronted with continued spending pressures. Finally, the current unfolding of the financial crisis may lead to pressures to increase short-term discretionary spending to counterbalance the negative effects on growth and employment, and to higher costs of servicing outstanding public debt. The resulting combined effect of markedly lower fiscal revenues and pressures for higher current spending would undermine the envisaged fiscal path. Therefore, an appropriate fiscal response under current circumstances would require both bold fiscal measures to reign in current spending and the introduction of a binding fiscal rule. The programme is rather mute as regards the content of the fiscal rule which would represent an important step in the fiscal area.

3.5.3. - Structural balance

The PEP 2009-2011 provides an overview on the cyclical position of the economy and the impact of fiscal policy, using the same methodology in estimating cyclically adjusted primary balances as in last year's submission. On this basis, estimated potential growth would still exceed real output in 2011, but the gap would be on a declining trend. As of 2008, the structural and actual primary budget balances started to differ from each other significantly and the actual budget surplus significantly receded. It is estimated that the primary budget surplus which was around 5%-5.5% of GDP up to 2008, will recede to 1.4% on average in 2009-2011. On this basis, the PEP concludes that fiscal policy has pro-cyclical effects in 2009-2011. Given the methodological weaknesses, the statements on the effects of fiscal policy certainly need to be taken with caution.

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

The PEP 2009-2011 projects a baseline scenario of a gradual increase of general government debt from 39.5% of GDP in 2008 to 44.1% of GDP in 2010, followed by a decrease to 43.4% in 2011. Projections on the decomposition of changes in the debt ratio appear sufficiently comprehensive and consistent with the macro-economic and fiscal assumptions. The nominal GDP effect and the projected worsening of the primary balance in 2009 have a marked effect on the increase of the debt ratio. The public debt sensitivity analysis presented in the PEP shows that the public debt ratio could increase by about 10 percentage points by 2011 under a combined shock scenario, i.e. when growth falls by 2%, the TRL depreciates by 5% and real interest rates increase by 500 base points. The analysis undertaken in the PEP is useful and confirms the need for continued fiscal discipline in order to ensure public debt sustainability. However, the current uncertainties regarding growth prospects may justify some analysis on the sensitivity of public debt to a larger growth contraction in the next programmes, and to subsequently worse fiscal balance outcomes.

The debt management strategy continues to be broadly appropriate as it tries to meet the financing requirements at a low cost while maintaining reasonable risk levels. Borrowing mainly in domestic currency, at fixed rates and at longer maturities remains the main objective of the Treasury, which is overall consistent with the lower availability of international financing since October 2008. At the same time, an overreliance on the domestic market in the context of significantly higher than planned roll-over debt ratios (as witnessed in the first months of 2009) may exert a negative crowding-out effect on the borrowing of the private sector. In this respect, an expansion of the program to tap international capital markets through sovereign bond issues would provide some relief on the domestic credit market. The contingent liabilities of the government have remained under control also

in 2008, as the Treasury guaranteed stock of debt increased by about USD 800 million to USD 5.6 billion at the end of the year. In 2009, also in response to the economic crisis and tighter financing, the government has extended the limit for Treasury guarantees to USD 4 billion, from USD 2 billion in 2007.

Budgetary implications of major structural reforms

As required, the programme (in its Annex) presents some estimates of the fiscal impact of reforms envisaged over the PEP horizon, which is a useful complement. A summary overview is presented in table 4 of this assessment. It shows that structural reforms will have an important impact on the country's fiscal position. The agricultural reform project is expected to be finalized in 2009 and may cost 0.5% of GDP in 2009. The labour market reform, if coming into effect with the currently specified parameters, is expected to impose an additional burden of about 0.2% of GDP on the budget in 2009-2011.

3.5.4. Sensitivity analysis and comparison with previous programme

Like in last year's PEP, various sensitivity analyses were presented. One scenario examined the sensitivity of public finances to lower growth and higher interest rates. According to calculations presented in the PEP, the debt situation appears to be sustainable. The most critical scenario is that of an increase/decrease of real interest rates for TRL-denominated debt by 5 percentage points compared to the baseline scenario, whereby the gross debt level would rise/fall by 1.7 percentage points. While the analysis concludes plausibly that the sensitivity of the debt stock has fallen, this argument could be strengthened by the inclusion of more critical scenarios, in particular in view of the size of the current contraction in growth observed worldwide.

