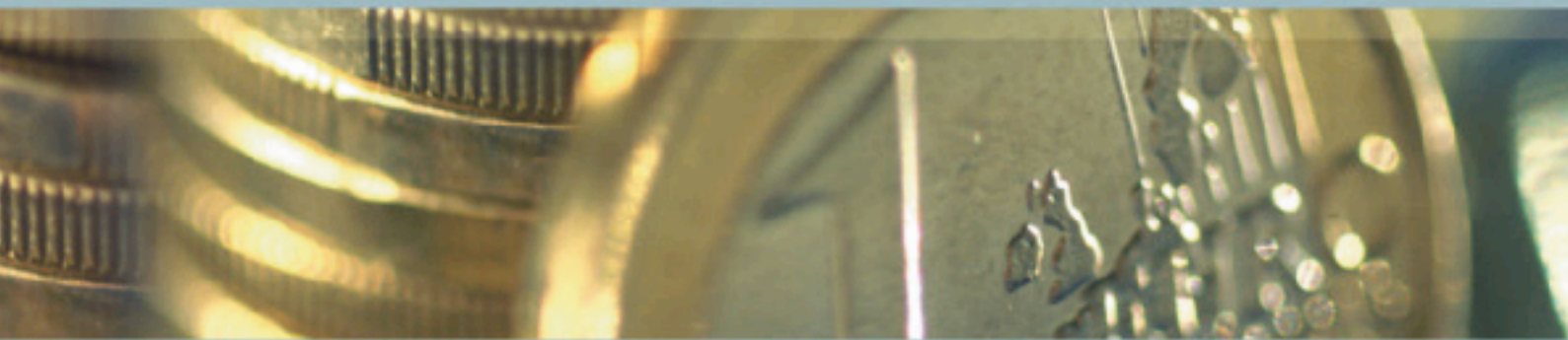


# EUROPEAN ECONOMY

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## 2011 Pre-accession Economic Programmes of candidate countries: EU Commission assessments

Directorate-General for Economic and Financial Affairs

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European Commission

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## Occasional Papers

2011 Pre-Accession Economic Programmes of  
candidate countries: EU Commission's assessments



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## INTRODUCTION

In this Occasional Paper the Directorate General for Economic and Financial Affairs publishes its overview and assessments of the 2011 Pre-accession Economic Programmes of the candidate countries (Croatia, the former Yugoslav Republic of Macedonia, Iceland, Montenegro 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 five countries have published their 2011 programmes, which can be found on the web under following addresses:

Croatia

<http://www.mfin.hr/adminmax/docs/2010%20-%20Pre-Accession%20Economic%20Programme.pdf>

The former Yugoslav Republic of Macedonia

[http://www.finance.gov.mk/files/u9/1\\_PEP\\_2011\\_2013\\_angl\\_final\\_08\\_02\\_2011\\_za\\_web\\_0.pdf](http://www.finance.gov.mk/files/u9/1_PEP_2011_2013_angl_final_08_02_2011_za_web_0.pdf)

Iceland

<http://eng.efnahagsraduneyti.is/Publications/nr/3199>

Montenegro

<http://www.mf.gov.me/en/news/102868/Montenegro-Economic.html>

Turkey

<http://www.dpt.gov.tr/PortalDesign/PortalControls/WebIcerikGosterim.aspx?Enc=83D5A6FF03C7B4FCCB2785FFCF87746E>

These assessments were prepared in the Directorate-General for Economic and Financial Affairs under the guidance and coordination of Carole Garnier. The principal authors were Hans Berend Feddersen (Croatia), Bernhard Böhm (the former Yugoslav Republic of Macedonia), Uwe Stamm (Iceland), Antonio Sanchez Pareja (Montenegro) and Dirk Verbeken (Turkey).

The programmes and this assessment were discussed at experts' level in two multilateral meetings held in Brussels on 28 April and 5 May 2011 and at ministerial level during the ECOFIN Council on 17 May. Representatives from EU Member States, the ECB, the Commission and the candidate countries attended this meeting.

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# Part I

## Overview



# 1. OVERVIEW

## 1.1. SUMMARY AND CONCLUSIONS

Croatia, the former Yugoslav Republic of Macedonia, Turkey and, for the first time, Iceland were invited to submit their annual Pre-accession Economic Programmes (PEPs) covering the period 2011-2013 by 31 January 2011. Having been granted candidate status by the European Council's decision of 17 December 2010, Montenegro submitted an Economic and Fiscal Programme (EFP) covering the period 2011-13 which is being presented and assessed together with the four PEPs. The preparation, assessment and discussion of these programmes serve to strengthen the economic planning capacity in the countries and to prepare them for their eventual participation in the economic policy co-ordination and budgetary surveillance mechanisms of Economic and Monetary Union (EMU).

The programmes provide an overview of economic policy plans over a broad range of issues. In particular, they show the governments' intentions to further advance structural reforms, enhance productivity and align with the EU's *acquis* and best practices with a view to achieve high growth in order to catch up with, and prepare for EU membership. However, the degree of ambition and precision in policy implementation across the programmes varies.

The macroeconomic frameworks of all candidate countries are in line with last year's programmes, expecting a positive economic growth in 2011 and a further acceleration in 2012 and 2013. The fiscal frameworks of all countries foresee a continuous decline in fiscal deficits. Montenegro and Iceland project a budget surplus by 2013. Like in previous submissions, the structural reform agendas reveal a varying focus and degree of ambition.

The Croatian PEP presents a comprehensive medium-term macroeconomic and fiscal framework projecting a relatively realistic macroeconomic scenario. It foresees moderate output growth, relatively low inflation and a widening of the current account deficit over the programme period. The budgetary strategy is reasonably ambitious and generally consistent with the macroeconomic forecast. However, the budget deficit is projected to increase in 2011, pushing the planned fiscal consolidation forward to the outer years. The credibility of the fiscal programme would have benefited from more concrete information regarding the measures intended to rein in current spending. As in previous years, the challenge for policymakers will be to meet the planned budgetary targets. The presentation of structural reforms is mainly backward-looking and a clear link between core objectives and specific measures is rarely established.

The programme of the former Yugoslav Republic of Macedonia is based on a plausible economic scenario for 2011 but may be slightly on the optimistic side as regards growth acceleration in the outer years. The fiscal strategy outlined in the programme appears feasible and foresees an increase in the share of capital spending, while keeping deficits low and public debt on a sustainable path. The PEP lays out a sufficiently comprehensive structural reform programme which is in line with the country's structural challenges and EU accession requirements but would have benefited from more explicit policy priorities. While the quality of the presented data has improved, the analysis and comparability is strongly hampered by the weak alignment with ESA 95 methodology.

The macroeconomic scenario underlying Iceland's first PEP appears to be somewhat optimistic. The primarily investment-led economic growth is expected to turn to positive territory in 2011 and accelerate in the outer years. The outlook for inflation seems to be broadly reasonable, while the external imbalance is set to broaden over the programme period. The fiscal framework presented in the programme foresees a balanced budget in 2012 and a surplus in 2013 which is in line with the government's objective to pursue fiscal consolidation over the medium-term and represents an appropriate response to the vulnerabilities arising from the huge public debt stock. The strong, front-loaded fiscal adjustment is ambitious and relies on a reduction primarily in the current spending ratio.

While the 2011 budget seems sufficiently backed by concrete fiscal measures, the credibility of the fiscal programme beyond 2011 could be strengthened by providing more information on expenditure measures and their quantitative effects. Moreover, the link between the structural reform priorities and the realisation of the fiscal targets could be elaborated in more detail. Although the programme addresses a broad range of structural challenges, the emphasis is on past achievements, with limited explanation of the future measures needed to tackle the key structural priorities.

Montenegro's baseline macroeconomic outlook appears to be broadly plausible and somewhat more cautious than in the previous programme. It is accompanied by two alternative scenarios illustrating potential upside and downside risks. The decline in the current account deficit seems, however, to be based on rather optimistic assumptions concerning growth in exports and stability of imports. The fiscal strategy aims at achieving a budget surplus in 2013, through a gradual reduction of expenditures in real terms. Key revenue and expenditure measures for 2011 are broadly explained, while the information for the outer years remains less detailed. Although the scope for improvement remains, this year's programme displays a notable progress in spelling out the structural reform agenda, including an evaluation of the budgetary impact.

The Turkish PEP presents a comprehensive medium-term macroeconomic framework. The programme's overarching objectives are largely appropriate. However, the projections for key variables in the Turkish PEP as well as the policy-mix would have benefited from updating in the light of recent developments. The medium-term scenario is plausible, albeit rather optimistic, especially with respect to the pace of disinflation and the widening of the external imbalances. The programme's fiscal strategy is characterised by a gradual reduction of the budget deficit which is expected to contribute to disinflation and public debt sustainability. The fiscal policy objectives appear to be realistic, although not sufficiently ambitious. Structural reforms, as presented in the PEP, aim at enhancing the competitiveness of Turkey's key economic sectors. Although displaying the appropriate priorities, the programme's structural reform agenda is insufficiently linked to the fiscal scenario.

This exercise of submitting, assessing and discussing annual PEPs will continue to support the countries in preparing for accession. 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 enhance 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 notably a macro-economic scenario, a fiscal framework and a structural reform agenda.

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 programmes are in line with 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.

### 1.3. THE 2011 PROGRAMMES

Countries were requested to submit their programmes by 31 January 2011. All countries except Turkey complied with this deadline. All five programmes have been made public <sup>(1)</sup>.

According to the programmes, economic growth in 2010 <sup>(2)</sup> is estimated to have been strong in Turkey at 6.8% and to a lesser extent in the former Yugoslav Republic of Macedonia and Montenegro at 2% and 0.5%, respectively. On the other hand, real GDP continued to contract by 3% in Iceland and 1.6% in Croatia. For 2011, all countries expect to register a positive economic growth. Turkey is set to post the strongest real GDP growth at 4.5% and thereafter to accelerate to 5.5% by end of the programme period. Economic growth in the former Yugoslav Republic of Macedonia is forecast at 3.5% in 2011 and is expected to accelerate to 5.5% by 2013. Montenegro's programme anticipates real GDP growth to grow at a faster pace from 2.5% in 2011 to 4% in 2013. Similarly, economic activity in Iceland is foreseen to follow a gradual pick-up from 1.9% in 2011 reaching 3% in 2013. The macroeconomic outlook for Croatia is more cautious. Output growth is expected to amount to 1.5% in 2011 and to increase to 2.5% by 2013.

All programmes envisage economic growth to be driven mainly by domestic demand, based on expected improvements in consumer confidence and a turnaround in investment. This domestically-led growth translates in a widening of the current account deficits in all countries, except Turkey and Montenegro. Overall, the programmes' assumptions still tend to be somehow on the optimistic side. Although the degree of uncertainty may have declined, compared to last year's submission, there are downside risks to the macroeconomic outlook which include in particular slow progress with household and corporate debt restructuring, future performance of external demand, heightened

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<sup>(1)</sup> Croatia:

<http://www.mfin.hr/adminmax/docs/2010%20-%20Pre-Accession%20Economic%20Programme.pdf>

The former Yugoslav Republic of Macedonia:

[http://www.finance.gov.mk/files/u9/1\\_PEP\\_2011\\_2013\\_angl\\_final\\_08\\_02\\_2011\\_za\\_web\\_0.pdf](http://www.finance.gov.mk/files/u9/1_PEP_2011_2013_angl_final_08_02_2011_za_web_0.pdf)

Iceland:

<http://eng.efnahagsraduneyti.is/Publications/nr/3199>

Montenegro:

<http://www.mf.gov.me/en/news/102868/Montenegro-Economic.html>

Turkey:

<http://www.dpt.gov.tr/PortalDesign/PortalControls/WebIcerikGosterim.aspx?Enc=83D5A6FF03C7B4FCCB2785FFCF87746E>

<sup>(2)</sup> Since the submission of the programmes, revised real GDP growth data for 2010 have been published as follows: Croatia - 1.2%, the former Yugoslav Republic of Macedonia 0.7%, Iceland -3.5%, Montenegro 1.1% and Turkey 8.9%.

**Table 1.1.1:**  
**Pre-Accession Economic Programmes 2009-2013**  
**Key indicators**

	2009	2010	2011	2012	2013
<b>Real GDP growth (% change)</b>					
Croatia	-5.8	-1.6	1.5	2.0	2.5
The former Yugoslav Republic of Macedonia	-0.9	2.0	3.5	4.5	5.5
Iceland	-6.8	-3.0	1.9	2.9	3.0
Montenegro	-5.7	0.5	2.5	3.5	4.0
Turkey	-4.7	6.8	4.5	5.0	5.5
<b>Unemployment rate (% , LFS)</b>					
Croatia	9.1	12.0	11.7	10.8	10.0
The former Yugoslav Republic of Macedonia	32.2	32.0	30.6	29.4	27.6
Iceland	8.0	8.1	7.2	5.6	4.5
Montenegro	11.4	11.6	11.1	10.3	9.2
Turkey	14.0	12.2	12.0	11.7	11.4
<b>Current account balance (% of GDP)</b>					
Croatia	-5.5	-2.8	-3.8	-4.7	-5.7
The former Yugoslav Republic of Macedonia	-6.7	-3.6	-4.3	-5.7	-6.3
Iceland	-2.2	-2.9	-3.6	-4.9	-5.8
Montenegro	-30.1	-24.6	-19.3	-18.2	-17.3
Turkey	-2.3	-5.4	-5.4	-5.3	-5.2
<b>Inflation (CPI, annual % change)</b>					
Croatia	2.4	1.1	2.2	2.5	2.5
The former Yugoslav Republic of Macedonia	-0.8	1.6	3.0	3.0	3.0
Iceland	12.0	5.4	2.5	2.6	2.4
Montenegro	3.4	0.7	2.5	2.5	2.5
Turkey	6.5	6.4	5.5	5.0	5.0
<b>General government balance (% of GDP)</b>					
Croatia	-4.1	-5.2	-5.6	-3.9	-2.4
The former Yugoslav Republic of Macedonia	-2.7	-2.5	-2.6	-2.2	-1.9
Iceland	-9.9	-6.0	-2.6	0.1	2.8
Montenegro	-5.7	-4.0	-2.4	-0.1	1.7
Turkey	-5.5	-3.7	-2.1	-1.8	-1.1
<b>General government gross debt (% of GDP)</b>					
Croatia	35.4	41.6	44.2	46.3	46.7
The former Yugoslav Republic of Macedonia	23.7	24.0	26.0	26.1	25.5
Iceland	92.5	96.3	100.8	94.4	88.7
Montenegro	38.2	41.8	42.9	40.9	37.5
Turkey	45.5	42.3	40.6	38.8	36.8

Source: Pre-Accession Economic Programme (PEP) 2011

consumption outlays will drive the consolidation. The approaches are quite different among the countries as regards the sequencing of the fiscal adjustment within the programme period. In Iceland, the deficit adjustment is spread almost evenly between 2011 and 2013. Montenegro's consolidation will reach a peak in 2012, while in the former Yugoslav Republic of Macedonia and Croatia the adjustment appears to be back-loaded, taking place primarily in 2012-2013. In the case of Turkey, the largest reduction in the budget deficit is set to take place in 2011.

Like in previous submissions, the structural reform agendas reveal a varying focus and degree of ambition. All programmes would in general have benefited from a closer link between reform measures and the fiscal framework. Furthermore, except for the former Yugoslav Republic of Macedonia and Montenegro, the reform priorities set in the programmes do not appear to be fully aligned with accession-related priorities, as described in the Commission's progress reports, Opinion

inflationary pressures and the evolution of capital inflows, notably workers' remittances and FDI inflows. All countries are projecting fiscal consolidations leading to improvements in the budget deficit over the programme horizon. Iceland is expected to undergo the largest fiscal adjustment, equivalent to an improvement of almost 9 percentage points of GDP, as the fiscal deficit of 6% of GDP projected for 2010 is envisaged to turn into a surplus of 2.8% by 2013. Montenegro is also projecting a budget surplus of 1.7% in 2013 which translates in an adjustment of 5.7 percentage points of GDP. The Croatian programme projects a decline of 2.9 percentage points in the government deficit, from 5.2% of GDP in 2010 to 2.3% by 2013. Turkey's fiscal deficit is foreseen to steadily decline from 3.7% of GDP in 2010 to 1.1% in 2013. In the case of the former Yugoslav Republic of Macedonia, the deficit is set to fall by 0.6 percentage points of GDP, reaching 1.9% of GDP in 2013. For all countries, the fiscal adjustment will primarily be driven by a reduction in the expenditure-to-GDP ratio. In the case of Croatia, reductions in public consumption and social transfers will be the main sources for the fiscal adjustment, while in the case of Turkey and Iceland lower public consumption spending will be the largest contributor. In the former Yugoslav Republic of Macedonia, restraint in transfers and public



and the European Partnership documents. In the case of Croatia, the programme would have benefited in particular from increasing efforts to speed up enterprise restructuring, improve education and enhance the functioning of labour markets. Iceland's programme is largely backward looking and contains few concrete structural reform measures to address the country's key structural priorities. For the former Yugoslav Republic of Macedonia, the structural reform programme is in line with the country's overall structural challenges but the PEP is not explicit on the government's reform priorities. Montenegro's structural reforms package covers a wide range of economic sectors notably a review of the pension system, restructuring of strategic industries, public administration reform and privatisation. The structural reforms in Turkey's PEP aim at enhancing the international competitiveness of key economic sectors programme as well as measures to increase the efficiency in the private sector and in the public administration. Like in previous submissions, however, the programmes are often very detailed when describing past developments and rather ambiguous when explaining future plans. In addition, the links between the outlined structural reforms and the macroeconomic and fiscal frameworks are not always clearly discussed. Overall, the full and determined implementation of the proposed reforms should strengthen the economies of the candidate countries, in particular in view of their increasing EU integration.

#### 1.4. 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<sup>(3)</sup>. Clearer and more convincing information on the specific implementation of these objectives would have been useful in some cases.

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

#### 1.5. FOLLOW-UP

The programmes and their assessments by the Commission services will be 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 will take place on 28 April 2011 and discuss and assess the individual programmes. On 5-6 May, a High-level meeting between the EFC and representatives of the candidate countries will be held and the draft conclusions prepared at the Alternates level will be endorsed. The Ministerial Meeting between the ECOFIN and their counterparts from the candidate countries is scheduled for 17 May 2011 and intends to adopt and publish the conclusions on the programmes of the Candidate Countries.

This exercise has been, since its start, an annual one. Therefore, the countries will again be invited to submit a programme, covering the period 2012-2014.

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<sup>(3)</sup> So far, the Commission considers Croatia, Iceland and Turkey to have achieved the status of a 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 continued to move closer towards becoming a functioning market economy. To become a functioning market economy, Montenegro needs to address internal and external imbalances, as well as existing weaknesses, notably in the financial sector and the functioning of labour markets, and strengthen the rule of law.



# Part II

Country analysis

# 1. CROATIA

## 1.1. EXECUTIVE SUMMARY

Croatia's seventh Pre-Accession Economic Programme ("PEP 2011-2013") presents a comprehensive medium-term macroeconomic and fiscal framework based on the projection of a relatively slow recovery from the severe recession in 2008-2010. The programme's fundamental objective is the maintenance of macroeconomic stability and the creation of conditions for recovery and sustainable economic growth. The document largely complies with the formal requirements and appears broadly consistent with earlier key policy documents and the 2011 state budget.