3.5.5. Quality of public finance and institutional features

The PEP 2009-2011 refers in a very general way to recent and ongoing institutional changes and policies which are deemed to improve the quality of public finances over the medium term. It emphasises improvements in budget management, revenue collection and expenditure control as well as the adoption of a new public procurement system in line with EU practice and a new legal framework for public-private partnerships. The programme foresees that, in order to reduce the need for ad-hoc measures to reach fiscal targets, efforts to widen the tax base, better capture the unregistered economy, and decrease the number of tax exemptions will be intensified. Turkey has accomplished a remarkable effort of fiscal consolidation but ensuring a high-quality fiscal adjustment will be a key challenge in the coming years. Indeed, fiscal imbalances might emerge over the medium term, either as a result of past policy commitments, for example in education and access to the universal health insurance, or owing to a still pending reform agenda. In addition, infrastructure investment may need to increase in less developed regions, given the persistence of regional disparities in Turkey.

As public expenditures are already relatively high there is limited scope for Turkey to increase expenditure in order to meet pressing convergence challenges. Expenditure will also be contained in order to make room for lower taxes in the long run while preserving a sound fiscal framework. Fiscal policy would thus need to focus on trade-offs in expenditure allocations, possibly by reducing spending in functional areas, where it appears to be oversized in comparison with other similar countries. At the same time, reforms will be implemented with the aim of improving the efficiency of expenditure programmes in areas where expenditure pressures are being felt, such as health care, education, social protection. Reforms focused on the modernization of civil service pay and employment system and the rationalization of the investment programme, will also help contain pressures on the wage bill as well as investment spending and thus contribute to better control public

expenditure across functional areas. Efficiency considerations are considered to be the main priority in public expenditure policies.

Conversely, the Turkish authorities have embarked on an ambitious reform by establishing a revenue administration. This reform intends to increase the efficiency of tax collection, by means of enhancing automation, training staff and improving all underpinning facilities. In addition, tax laws and regulations will be amended in order to re-assess tax exemptions with the objective of simplification and rationalization of the tax system. Public expenditures will be prioritized with respect to resource scarcity and their impact on potential growth in the context of economic and social benefits. Public agencies and institutions will revise their resource allocations under the specified priorities considering the budgetary means. In this context, some activities and projects of lower priority will be eliminated and the thereby created fiscal space will be allocated to expenditure priorities with assumed growth potential.

The basic objective of the tax policies to be implemented is to contribute to supporting growth and employment in accordance with macroeconomic policies, reducing informality in the economy, and creating a tax system that is simpler, fairer and with wider base. Fight against the informal economy has been stepped up in accordance with the strategy established thanks to the cooperation between all relevant public bodies. Works are underway to establish a call center where incidents can be reported easily and on time. A risk analysis center was set-up under the Revenues Administration and risk analysis models are developed for the supervision and compliance analysis on the corporate tax, income tax and VAT payers, for the purpose of speeding up and improving the fight against informal economy. Furthermore, labeling practice was started for the tobacco and alcohol market through the product tracking systemso as improve the tracking and supervision of the sector. At sectoral level, analysis works were conducted on risky tax-payer groups in order to research, analyze and report the tax deficit. Risk project work to determine and reduce informal economic activity will be elaborated upon.

3.5.6. Sustainability of public finance

Like in the previous years, the 2009 PEP does not contain a separate section on the long-term sustainability of public finances. It would greatly benefit from some demographic and macroeconomic scenarios. Turkey’s situation differs dramatically from that of EU Member States. With its very young population (the average age is just 28), falling birth rates, and significant in- and outward migration, some more in-depth analysis would be crucial in the context of a PEP, in particular since the Turkish authorities are moving to new health and pension systems, whereby key indicators, like for example retirement age, dependency ratio and overall labour market participation might be subject to significant changes.

Indeed, even in case of a full implementation of the reform proposals, Turkey is not so well placed to meet the costs of an ageing population. The introduction of a new and responsible social security system, and more generally, the future costs of the pension and health-care systems should therefore be monitored constantly and very carefully.

The PEP 2009-2011 contains a short analysis of the long-term sustainability of public finances with a focus on pension, health and interest expenditure. Assumptions on long-term population trends as well as on participation rates have not been changed compared to last year's PEP. Differences to last year's scenario result primarily from the significantly lower growth rates due to the ongoing crisis, which may call for additional measures. The obvious challenges arising from demographic pressures remain significant, also in view of an already relatively high public debt ratio and a very low participation rate. Moreover, long-term sustainability could be further eroded, if growth and productivity trends turned out to be less comfortable and if participation rates fell below levels assumed under the programme. Given the risks and magnitude of challenges, the programme would have benefited from

outlining a somewhat more thorough policy response to the challenges of an ageing society, beyond the ongoing social security reform.