Macroeconomic performance in 2010 was still marked by recession. The economy contracted for most of the year albeit to a diminishing degree. Annual GDP is now estimated to have declined 1.2% year-on-year which is significantly less than the 6.0% drop in 2009. Employment fell sharply, pushing up the unemployment rate by about 3 percentage points. Consumer price inflation declined to an annual average of 1.1% as inflationary pressures subsided further in the context of considerable slack in resource utilisation. Against the background of depressed domestic demand the current account deficit fell to 1.3% of GDP. Gross external debt, a major challenge for macroeconomic performance, rose to just above 100% of GDP by the end of 2010. Following the budget revision last August, the fiscal deficit of general government was set at 5.2% of GDP for 2010, up from 4.1% in the preceding year. According to preliminary information from the Ministry of Finance, this budgetary target has been broadly met.

Looking forward, the PEP projects a macroeconomic scenario for 2011-2013 with moderate output growth and relatively low inflation. Real GDP is seen to accelerate gradually from 1.5% growth in 2011 to 2.5% in 2013. The unemployment rate is projected to recede from the peak in 2010 by 2 percentage points over three years. Consumer price inflation is expected to stabilise at 2.5%. The current account deficit will widen again to more than 5% of GDP by 2013 as imports recover in parallel with domestic demand. Since nominal GDP is projected to increase roughly in line with external debt, the latter will remain close to 100% of GDP. Overall, the macroeconomic scenario is internally consistent and appears relatively realistic. However, the programme would have benefited from a more detailed assessment of risks, especially since recently released data suggest that growth in the near term may be weaker than expected in the PEP.

Croatia's fiscal performance in 2010 fell short of the projections presented in "PEP 2010-2012" which had been based on the December 2009 state budget and the assumption of a quick return to economic growth. Contrary to this assumption, the recession dragged on, resulting in lower-than-expected tax revenues. Furthermore, a number of policy measures in the spring of 2010 added to the budgetary shortfall. Consequently, the budget had to be revised in August which increased the general government's projected net borrowing from 3.3% to 5.2% of GDP. Following the 2011 state budget, the "PEP 2011-2013" does not foresee any fiscal consolidation in the current year in terms of the fiscal deficit of general government. Mainly as a consequence of last year's changes in the tax regime, net borrowing is expected to rise to 5.6% of GDP. Realizing even this deficit target will require a determined and sustained effort to rein in expenditures – a challenge which has proved difficult to meet in the past. In 2012 and 2013, when the provisions of the new Fiscal Responsibility Law will take hold on the budget, the deficit is projected to decline to 3.9% and 2.4% of GDP, respectively. Overall, the public finance scenario is consistent with the macroeconomic forecast in general. The challenge for policymakers will be to implement the measures needed to rein in public expenditures and to meet the planned budgetary targets. If the projected scenario is realised, Croatia will move closer to achieving medium-term fiscal sustainability.

The PEP covers a range of structural reform areas, such as the enterprise and financial sectors, labour market, agricultural sector, public administration, education, health care, the judiciary and environmental protection. The presentation is often backward looking, providing information on past and ongoing reform measures and initiatives with a strong emphasis on legislative action and EU harmonisation. The programme does not fully and consistently establish a clear link between the core objectives and the instruments and measures described. To serve as useful guidance for the implementation of structural reforms, the programme would benefit from the definition of clear objectives, specific measures and concrete time frames for implementation. More emphasis should have been given to measures urgently needed to improve the business environment in view of the significant regulatory and 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 is generally weak. Intensified efforts to speed up the implementation of reforms, in particular in the areas of enterprise restructuring, education and labour markets would help to increase the economy's growth potential and international competitiveness over the medium and longer term.

Although the macroeconomic scenario is close to the recent mainstream view among economic forecasters, the risks regarding the growth prospects appear to be concentrated on the downside, particularly in view of developments in early 2011. High frequency data suggest that economic activity has weakened again in the winter months. The surge in the price for crude oil in the first quarter may put a damper on growth, at least temporarily. The relatively high level of interest rates could restrain domestic demand more than expected. Regarding structural reforms, it may not be possible to muster the necessary political support, particularly on labour market and pension reforms. The same applies to measures needed to reduce the fiscal deficit. A particular risk regarding the chances of implementing the envisaged measures are the parliamentary elections which have to be held in March 2012 at the latest.

*Table II.1.1:  
Comparison of key macroeconomic and budgetary projections*

		2009	2010	2011	2012	2013
Real GDP growth (% change)	COM	-5.8	-1.8	1.5	2.1	n.a.
	<b>PEP 2011</b>	<b>-5.8</b>	<b>-1.6</b>	<b>1.5</b>	<b>2.0</b>	<b>2.5</b>
Consumer price inflation (%)	COM	2.4	1.1	1.8	2.0	n.a.
	<b>PEP 2011</b>	<b>2.4</b>	<b>1.1</b>	<b>2.2</b>	<b>2.5</b>	<b>2.5</b>
General government balance (% of GDP)	COM	-4.1	-5.7	-6.1	-5.6	n.a.
	<b>PEP 2011</b>	<b>-4.1</b>	<b>-5.2</b>	<b>-5.6</b>	<b>-3.9</b>	<b>-2.4</b>
Primary balance (% of GDP)	COM	-2.4	-3.7	-3.9	-3.4	n.a.
	<b>PEP 2011</b>	<b>-2.4</b>	<b>-3.3</b>	<b>-3.4</b>	<b>-1.7</b>	<b>-0.2</b>
Government gross debt (% of GDP)	COM	35.4	40.9	45.9	49.9	n.a.
	<b>PEP 2011</b>	<b>35.4</b>	<b>41.6</b>	<b>44.2</b>	<b>46.3</b>	<b>46.7</b>

*Sources: Pre-Accession Economic Programme (PEP) 2011, Commission autumn 2010 forecast (COM)*

## 1.2. INTRODUCTION

Croatia submitted its seventh Pre-Accession Economic Programme on 31 January 2011, following government adoption and earlier consultation of economic and social partners. The programme covers the period 2011-2013 and represents an update of the previous years' submission. It builds on earlier policy documents, such as the "Government Programmes Strategy 2011-2013", the "Economic and Fiscal Policy Guidelines 2011-2013" and the "Economic Recovery Programme" from April 2010.

### 1.3. KEY CHALLENGES

The key challenge for Croatia's economic policy is to provide the conditions for sustainable growth while preserving macroeconomic stability. This requires a strengthening of the economy's international competitiveness through internal structural reforms as macroeconomic policy is heavily constrained by the large external debt and the need for fiscal consolidation. The process of fiscal consolidation requires significant expenditure reforms with a view to restructure current spending towards a more growth-oriented and sustainable pattern. The belated and fragile recovery from the recession has revealed, more clearly than before, the structural weaknesses of the Croatian economy which need to be tackled urgently. The required measures are, in particular, the swift and effective implementation of structural reforms in areas such as privatisation and corporate sector restructuring, labour market, business environment, social security, education, and public administration. The PEP is meant to provide guidance for policymaking and reform implementation.

As pointed out in the Commission's most recent Progress Report on Croatia's accession process which refers to the period from October 2009 to September 2010, structural reforms generally advanced at a very slow pace, not least with respect to privatisation and the restructuring of loss-making enterprises. The investment climate continued to suffer from a heavy regulatory burden and numerous para-fiscal taxes. The labour market remained highly rigid, with low employment and participation rates which declined further during the recession. In the fiscal area, the authorities made limited efforts to contain the rising deficit and to increase the efficiency of public spending. Social transfer payments remained high and not well-targeted and a large number of state-owned enterprises continued to receive state support through direct and indirect subsidies and guarantees. For achieving medium-term fiscal sustainability, it remains a key challenge to improve the budgetary process and discipline and to enhance the efficiency of public spending.

### 1.4. RECENT ECONOMIC DEVELOPMENTS AND MEDIUM-TERM SCENARIO

#### 1.4.1. Recent macroeconomic developments

Recent macroeconomic developments are covered appropriately in the PEP. In the context of the global economic and financial crisis Croatia's economy contracted by 9% between mid-2008 and mid-2010. Although most of this contraction occurred before mid-2009, GDP still declined by 2.3% between the second quarter of 2009 and the second quarter of 2010. The economy seemed to embark on a modest recovery in the third quarter of 2010 when GDP increased by 0.3% year-on-year, but the fourth quarter saw a renewed weakening of economic activity as GDP fell 0.6% in year-on-year terms. Annual growth registered -1.2% following -6.0% in 2009% <sup>(4)</sup>. All components of domestic demand contributed to GDP contraction in 2010, but this was to a large extent offset by improving net exports. Industrial production, after a temporary stabilisation, has resumed its downward trend and was 4.1% lower year-on-year in February 2011. As a consequence of the recession, the current account deficit has narrowed from 9.2% to 1.3% of GDP over two years. Inflows of foreign direct investments have declined commensurate to the current account deficit. At first, the labour market reacted relatively slowly to the decline in output, but in the second quarter of 2010 the unemployment rate surged to a level above 12% of the labour force. Inflation has dropped by about 5 percentage points to around 1% in 2010. In spite of a more favourable external economic environment than projected in last year's PEP, the Croatian economy has been much slower to recover from the recession than expected.

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<sup>(4)</sup> These figures are based on the estimate released by the Central Bureau of Statistics (CBS) on 31 March 2011. In the PEP, which was finalised earlier, annual GDP growth in 2010 was projected to have been -1.6% (see table II.1.1 and II.1.2).