3.6. STRUCTURAL REFORMS

The PEP 2009-2011 covers a broad range of structural reforms related to the enterprise and financial sector, labour market, agricultural sector, public administration, education, health care, judiciary, and environment. The presentation is often backward looking, providing information on past and ongoing reform initiatives with a strong emphasis on harmonisation with EU requirements. More emphasis has been given to measures aimed at fighting the informal economy and improving the business environment, given the pertaining administrative obstacles still in place. The programme contains fiscal impact estimates on some measures, but the link between the structural reform agenda and the implementation of the fiscal strategy could be further strengthened. The full implementation of the structural reform agenda would in some cases require the establishment of time bound action plans and the definition of concrete measures and clear targets. The general aim of the PEP's structural reform agenda is to increase the efficiency in the private sector and the public administration and to support the strengthening of market forces. It is a mere update from the plans put in place over the last years, and covers various issues. The outlined reforms are at different stages in their implementation. The programme is quite clear on results and delays compared with what was outlined in the 2007 PEP. In some areas, however, e.g. competition policy and the investment climate, the programme would have benefitted from a better clarification of the targeted results and of the speed of operation. In the area of privatisation, the government has modified its plans after the submission of the PEP, thereby delaying some key privatisations. The budgetary effects of reforms to be implemented are outlined for all major reform areas, although cost estimates beyond 2008 are often lacking. Overall, the structural reform agenda should be broadly supportive of further enhancement of Turkey's capacity to cope with competitive pressures and market forces within the EU. More emphasis should be put on labour market reforms in order to support job creation and re-allocation during the economic transformation process. As in previous years, the PEP also lacks clear policies and descriptions concerning research and development and innovation, an area which would be important to support a transformation to a knowledge-based economy, as laid out in the Lisbon agenda. On such a basis, it would be conducive to meeting the objectives of the Lisbon agenda concerning product, labour and capital markets and the establishment of a knowledge based economy. Intensified efforts to speed up the implementation of reforms, in particular in the areas of enterprise restructuring and privatisation, liberalisation of the energy market, education and labour markets flexibility would be supportive to the fulfilment of the second Copenhagen economic criteria over the medium term.

Table II.3.4:

Net direct budgetary impact of key reform commitments (EUR million)

Description of the Policy	2008	2009	2010	2011
1. Labour market	-696.8	-791.7	-897.0	-950.0
2. Agriculture	-1,953.9	-1,818.0	-11.5	0.0
3. Regional Development	-29.2	-66.1	-58.7	-54.9
4. Health and social security	33.6	75.5	100.0	100.0
5. Transportation	-2.1	-2.2	-0.4	-143.0
6. Energy	0.0	-	-	-
Total impact on the budget	-2,648.4	-2,602.5	-867.6	-1,047.9
Total impact on the budget (in % of GDP)	-0.7	-0.7	-0.2	-0.2

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

3.6.1. Product and capital markets

The PEP 2009-2011 touches upon the following main reform areas related to the functioning of product markets: strengthening of competition policy and state aid control, privatisation, enterprise restructuring (railway sector, shipbuilding) and SME development. Further progress has been achieved in the area of competition policy and state aid control. The PEP envisages a continuation of measures aimed at a strengthening of the legal and institutional framework and a further harmonisation with EU requirements, which is welcome. The PEP rightly highlights the successful continuation of the privatisation process during 2007. Privatisation revenues amounted to USD 7.5 billion[1] in the year up to November 2007. Such strong continuation of privatisation inflows constitutes a real achievement and is in stark contrast to the low levels attained in earlier years. However, despite strong inflows, delays have been encountered in certain sectors compared to what was envisaged in the 2006 PEP. For several companies the sales procedures have taken longer than expected. The PEP outlines important sectors and companies for which privatisation efforts are envisaged to continue during the programme period. These are, for example, banks, games of chance, ports and activities related to the sugar and petrochemical industry.

There is a risk that further delays will occur during the programme period compared to the outlined plans. After two years of relatively intensive privatisation, the remaining portfolio of state-owned enterprises is likely to be more challenging to privatise: it is concentrated in areas where privatisation can be seen as more sensitive. This seems to be for example the case for the energy sector, where tenders were launched in early 2009 for the privatisation of electricity distribution companies through transfer of operation rights. In addition, efforts are being made to privatise power distribution and generation simultaneously, which may be complicated by the fact that the sector is characterised by cross-subsidisation and that the privatisation of the distribution network may suffer from low profitability caused by imperfections in the pricing policy.

Concerning the area of competition law and policies, no progress since the 2007 PEP has been achieved in putting in place a consistent monitoring of state aids. The lack of regulation and monitoring of state aids continue to affect transparency and the overall competitive environment negatively. Further steps have been taken to improve the business environment. One positive development is the facilitation and simplification of the licensing process. A well-established policy framework, including for example, via the Investment Advisory Council, continues to support the reform process and to identify the problematic issues for investors. However, the PEP contains very limited information on issues that will be addressed over the programme period.

In the field of banking, the harmonisation with EU and Basel II regulatory frameworks has not been advanced as planned. A 25% share of the Halkbank's capital has been sold to private investors in February 2007. However, a concrete times schedule for the privatisation of the largest state bank, Ziraat Bank, has been delayed. But overall, the past and planned measures are supportive of the overall positive developments in the sector. Despite the demonstrated improved resilience of the Turkish banking sector to severe market fluctuations, a continued strengthening of supervision will be important to further decrease risks in particular in the context of the still rapidly growing banking operations. Concerning capital markets, several legal acts were put into effect in order to protect investors in capital markets and create a more stable and efficient market in line with the EU acquis. The programme gives a thorough overview of recent and planned measures aimed to align the financial sector legislation and in particular prudential regulations with EU requirements. This process appears to be well on track. Moreover, the banking sector has become more resilient as a result of a number of specific supervisory measures that have been taken to address potential macro-financial vulnerabilities. Additional capital requirements were imposed on fast-growing banks, and risk weights

[1] This currency denomination is the choice of the programme itself.

on un-hedged foreign currency loans were increased. Banks' capital adequacy, asset quality and profitability have remained at comfortable levels. One would have expected the programme to discuss in more detail the new challenges for domestic financial and capital markets in the context of the global financial crisis and the possible policy responses to mitigate risks for financial sector stability.

3.6.2. Labour market

Like in previous years, the programme underlines the main problems and challenges in the Turkish labour market, such as the very low participation rates, the contraction of employment in the agricultural sector and the growing young population. It also shows that there has been no significant improvement in unemployment or participation rates since the last PEP. The programme strongly emphasises the link between the labour market and the education sector and the need to reduce the skills mismatch between labour demand and supply. The overall educational attainment levels of the labour force are still low, despite improvements during the past decade. Since the submission of the last PEP, some measures have been taken, for example to allow graduates from vocational high schools to switch to specific baccalaureate programmes more smoothly and to increase the availability of higher education. Looking forward over the programme period, the PEP is quite vague on concrete measures that will be taken to further improve educational standards, apart from continuing the Privatization and Social Support Project and the Basic Education Programme. There is insufficient information about the planned scope for active labour market policies or the resources which will be put aside for this purpose.

Non-wage labour costs remain high and the regulations of the labour market rigid, protecting workers rather than jobs. Tackling these issues in a more systematic way would be supportive of addressing the identified challenges in the labour market, reduce informality, and support the creation of jobs in the challenging transformation period ahead. The programme proposes to reduce the cost of employment by introduction of some measures, but these seem rather minor and the timing is not clear.

3.6.3. Other reform areas

The PEP outlines a wide range of areas where reform efforts have been ongoing and are foreseen to continue over the programme period. Further efforts have been made to improve efficiencies in the agricultural sector, the public administration, the health and social security system, transportation, and some other smaller areas, which are yielding positive results, e.g. for the budgeting process and transparency. However, the information provided in the PEP appears in many cases rather piecemeal and often further steps to be taken in these areas remain vague. Local governments' reform is important in order to strengthen their role and abilities to perform the needed services. Legal reforms have proceeded, but the PEP acknowledges that there are deficiencies in the capacity to implement laws at the local level.

A large number of efforts have been ongoing aiming to raise the efficiency and production standards in the agricultural sector. For example, further reforms took place concerning agricultural support policies and support for rural development investments. Work continued within the project to prepare for the implementation of the EU's Common Agricultural Policy. The agricultural sector remains relatively inefficient and highly labour intensive, implying a large scope for reforms yielding improvements. The significant reduction in agricultural employment over the past year highlights that the transformation process is continuing, partly supported by policies but also driven by market forces. The PEP outlines the budgetary effects of a number of planned reforms in the agricultural sector. Several projects are estimated to carry relatively large positive net effects on the budget, thereby limiting the overall net costs for agricultural reforms, but it is unclear from the programme how these funds will be generated.