Table II.1.2:

Comparison of macroeconomic developments and forecasts

	2009		2010		2011		2012		2013	
	COM	PEP	COM	PEP	COM	PEP	COM	PEP	COM	PEP
Real GDP (% change)	-5.8	<b>-5.8</b>	-1.8	<b>-1.6</b>	1.5	<b>1.5</b>	2.1	<b>2.0</b>	n.a.	<b>2.5</b>
<i>Contributions:</i>										
- Final domestic demand	-8.6	<b>-8.6</b>	-4.9	<b>-4.5</b>	1.4	<b>1.7</b>	2.3	<b>2.4</b>	n.a.	<b>3.0</b>
- Change in inventories	-1.2	<b>-1.2</b>	-0.7	<b>0.1</b>	0.4	<b>0.2</b>	0.2	<b>0.3</b>	n.a.	<b>0.3</b>
- External balance of goods and services	4.7	<b>4.7</b>	3.9	<b>2.6</b>	-0.3	<b>-0.4</b>	-0.4	<b>-0.7</b>	n.a.	<b>-0.9</b>
Employment (% change)	-1.9	<b>-1.9</b>	-4.3	<b>-3.9</b>	-0.2	<b>0.6</b>	1.0	<b>1.3</b>	n.a.	<b>1.3</b>
Unemployment rate (%)	9.1	<b>9.1</b>	12.5	<b>12.0</b>	12.3	<b>11.7</b>	11.2	<b>10.8</b>	n.a.	<b>10.0</b>
GDP deflator (% change)	3.3	<b>3.3</b>	0.2	<b>0.5</b>	1.2	<b>1.5</b>	1.6	<b>2.2</b>	n.a.	<b>2.3</b>
CPI inflation (%)	2.2	<b>2.4</b>	1.1	<b>1.1</b>	1.8	<b>2.2</b>	2.0	<b>2.5</b>	n.a.	<b>2.5</b>
Current account balance (% of GDP)	-5.4	<b>-5.4</b>	-2.8	<b>-2.8</b>	-3.7	<b>-3.8</b>	-4.7	<b>-4.7</b>	n.a.	<b>-5.7</b>

Sources: Pre-Accession Economic Programme (PEP) 2011, Commission Autumn 2010 forecasts (COM)

#### 1.4.2. Medium-term macroeconomic scenario

The PEP 2011-2013 presents a comprehensive medium-term macroeconomic scenario with projections for key economic variables, covering GDP and its demand components, employment and wages, inflation as well as balance of payments developments. The projected path for GDP growth is significantly lower than in last year's PEP scenario, which had overestimated the economy's ability to recover from the severe domestic recession triggered by the global economic and financial crisis in 2008-2009. Hence, the macroeconomic scenario has become more realistic and does not differ to a large extent from the Commission's autumn 2010 forecast and from most other official and private forecasts made around the same time as the PEP. It is, however, possible that at least some of the factors which have held back the domestic recovery in 2010 will continue to restrain the economy in 2011 and possibly even beyond. This risk is underlined by the somewhat disappointing economic data since the beginning of the year. The programme would therefore have benefited from a more detailed assessment of the risks related to an underestimation of the factors which have impeded growth over the past year. This could, for instance, have been done by presenting an alternative scenario to the baseline macroeconomic scenario.

The external assumptions of the PEP 2011-13 have changed somewhat compared to previous years' programme. World output and trade, as well as export market growth, have been revised upwards which should help domestic growth. The upward revision of the projected oil price by about 10 \$/barrel for 2011 and 2012 has the opposite effect. Negative risks for output growth, inflation and the current account are implied by the fact that the oil price has been significantly higher in the first quarter of 2011 than the projected average price of 90 \$/barrel for 2011.

#### Real sector

The PEP projects that the Croatian economy will revert to positive annual growth rates in the programme period following two years with negative annual growth rates. Real GDP is set to accelerate moderately from 1.5% growth in 2011 to 2.0% in 2012 and 2.5% in 2013. The resumption of growth is driven by domestic demand, including a re-stocking of inventories. Private consumption is expected to grow by 1.8% in 2011 as a result of increased consumer optimism (partly related to the approaching EU membership), somewhat higher household borrowing in combination with slightly decreasing borrowing costs, and a positive wealth effect from an appreciation of household financial assets. In the following two years, consumer spending is expected to receive additional support from rising household income as employment is projected to increase by 1.3% annually and real wages by around 2%. Investment is projected to grow 3.0% in 2011 (following an estimated decline of 11.7% in 2010) and to accelerate slightly during the remainder of the programme years. The need to replace worn-out equipment is given as the main reason for the revival of investment growth, also expected to

be supported by improved credit availability. Exports of goods and services are seen to continue to increase in the 4-5% range in 2011 and 2012 before accelerating to close to 6% in 2013 which is roughly in line with projected growth in Croatia's export markets. Imports are seen to follow a somewhat steeper rise to close to 7% by 2013 from last year's contraction. This means that net exports will contribute negatively to GDP growth throughout the programme period in contrast to the recession years. The labour market is expected to return to modest employment growth in 2011 following the sharp job loss in the preceding year. The unemployment rate is seen to decline by 2 percentage points over three years from 12% in 2010.

The PEP's growth scenario is close to the Commission's autumn 2010 forecast which projected 1.5% GDP growth in 2011 and 2.1% in 2012. Looking at the individual GDP components, the two growth scenarios are also relatively similar. However, the PEP is more optimistic regarding the labour market, where the Commission expects lower wage increases, a later return to employment growth, and somewhat higher unemployment in 2011-2012. The PEP's growth projection for 2011 is also close to the IMF's forecast in the World Economic Outlook from October 2010 (1.6%) and the central bank's forecast from December 2010 (1.4%). However, the economic data released in the first five months of 2011 suggest that it might be difficult for the Croatian economy to meet these projections. GDP declined by 0.6% year-on-year in 2010 Q4. In seasonally adjusted quarter-on-quarter terms this can be estimated to correspond to a decline of about 1% which creates an unfavourable statistical base for annual growth in 2011. Industrial production has trended down again in recent months and was 4.1% lower year-on-year in March. Retail sales data for the first three months of 2011 indicate that consumer spending has not yet revived. Employment has continued to trend down and the rate of registered unemployment increased to a long-term high in January before falling back slightly to 18.2% in April (0.8 percentage points higher year-over-year). These data suggest that the recovery is not yet firmly established, that growth forecasts might be revised down, and that the PEP's growth scenario for 2011 may start to look optimistic regarding both GDP and employment. To the extent that the recent data softness indicates underlying weakness of competitiveness, the PEP's growth forecast for the following two years may also be too optimistic.

## Inflation

Annual average consumer price inflation declined to 1.1% in 2010 from 2.4% in 2009, mainly as a result of the growing slack in resource utilisation transmitted to price- and wage-setting. Most prominently, the compensation of employees fell on an annual level. In the course of 2010 and early 2011 imported inflationary pressures have increased mainly as a result of rising international prices for energy and non-energy commodities. This has lifted the year-on-year increase in consumer prices from below 1% in mid-2010 to 2.4% in April 2011. Core inflation has increased from last year's sub-zero rates to positive numbers in recent months, but remains clearly below headline inflation. Croatia's monetary and exchange rate regime has provided a stable anchor for the inflation performance.

The PEP's inflation scenario for the programme years appears plausible and consistent with the projections for growth and employment. It expects annual average inflation to increase to 2.2% in 2011 and further to 2.5% in the following two years. In addition to imported inflationary pressures already built up and expected to persist in the context of continued global recovery, the projected growth in domestic demand should also contribute to slightly higher inflation<sup>(5)</sup>. The programme considers the main upside risks to this inflation outlook to come from the external side (higher-than-projected commodity prices should the global recovery be stronger than expected and/or dollar appreciation) and from a higher pass-through of already imported inflation to consumer prices. Relatively high producer price inflation over the past year does actually indicate that many producers have cut their margins during the economic downturn which they may try to reverse when the

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(5) The fact that the currently negative output gap is projected to close already in 2012 and become significantly positive in 2013 may warrant some increase in the inflation rate between 2012 and 2013.



economy improves. The oil price increase in the first quarter of 2011 suggests that political unrest in oil-producing countries constitutes an additional upside risk to near-term inflation. Weaker than expected domestic growth is considered to constitute a downside risk to the inflation projection.

### Monetary and exchange rate policy

The programme's basic assumption is that the present policy framework of a tightly managed float and price stability as core objective remains in place. For many years, a stable kuna-euro rate has served the country well in preserving financial stability and in anchoring inflation expectations. The PEP rightly argues that the choice of such a regime is also determined by the economy's small and open nature and a high degree of euroisation of the domestic financial system.

Monetary policy was little changed in 2010. Within the constraint of the exchange rate regime it aimed at maintaining a high level of liquidity to the domestic banking sector to encourage lending to the non-financial sector. The central bank stabilised the kuna-euro exchange rate by intervening on both sides of the market on several occasions in the course of the year. The PEP projects that the kuna-euro rate will remain stable at around 7.30 kuna per euro throughout the programme period.

The financial sector has remained stable over the past year. Bank lending to the private sector increased very slowly and was practically stagnant for the household sector when adjusted for exchange rate changes. The capital adequacy ratio of the banking sector stood at a relatively high level of 18.4% at the end of 2010. However, the ratio of non-performing loans to total loans continued its upward trend which had started with the recession. It registered 11.2% at the end of 2010 compared to 7.8% at the end of 2009 and 4.9% at the end of 2008. The deterioration in the quality of bank loans is most pronounced for corporate loans.

### External sector

The current account deficit declined sharply to 1.3% of GDP in 2010 in the context of depressed economic activity<sup>(6)</sup>. As in the preceding year, imports of goods and services declined, although at a much reduced rate. At the same time, the current account also benefited from a turnaround to growth in exports as the recovery took hold in major foreign markets. It has to be stressed that the sharp narrowing of the current account deficit over the past two years is only a reflection of the severity of the recession and does not signify improving international competitiveness and a gain of market share. Actually, Croatia lost export market share to a significant degree in 2010. Consequently, the PEP projects a renewed worsening of the current account balance for the programme years in parallel with the recovery in domestic economic activity. It is expected that the deficit will widen gradually over the three years to 5.7% of GDP in 2013 which is consistent with the trajectory for output growth and implies that the structural deficit persists unchanged. Although the net inflow of foreign direct investment is projected to stage a partial recovery over the programme period, the share of the current account deficit financed by net FDI inflows in 2013 is projected to be lower than before the recession (64% compared with 75% in 2008). Since nominal GDP is projected to rise at a rate which is only marginally below the current-account-deficit/GDP ratio, the gross external debt to GDP ratio should remain close to the current level of about 100%. Generally, the PEP provides a rather detailed account of the developments in the external accounts in the past few years, but would have benefited from setting out more clearly the determinants of the projected evolution in 2011-2013.

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<sup>(6)</sup> Data reported by the Croatian National Bank in April 2011.

## 1.5. PUBLIC FINANCE

The stated objective of fiscal policy remains the consolidation of public finances. The PEP stresses that the Fiscal Responsibility Law which came into force on 1 January 2011 will be instrumental in achieving this objective. The consolidation of public finances is supposed to interact positively with the achievement of twelve structural reform objectives which are laid down in the document "Strategy of Government Programmes for the 2011-2013 period".

Last year's PEP had projected a narrowing of the fiscal deficit in 2010 to 3.3% of GDP, but this has not been achieved. With the recession dragging on for longer than expected, tax revenues fell far short of projections. As a consequence, the state budget had to be revised in August to take this into account and also some changes to the income tax regime adopted in the first half of the year. Net borrowing of general government has therefore increased from 4.1% of GDP in 2009 to 5.2% in 2010 according to this year's PEP. Recent, but still preliminary, information from the Ministry of Finance indicates that the 2010 budgetary outcome has been close to plan with regard to the overall deficit, but only by keeping public investment expenditure below budget at the order of 0.5 percentage points of GDP.

Looking forward, net borrowing by general government is projected to rise to 5.6% of GDP in 2011 before reversing course and falling to 3.9% in 2012 and 2.4% in 2013. The fiscal consolidation in 2012-2013 is planned to be achieved by reducing total expenditures by 4 percentage points of GDP gradually over three years to 39% of GDP in 2013. Total revenues are projected to remain relatively stable, ranging between 36 and 37% of GDP in the three programme years which is about 1 percentage point lower than in 2010. In this scenario, public debt will rise by a total of 5 percentage points over three years and reach 46.7% of GDP in 2013.

This fiscal strategy appears reasonably ambitious. There are, however, considerable risks that it will not be achieved. First, as mentioned above, the economic growth forecast on which in particular projected tax revenues depend, is more likely to be too high than too low. Secondly, the concrete expenditure reductions, required to implement the strategy, still need to be specified to some extent and to be adopted which may prove politically difficult. Thirdly, the upcoming parliamentary elections constitute a broader political risk that the commitment to the fiscal strategy will diminish after the elections.

### Box II.1.1: The Fiscal Responsibility Law

The Fiscal Responsibility Law, which came into force on 1 January 2011, aims to ensure medium- and long-term sustainability, transparency and discipline for public finances and applies to all bodies of general government. It contains two fiscal rules: an expenditure rule and a balanced budget rule. The expenditure rule stipulates that total expenditures of general government shall be reduced by a minimum of 1% of GDP annually. The expenditure rule will only apply until the primary fiscal balance has been brought back to zero or better. When this has been achieved, the balanced budget rule takes over. This rule aims to keep the cyclically-adjusted primary fiscal balance in balance (or in surplus) throughout the economic cycle. The ultimate objective of these fiscal rules is debt sustainability, i.e. to stabilise and reduce the ratio of public debt to GDP.

The law foresees the possibility that expenditures will exceed the budget and therefore be temporarily inconsistent with the fiscal rules. Such overspending shall be fully offset through expenditure reduction in the following year. Two types of expenditures are excluded from the fiscal rules, viz. expenditures linked to natural disasters and expenditure increases linked to projects co-financed with the EU under IPA programmes. The reporting on the application of the fiscal rules has to be done semi-annually. The fiscal rules have to be applied for the first time in the preparation of the budgets for 2012.

In addition to fiscal rules, the law has some general provisions on financial control to ensure the lawful, authorised and appropriate spending of budgetary funds. This includes the mandatory compilation by the finance ministry of an annual statement of fiscal accountability for the preceding year. Regarding enforcement, it is stipulated that the finance minister shall put his/her mandate at the disposal of the prime minister when the provisions of the law have been violated. The same applies, *mutatis mutandis*, to the heads of the budgetary beneficiaries of local and regional self government units. It is left to the finance ministry to control the enforcement of the law.

Empirical evidence from other countries shows that fiscal performance can be improved by well-designed fiscal rules. Overall, it seems that the new law has the potential to improve Croatia's fiscal performance. It should also facilitate adherence to EMU's fiscal framework upon accession to the EU.

#### 1.5.1. Budget implementation in 2010

Net borrowing by general government increased from 4.1% of GDP in 2009 to 5.2% in 2010 according to the PEP. Subsequent, but still preliminary, information from the Ministry of Finance about the 2010 budget execution indicates that the deficit target has been broadly met. According to the PEP, the budgetary deterioration between 2009 and 2010 took place on the revenue side where income tax revenues and, to a lesser extent, social contributions, declined. This was mainly the consequence of the continuing economic contraction and the associated rise of unemployment. Overall, revenues decreased by 3.0% year-on-year and their share of GDP fell by 0.7 percentage points. Although total expenditures were reduced by 0.2% according to the PEP, their share of a declining GDP increased by 0.4 percentage points.

Like in 2009, the budget performance failed to meet the original budget proposal by a wide margin in 2010. The most important reason was the overly optimistic macroeconomic forecast which had projected 0.5% real GDP growth which compares with -1.6% in the PEP (and the recent official estimate of -1.2%). A number of discretionary policy measures, particularly regarding the tax regime, added to the budgetary shortfall. The original budget, which had been adopted in December 2009 and provided the basis for last year's PEP, operated with a budgetary deficit for general government corresponding to 3.3% of GDP. According to this year's PEP, the deficit is 1.9 percentage points higher at 5.2% of GDP. Revenues had been projected to rise by 1.5% compared to 2009, but fell instead by 3.0%. The main items responsible were income tax revenues, social contributions and

VAT. Total expenditures had been projected to fall by 0.5%, but fell only by 0.2%. The reduction of the nominal GDP growth forecast from +2.3% in last year's PEP to -1.1% in this year's PEP has augmented the rise in the projected budget deficit when expressed as a share of GDP.

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

	2009	2010	2011	2012	2013	Change: 2010-13
<b>Revenues</b>	38.5	37.8	36.3	36.8	36.6	-1.2
- Taxes and social security contributions	34.2	33.7	32.3	32.3	32.2	-1.5
- Other (residual)	4.3	4.1	4.0	4.5	4.4	0.3
<b>Expenditure</b>	42.6	43.0	41.9	40.7	39.0	-4.0
- Primary expenditure	40.9	41.1	39.7	38.5	36.8	-4.3
<i>of which:</i>						
Gross fixed capital formation	1.8	1.8	1.9	1.7	1.5	-0.3
Consumption	0.0	0.0	0.0	0.0	0.0	0.0
Transfers & subsidies	19.4	19.9	19.0	18.2	17.5	-2.4
Other (residual)	19.7	19.4	18.8	18.6	17.8	-1.6
- Interest payments	1.7	1.9	2.2	2.2	2.2	0.3
<b>Budget balance</b>	-4.1	-5.2	-5.6	-3.9	-2.4	2.8
- Cyclically adjusted	-1.8	-2.6	-3.2	-1.8	-0.3	2.3
<b>Primary balance</b>	-2.4	-3.3	-3.4	-1.7	-0.2	3.1
<b>Gross debt level</b>	35.4	41.6	44.2	46.3	46.7	5.1

*Sources: Pre-Accession Economic Programme (PEP) 2011. Consumption is part of 'other (residual).'*

#### 1.5.2. Near-term and medium-term budget strategy

The parliament adopted the state budget for 2011 and budget projections for the two following years on 23 November 2010. This provides the main elements for the fiscal scenario in the PEP 2011-2013. The budgetary figures in the PEP, however, are adjusted to comply with the requirement to present budget performance and strategy in terms of general government. For the current year, the authorities envisage a 1.0% fall in total revenues and a 0.4% rise in total expenditures compared with 2010. As a share of GDP, revenues will fall by 1.5 percentage points to 36.3% while expenditures will fall by 1.1 percentage points to 41.9%. Consequently, the fiscal deficit of general government is projected to rise by 0.4 percentage points to 5.6% of GDP. The underlying macroeconomic scenario sets both real GDP growth and inflation (GDP deflator) to 1.5% in 2011.

The main contributing factor to the decrease in overall revenues is lower income tax receipts. This is primarily a consequence of the phased repeal in 2010 of the special crisis tax on salaries, pensions and other receivables which had been imposed in mid-2009. Another reason is last year's change in income tax rates and tax brackets which lowers annual revenues by an estimated 0.3% of GDP. Whether the budgeted revenues for 2011 will materialise to the full extent depends primarily on the fulfilment of projected output and employment growth.