Table II.3.5:

Annex: Structural indicators

	TURKEY					EU 27				
	2004	2005	2006	2007	2008	2004	2005	2006	2007	2008
General economic background										
Real GDP [1]	9.4	8.4	6.9	4.5	1.1	2.5	2.0	3.1	2.9	1.4
Labour productivity [2]	53.9	58.0	61.8	64.0	63.7	100	100	100	100	100
Real unit labour cost [3]	n.a.	n.a.	n.a.	n.a.	n.a.	-1.4	-0.6	-1.1	-0.8	-1.6
Real effective exchange rate [4]	108.1	113.8	123.2	120.6	130.3	101.2	107.5	106.4	107.9	114.0
Inflation rate [5]	10.1	8.1	9.3	8.8	10.4	2.0	2.2	2.2	2.3	3.7
Unemployment rate [6]	10.3	10.2	8.4	8.5	n.a.	9.0	8.9	8.2	7.1	7.0
Employment										
Employment rate [7]	46.1	46.0	45.9	45.8	n.a.	63.0	63.6	64.5	65.4	n.a.
Employment rate - females [8]	24.3	23.8	23.9	23.8	n.a.	55.5	56.3	57.3	58.3	n.a.
Employment rate of older workers [9]	33.2	31.0	30.1	29.5	n.a.	40.7	42.3	43.5	44.7	n.a.
Long-term unemployment [10]	3.5	3.5	2.5	2.2	n.a.	4.2	4.1	3.7	3.0	n.a.
Product market reforms										
Relative price levels [11]	59.1	66.7	66.3	71.5	n.a.	100	100	100	100	100
Total trade-to-GDP ratio [12]	20.2	19.8	21.6	21.1	n.a.	9.0	9.8	10.7	10.7	n.a.
Net FDI [13]	0.5	1.2	2.0	3.1	n.a.	0.9	1.7	2.2	3.4	n.a.
Market share electricity [14]	39.0	38.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Sectoral and ad-hoc state aid [15]	n.a.	n.a.	n.a.	n.a.	n.a.	0.6	0.6	n.a.	n.a.	n.a.
Business investment [16]	28.4	17.4	13.3	5.5	n.a.	17.2	17.7	18.2	18.7	n.a.
Knowledge-based economy										
Tertiary graduates [17]	5.6	5.7	6.2	n.a.	n.a.	12.5	13.2	13.0	n.a.	n.a.
Spending on human resources [18]	4.1	n.a.	n.a.	n.a.	n.a.	5.1	5.0	n.a.	n.a.	n.a.
Educational attainment [19]	42.0	44.0	44.7	46.4	n.a.	77.1	77.5	77.9	78.1	n.a.
R&D expenditure [20]	0.5	0.6	0.6	n.a.	n.a.	1.8	1.8	1.8	1.8	n.a.
Broadband penetration rate (EU25) [21]	n.a.	n.a.	n.a.	n.a.	n.a.	6.5	10.6	14.8	19.0	n.a.

1. Growth rate of real GDP in %. 2. Labour productivity per person employed - GDP in PPS per person employed relative to EU-25 (EU-25=100). 3. Ratio of compensation per employee to nominal GDP per person employed, total economy, annual percentage change. 4. Vs IC36 (1995 = 100), current year's values are based on Commission's forecast deflator figures, nominal unit labour cost deflator. 5. Annual average rate of change in Interim Harmonized Indices of Consumer Prices (HICPs). 6. Unemployed persons as a share of the total active population. 7. Employed persons aged 15-64 in % of total population of the same age group. 8. Employed women aged 15-64 in % of total female population of the same age group. 9. Employed persons aged 55-64 in % of total population of the same age group. 10. Long-term unemployed (over 12 months) in % of total active population aged 15-64. 11. Comparative price levels of final consumption by private households including indirect taxes (EU-25=100). 12. Trade integration - Average value of imports and exports of goods divided by GDP. 13. In % of GDP, EU-25 = Average value
of inward and outward FDIs flows in % of GDP. 14. Market share of the largest generator (% of total net generation). 15. In % of GDP. 16. Gross fixed capital formation by the private sector in % of GDP. 17.Tertiary graduates in science and technology per 1000 of population aged 20-29. 18. Public expenditure on education in % of GDP. 19. Percentage of the population aged 20 to 24 having completed at least upper secondary education. 20. GERD (Gross domestic expenditure on R&D) - in % of GDP. 21. Percentage of households who have Broadband access at home.

f: forecast, e: estimated value, p: provisional value, b: break in series, s: Eurostat estimate, r: revised value, q: estimated from quarterly values.

Source: Commission services.