Regarding expenditures, the 2011 budget reflects the conclusion issued by the Croatian parliament in connection with the revision of the 2010 state budget, that the revised expenditures for 2010 should constitute the ceiling for central government expenditures in 2011 and 2012. The small rise in projected 2011 expenditures is accounted for by spending not covered by the parliament's decision, i.e. by public bodies outside the central government, particularly the utility "Croatian Waters". The only expenditure items which show a year-on-year rise in both nominal terms and as a share of GDP are interest expenditure (+0.3 percentage points of GDP) and gross fixed capital formation (+0.1 percentage points of GDP). Social transfers will see a 1.4% nominal year-on-year cut. In spite of the parliament-imposed cap on central government expenditure, it is not a foregone conclusion that overall spending can be kept within the stipulated limit, not least in view of the budgetary overruns in past years and a long-standing "stickiness" of many public expenditures.

Overall, fiscal revenues are projected to decline in 2011 following last year's changes in the income tax regime. On the expenditure side, on the other hand, the budget envisages restraint, but it may be challenging to keep expenditures within the budgetary limits, particularly in an election year. Most importantly, the balance of risks is tilted towards a higher deficit because recent economic data suggest that both the Commission's autumn forecast and the PEP's macroeconomic scenario may have become too optimistic regarding GDP growth in 2011.

Beyond the current year, total revenues are projected to rise 5.8% in 2012 and 4.3% in 2013 in nominal terms. This is primarily a reflection of the projected rise in nominal GDP (4.3% and 4.9%, respectively, for the two years). No changes in the tax regime are anticipated for this period, except those relating to EU accession. As a share of GDP, total revenues remain in the 36% - 37% range. On the expenditure side, restraint is projected to continue beyond the current year. In nominal terms, total expenditures are budgeted to increase 1.3% in 2012 and 0.5% in 2013, but their share of GDP would fall by 1.2 percentage points in 2012 and by 1.7 percentage points in 2013 (when they reach 39.0%). This means that the fiscal scenario fulfils the requirement set by the new Fiscal Responsibility Law that expenditures are to be reduced by a minimum of 1% of GDP starting in 2012. If revenues and expenditures developed as projected, net borrowing by general government would fall to 3.9% in 2012 and to 2.4% in 2013, i.e. a significant fiscal consolidation. Like for 2011, these deficit projections are subject to the above-mentioned risks concerning the macroeconomic scenario. The sensitivity analysis (see section 3.3. below) attempts to assess the budgetary consequences if output growth should fall short of the macroeconomic assumptions.

### 1.5.3. Structural balance

The PEP 2011-2013 provides estimates regarding the cyclical state of the economy and structural balances, applying the same methodology as in last year's submission. Like last year, potential GDP growth has been lowered significantly for the first two programme years and the two preceding years. The method underlying this recalculation is not revealed. For the third programme year (2013) potential growth is set to 1.9%. The projected actual growth rates will exceed potential growth rates throughout the programme period. The negative output gap closes already in 2012 according to this calculation. Like the unadjusted fiscal balance, the cyclically adjusted primary balance deteriorates in 2011 before starting to improve. In 2013 the cyclically adjusted primary deficit is projected to correspond to 0.3% of GDP. The PEP concludes that fiscal policy has been anti-cyclical since the beginning of the recession in 2008 and that this will continue throughout the programme years. Given the uncertainties relating to the applied methodology, this conclusion should be considered with caution. There is scope for refining the analysis in future submissions.

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

The fiscal scenario in the PEP 2011-2013 projects a gradual increase of public debt from 41.6% of GDP in 2010 to 46.7% in 2013 <sup>(7)</sup>. Projections on the decomposition of changes in the debt ratio show that its deterioration is exclusively driven by the negative primary balance and interest payments in each year over the PEP horizon. In contrast to the two preceding years, below-the-line operations and stock-flow adjustments are projected to lower the increase of the debt ratio to a considerable extent. Particularly in 2011, these adjustments are projected to lower the debt ratio by 3 percentage points. Half a percentage point is specified as privatisation proceeds, but the remainder is unspecified. Some of it, but not all, can be attributed to rising nominal GDP which lowers the debt ratio.

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<sup>(7)</sup> The PEP defines public debt according to the Croatian budget act as general government debt, thus excluding guarantees provided by the government to the State Development Bank (HBOR).

The PEP contains a debt sensitivity analysis which reveals that the public debt ratio is particularly sensitive to a depreciation of the kuna-euro exchange rate, as around 70% of outstanding public debt is denominated in foreign currency, mostly in euro. A 25% depreciation of the kuna would lead to an increase in public debt by about 7 percentage points to the range of 53-54% of GDP in 2012-2013. Lower-than-projected GDP growth and an increase of contingent liabilities (e.g. under the restructuring programme for the shipbuilding industry) could also increase the debt ratio to a significantly higher level than projected in the baseline scenario.

The projected levels of public debt do not give rise to immediate concerns about debt sustainability. However, a rise of about 12 percentage points in the debt ratio between the end of 2008 and the end of 2010 calls for increased vigilance. In addition, both the sensitivity analysis and the discussion of fiscal risks underline the need for a prudent fiscal policy. Potential risks also result from a significant increase in public sector financing requirements partly related to the re-financing of maturing debt. Unfortunately, the programme provides only scattered information about the government re-financing strategy and potential risks resulting from contingent liabilities.

**Table II.1.4:**  
**Composition of changes in the debt ratio (% of GDP)**

	2009	2010	2011	2012	2013
<b>Gross debt ratio [1]</b>	<b>35.4</b>	<b>41.6</b>	<b>44.2</b>	<b>46.3</b>	<b>46.7</b>
Change in the ratio	6.1	6.2	2.6	2.1	0.5
<i>Contributions [2]:</i>					
<b>1. Primary balance</b>	<b>2.4</b>	<b>3.3</b>	<b>3.4</b>	<b>1.7</b>	<b>0.2</b>
<b>2. “Snow-ball” effect</b>	<b>2.4</b>	<b>2.3</b>	<b>1.0</b>	<b>0.4</b>	<b>0.1</b>
<i>Of which:</i>					
Interest expenditure	1.7	1.9	2.2	2.2	2.2
Growth effect	1.7	0.6	-0.6	-0.8	-1.1
Inflation effect	-1.0	-0.2	-0.6	-0.9	-1.0
<b>3. Stock-flow</b>	<b>1.3</b>	<b>0.6</b>	<b>-1.8</b>	<b>0.0</b>	<b>0.2</b>

**Notes:**

[1] End of period.

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

*Source: Pre-Accession Economic Programme (PEP) 2011, ECFIN calculations*

#### 1.5.5. Budgetary implications of major structural reforms

The programme presents estimates of the fiscal impact of structural measures in various policy fields envisaged over the PEP horizon. A summary overview is presented in table II.1.5 of this assessment. It shows that the overall net impact on the country's fiscal position is small at around 0.1% of GDP in 2011 and 2012 and miniscule in 2013. The net effect over the three-year period is insignificant. Most of the specific measures presented in the policy matrix of structural reform measures have indeed a negligible effect on the budget. The structural reform measure which achieves the largest budgetary saving is railway restructuring in 2011 in the form of fewer subsidies and reduced investment (0.12% of GDP). The costliest reform measures are water management activities under the heading of environmental protection in 2011 (0.17% of GDP). Overall, the reform measures presented in the policy matrix are neutral with respect to the objective of fiscal consolidation.

#### 1.5.6. Sensitivity analysis and comparison with previous programme

Like in previous years, the PEP 2011-2013 includes a sensitivity analysis which shows how public deficit and debt would react to economic shocks. The debt sensitivity analysis has already been mentioned above. For the fiscal deficit, the main scenario assumes a growth shock which puts GDP at half the growth rates of the baseline scenario in both 2011 and 2012. This would lower budgetary revenues to such an extent that the fiscal deficit of general government would be 0.5 percentage points higher in 2011 and 1.1% higher in both 2012 and 2013. This analysis demonstrates the high sensitivity of the fiscal balance to variations in economic growth which primarily works via the revenue side of the budget (as experienced in 2010). It would have been useful to expand the analysis by including a more severe growth shock, particularly since the growth shock which was simulated in last year's PEP was vastly exceeded by reality. In addition to the sensitivity analysis, the differences in the fiscal scenarios between the PEP 2010-2012 and the PEP 2011-2013 are shortly summarised and attributed to the difference in the underlying macroeconomic projections.

#### 1.5.7. Quality of public finance and institutional features

The PEP 2010-2012 refers to the institutional setup for the budgetary process, most notably the annual Strategy of Government Programmes which was instituted with the Budget Act which came into force at the beginning of 2009. The current Strategy of Government Programmes was adopted in September 2010 and covers the period 2011-2013. It contains the Government's strategic objectives and provides for their systematic monitoring and measuring of their achievement. The PEP also describes the new Fiscal Responsibility Law which was adopted in November 2010 which may help to improve budgetary discipline (see Box above).

The PEP does not specifically address the need to improve the budgetary process further and to enhance the efficiency of public spending. The remaining weaknesses pose a risk that budget outcomes will continue to diverge significantly from budget projections. The PEP lacks a vision and a strategy in addressing key policy challenges. There is considerable scope for rationalising and streamlining public expenditure, in particular to introduce a better targeting of social spending. Low employment and participation rates suggest the need to consider the relevant incentives in the tax system and the benefits regime. Overall, the PEP would benefit from presenting a more convincing policy strategy to improve the quality of public finances through concrete revenue and expenditure measures.

#### 1.5.8. Sustainability of public finance

The PEP 2011-2013 contains a short analysis of the long-term sustainability of public finances with a focus on pension, health and interest expenditure. The assumptions regarding long-term population trends have not been changed compared to last year's PEP, but the labour market participation rates have been revised up, labour productivity growth and real GDP growth have been revised down for the short and medium term. Total expenditures are projected to decrease from 43.0% of GDP in 2010 to 40.2% in 2020, but then to increase gradually to 43.7% in 2050. Total revenues are set to fall from 37.8% in 2010 to 36.6% in 2020 where they are projected to remain over the following thirty years. Spending on old-age pensions is expected to decline from 10.6% of GDP in 2010 to 8.6% in 2050, as a growing share of pensions is expected to be financed from individual capitalised pension funds. Pension contributions would fall initially but then stabilise around 5.6% of GDP from 2015 onwards. Health care spending is set to increase markedly from 6.3% of GDP in 2010 to 9.3% in 2050, mainly as a result of an ageing population. Interest expenditure on public debt is projected to rise gradually from 1.9% of GDP in 2010 to 3.3% in 2050.

The long-term fiscal challenges of an ageing society remain significant not least in view of an already relatively high public debt ratio and very low labour market participation rates. Moreover, there is a

risk that long-term fiscal projections will have to be revised in a negative direction, if growth and productivity trends turn out to have been overestimated and if participation rates fall below the levels assumed under the programme. The programme does not relate its long-term fiscal projections to the need to adopt concrete reform measures in areas like pensions, health care or labour markets which are the areas where reform has the potentially largest budgetary benefits. Overall, the programme would have benefited from sketching the outlines of a policy response to the challenges of an ageing society.

## 1.6. STRUCTURAL REFORMS

The PEP covers a broad range of structural reform areas identical to last years' programme. It does not fully and consistently establish a clear link between strategic objectives and the various instruments and measures described. To serve as a guide for the implementation of structural reforms, the programme would benefit from the definition of clear policy targets, concrete measures and a time frame for implementation. Surprisingly, the PEP makes only scattered references to the Economic Recovery Programme (ERP) which the government launched in April 2010 as the new cornerstone of its economic policy. The ERP is a package of structural reforms which seek to address the structural weaknesses of the economy and aim to create an environment encouraging sustainable economic growth. Although the ERP is a ten-year programme, the presentation would have gained from an introductory section describing how the ERP is linked to the PEP and how it will promote its structural reform objectives in 2011-2013.

More emphasis should also have been given to measures to improve the business environment, given the administrative obstacles still in place. The programme contains fiscal estimates for some measures, but the link between the structural reform agenda and the implementation of the fiscal strategy is generally weak. Intensified efforts to speed up the implementation of reforms, in particular in the areas of enterprise restructuring, education and labour markets would support the fulfilment of the second Copenhagen economic criteria.

*Table II.1.5:*

<b>Net direct budgetary impact of key reform commitments (in million EUR)</b>			
	<b>2011</b>	<b>2012</b>	<b>2013</b>
Enterprise restructuring and subsidies	59.4	12.2	-23.6
Labour market reforms	-9.1	15.3	8.9
Agriculture and rural sector	4.7	20.1	41.2
Health care reforms	-31.8	-3.4	0.2
Environmental protection	-79.6	8.6	-31.5
Other reforms	-0.2	-4.0	-1.6
<b>Total impact on the budget</b>	<b>-56.6</b>	<b>48.9</b>	<b>-6.5</b>
<b>Total impact on the budget (in % of GDP)</b>	<b>-0.12</b>	<b>0.10</b>	<b>-0.01</b>

*Source: 2011 Pre-accession Economic Programme (PEP), ECFIN calculations, a minus sign indicates a deteriorating of the budget balance.*

### 1.6.1. Product and capital markets

The PEP 2011-2013 touches upon a number of reform areas related to the functioning of product markets, such as competition policy, privatisation, railway and shipyard restructuring, energy and SME development. In the field of competition policy, the entering into force of the new Competition Act in October 2010 should enhance efficient competition among businesses in Croatia not least by strengthening the position of the Croatian Competition Agency.



The process of privatisation of state assets held in the privatisation fund is still only making slow progress. In mid-December 2010, the fund's portfolio comprised 769 companies, in 80 of which the state is a majority owner. The creation of the Agency for the Management of State Property is expected to facilitate the process, but a clear time frame for selling or liquidating state assets is still missing (except for the shipyards). The restructuring of the shipyards is moving forward in spite of the difficulties encountered in 2010. The PEP deplors the lack of a clear strategy for railway restructuring. Regarding the energy sector, the PEP is mainly describing recent and ongoing measures to strengthen the electricity and gas markets in accordance with the government's energy strategy from 2009. The programme fails to address the persisting shortcomings in the overall business environment, including weaknesses in the regulatory framework and inefficiencies in public administration.

#### 1.6.2. Labour market

In addition to the severe repercussions of the ongoing macroeconomic weakness on employment levels and the number of unemployed, the Croatian labour market suffers from deep-rooted structural problems, as evidenced by very low participation and employment rates as well as high rates of youth and long-term unemployment. The policy response, as described in the programme, does not include strategically relevant reform concepts and does not refer to the implementation of the part of the Economic Recovery Programme dealing with 'making the labour market more dynamic'. It continues to focus on active labour market measures by the Croatian Employment Service. However, as already mentioned in previous PEP assessments, a more comprehensive reform approach seems to be required to address the structural weaknesses of the Croatian labour market. Despite some actions taken, such as reducing incentives for early retirement, labour supply disincentives appear to continue. In line with EU requirements and the Europe 2020 Strategy, labour market policies should pay sufficient attention to tackle skill mismatches and to develop strategies for life-long learning.

#### 1.6.3. Other reform areas

Other reform areas covered are the agricultural sector, public administration, education, health care, the judiciary and environmental protection. Like for the previously mentioned sectors, the presentation is mainly backward looking, providing information on past and ongoing reform measures and initiatives with a strong emphasis on legislative action. Harmonisation with EU requirements has been treated with priority. The programme would have benefited from discussing the relevance of envisaged reforms in the context of the overall reform strategy.

### 1.7. OVERALL ASSESSMENT OF FORMAL REQUIREMENTS

#### Macro framework

The programme presents a clear and concise picture of past economic developments and covers most relevant data in an accurate way. Weaknesses remain with respect to data on sector's savings-investment balances. The PEP presents a sufficiently comprehensive and broadly consistent medium-term macroeconomic framework.

#### Fiscal framework

The fiscal programme is broadly consistent with the macroeconomic framework. However, the programme's fiscal target for 2011 does not entirely support the programme's notion of "fiscal consolidation". The programme could have been improved by providing more concrete information on

the envisaged fiscal policy measures, in particular on those to rein in current spending. The programme makes an effort to present fiscal data according to ESA standards. Historic data are fully in line with data submitted in the context of the 2010 fiscal notification. Unresolved issues remain with respect to the coverage of the general government sector as a number of "quasi-fiscal activities" (such as the Croatian Bank for Reconstruction and Development (HBOR), and Croatian Motorways) and a large number of municipalities are not included in the fiscal programme. PEP submissions would benefit from an explanation of operations and future plans of HBOR and Croatian Motorways.

### **Structural reforms**

This part of the programme would gain from a more coherent and consistent presentation of the structural reform agenda, better linking individual reform measures to the programme's key economic objectives and the fiscal strategy.

Table II.1.6:

Annex: Structural indicators

	Croatia					EU 27				
	2006	2007	2008	2009	2010	2006	2007	2008	2009	2010
<b>General economic background</b>										
Real GDP <sup>1</sup>	4.9	5.1	2.1	-5.8	-1.8f	3.2	3.0	0.5	-4.2	1.8
Labour productivity <sup>2</sup>	73.2	75.3	77.5	78.1	n.a.	100	100	100	100	100
Real unit labour cost <sup>3</sup>	-11.4	0.0	2.5	3.1	-3.1	-1.1	-0.7	0.8	2.9	-1.6f
Real effective exchange rate <sup>4</sup>	n.a.	n.a.	n.a.	n.a.	n.a.	115.0	121.7	123.7	120.7	n.a.
Inflation rate <sup>5</sup>	3.3	2.7	5.8	2.2	1.1	2.2	2.3	3.7	1.0	2.1
Unemployment rate <sup>6</sup>	11.2	9.6	8.4	9.1	11.8	8.2	7.2	7.0	8.9	9.6
<b>Employment</b>										
Employment rate <sup>7</sup>	55.6	57.1	57.8	56.6	n.a.	64.5	65.4	65.9	64.6	n.a.
Employment rate - females <sup>8</sup>	49.4	50.0	50.7	51.0	n.a.	57.3	58.3	59.1	58.6	n.a.
Employment rate of older workers <sup>9</sup>	34.3	35.8	36.7	38.4	n.a.	43.5	44.6	45.6	46.0	n.a.
Long term unemployment <sup>10</sup>	6.7	5.9	5.3	5.1	n.a.	3.7	3.1	2.6	3.0	n.a.
<b>Product market reforms</b>										
Relative price levels <sup>11</sup>	72.6	71.9	74.6	74.1	n.a.	100	100	100	100	100
Total trade-to-GDP ratio <sup>12</sup>	32.3	32.5	32.1	25.1	n.a.	10.7	10.7	11.5	9.7	n.a.
Net FDI <sup>13</sup>	6.6	8.1	6.7	2.7	n.a.	2.3	3.9	2.2	2.1	n.a.
Sectoral and ad-hoc state aid <sup>15</sup>	n.a.	n.a.	n.a.	n.a.	n.a.	0.6	0.5	2.2	n.a.	n.a.
Business investment <sup>16</sup>	n.a.	n.a.	n.a.	n.a.	n.a.	18.2	18.7	18.4	16.2	n.a.
<b>Knowledge based economy</b>										
Tertiary graduates <sup>17</sup>	6.0	6.8	10.1	n.a.	n.a.	13.4	13.8	13.9	n.a.	n.a.
Spending on human resources <sup>18</sup>	4.1	4.1	n.a.	n.a.	n.a.	5.0	5.0	n.a.	n.a.	n.a.
Educational attainment <sup>19</sup>	94.6	95.3	95.4	95.1	n.a.	77.9	78.1	78.4	78.6	n.a.
R&D expenditure <sup>20</sup>	0.8	0.8	0.9	0.8	n.a.	1.9	1.9	1.9	2.0	n.a.
Broadband penetration rate <sup>21</sup>	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	18.2	21.7	23.9	n.a.

1. Growth rate of real GDP in %. 2. Labour productivity per person employed - GDP in PPS per person employed relative to EU-27 (EU-27=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 (1999 = 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 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. 11. comparative price levels of final consumption by private households including indirect taxes (EU-27=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. Number of broadband access lines per 100 inhabitants.

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

Source: Commission services, national sources

## 2. THE FORMER YUGOSLAV REPUBLIC OF MACEDONIA

### 2.1. EXECUTIVE SUMMARY

The Pre-Accession Economic Programme for 2011 - 2013 (the "2011 PEP") of the former Yugoslav Republic of Macedonia presents a largely plausible economic scenario for 2011 but may be slightly on the optimistic side with respect to the speed of growth acceleration towards the end of the programme period. The fiscal strategy appears feasible and is in line with the budget for 2011 and the country's medium-term fiscal strategy. The description of structural reforms is broad and would have benefitted from a more explicit discussion of policy priorities. The links to EU accession related priorities are more pronounced than last year. Concerning content, form and data, the programme partly complies with the requested standard. Overall, the quality of the presented data has clearly improved compared to last year's submission.

The recovery from the output decline in 2009 remained moderate so far. Unemployment declined slightly, despite the adverse global conditions and the current account deficit improved, mainly thanks to strengthening external demand, underpinned by stable inflow of private transfers. Like in the past, the main accession related challenges are to address the still substantial labour market imbalances and to strengthen administrative and institutional capacities, in order to improve the quality of public administration, but also to strengthen the rule of law.

The macroeconomic scenario envisages a significant acceleration of economic growth, notably towards the end of the programme period. This appears rather optimistic in view of the current international economic environment and the strong reliance on domestic demand components. The programme presents estimates on the fiscal impact of various alternative scenarios, such as lower growth.

The authorities achieved the 2010 deficit target of 2.5% of GDP. However, like in the past, the original budget proposal had envisaged significantly higher revenues and expenditures, requiring the adoption of a supplementary budget in mid-2010 to proceed with the necessary adjustments. The fiscal framework envisages a rather continuous decline in the deficit to 1.9% by 2013. The revenue estimates of the fiscal framework appear optimistic for 2011, given a rather optimistic underlying growth scenario, but conservative for the remaining programme period. On the expenditure side, the strong increase in public investment in 2011 is noteworthy. Overall, the moderate decline in the deficit appears cautious, given the underlying scenario of a strong increase in GDP growth. In view of the country's track record of meeting its deficit objectives, the programme's fiscal targets appear overall feasible and sustainable within the projected macro framework.

The country's structural reform programme presents a broad range of measures, which are largely in line with the country's key challenges and the requirements for EU accession. However, a clear prioritisation is missing. Given the country's high level of structural unemployment, the programme could have devoted more emphasis on measures on how to address this issue.

Overall, the programme presents a slightly optimistic macroeconomic scenario and a feasible fiscal framework. Given the high level of structural unemployment, the overall policy mix would have benefitted from a stronger emphasis on this issue. The reliability and comparability of the provided data appears to be rather weak.

*Table II.2.1:  
Comparison of key macroeconomic and budgetary projections*

		2009	2010	2011	2012	2013
Real GDP growth (% change)	COM	-0.9	1.3	2.2	2.5	n.a.
	PEP 2011	-0.9	2.0	3.5	4.5	5.5
Consumer price inflation (%)	COM	-0.8	1.7	2.3	2.5	n.a.
	PEP 2011	-0.8	1.6	3.0	3.0	3.0
General government balance (% of GDP)	COM	-2.7	-2.5	-2.6	-2.3	n.a.
	PEP 2011	-2.7	-2.5	-2.6	-2.2	-1.9
Primary balance (% of GDP)	COM	-2.1	-0.3	-0.7	-0.8	n.a.
	PEP 2011	-2.1	-1.7	-1.8	-1.5	-1.3
Government gross debt (% of GDP)	COM	23.7	25.6	26.8	27.6	n.a.
	PEP 2011	23.7	24.0	26.0	26.1	25.5

*Sources: Pre-Accession Economic Programme (PEP) 2011, Commission 2010 Autumn Forecast (COM)*

## 2.2. INTRODUCTION

The former Yugoslav Republic of Macedonia submitted its fifth PEP on 31st January 2011, covering the period 2011-2013. The programme has been adopted by the government. It is a joint document based on contributions of a large number of line ministries and the Central Bank, under the coordination of the Ministry of Finance. Social Partners and the business community have been consulted for the first time on the draft document. The programme takes into account the 2011 budget and other national programmes, such as the National Development Plan, the Fiscal strategy for 2011-2013, the Investment strategy for 2011-13 and the National Plan for the Adoption of the Acquis (NPAA). The document also refers to the country's accession process, the European Partnership priorities and the Commission's assessment in the Progress Report.

The document partly complies with the content, form and data required for this exercise. It contains a general overview of recent economic developments and presents the requested 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. The document includes the required quantitative information. Weak alignment with ESA 95 strongly impedes the analysis and comparability of the presented data.

## 2.3. KEY CHALLENGES

The economic developments during 2010 point to a slow recovery from a rather moderate crisis-related decline in 2009. Although the country weathered the global financial crisis rather well, the key policy challenges remain unchanged: addressing structural unemployment, in particular among the young, improving the business environment in order to foster investment and job creation and improving the quality of public finances.

With respect to the country's accession perspective, important challenges continue to be to improve the functioning of the labour market, to strengthen administrative capacities and regulatory and supervisory agencies and improve the rule of law and contract enforcement.

## 2.4. RECENT ECONOMIC DEVELOPMENTS AND MEDIUM-TERM SCENARIO

### 2.4.1. Recent macroeconomic developments

After a moderate output decline by 0.9% in 2009, economic activity appears to have accelerated by 0.7% in 2010, mainly based on improved export growth, which benefitted from increased demand for metal products. Thanks to higher export revenues and sustained inflows of private transfers, the current account deficit dropped to 2.8% of GDP by the end of 2010. Inflation started to accelerate during the year, mainly driven by rising prices for imported energy. As a result, year-on-year consumer price inflation reached 3% in December 2010, bringing annual average inflation to 1.6% in 2010, compared to -0.8% on average in 2009. The recovery of economic activity also helped to improve tax revenues, which rose by 2.8% in 2010, compared to a decline by 7.4% the year before. Expenditure rose by 2.4% only, which together with nominal GDP growth by 3.6% helped to slightly reduce the central government deficit, from 2.7% of GDP in 2009 to 2.5% in 2010. The labour market remained largely unchanged in 2010. Employment rose by 1.3%, mainly due to strong job growth in the last quarter of 2010. Increased labour inspection probably also contributed to the increase in registered labour.

### 2.4.2. Medium-term macroeconomic scenario

Against the background of a rather moderate growth in the country's main export markets, the medium-term macroeconomic scenario expects a marked acceleration of GDP growth, from 2% in 2010 to 5.5% in 2013. This growth performance would be significantly above historic trend growth. The main driving forces are domestic components in particular investment and private consumption, increasing during the programme period on average by some 10% and 3% respectively. Exports are expected to increase by some 7½%, while import growth is forecast to remain rather moderate at some 7¾% on average. Inflation is expected to accelerate to some 3%, while the unemployment rate is projected to decline by about 1 percentage point each year, reaching 27.6% in 2013. As a result of strong export growth and the expected stability of high inflows of private transfers, the current account deficit, though almost doubling, is forecast to remain rather low, increasing from -2¾% of GDP for 2010 to -6¼% in 2013.

Overall, this growth profile appears optimistic but feasible in 2011. However, towards the end of the programme period the programme looks increasingly optimistic, in particular as the expected strong increase in domestic demand is likely to also trigger a significant increase in imports, dampening growth and increasing the external imbalances.

Table II.2.2:

Comparison of macroeconomic developments and forecasts

	2009		2010		2011		2012		2013	
	COM	PEP	COM	PEP	COM	PEP	COM	PEP	COM	PEP
Real GDP (% change)	-0.9	-0.9	1.3	2.0	2.2	3.5	2.5	4.5	n.a.	5.5
<i>Contributions:</i>										
- Final domestic demand	-4.0	-4.0	-0.3	-2.0	3.1	3.9	3.9	5.2	n.a.	6.5
- Change in inventories	0.0	n.a.	0.0	n.a.	0.0	n.a.	0.0	n.a.	n.a.	n.a.
- External balance of goods and services	3.1	3.1	1.6	4.0	-1.0	-0.4	-1.4	-0.7	n.a.	-1.0
Employment (% change)	3.4	3.4	1.0	0.4	2.0	3.0	2.5	3.0	n.a.	4.0
Unemployment rate (%)	32.2	32.2	31.9	32.0	31.1	30.6	30.0	29.4	n.a.	27.6
GDP deflator (% change)	0.3	0.3	1.9	2.0	3.3	3.0	3.4	3.0	n.a.	3.0
CPI inflation (%)	-0.8	-0.8	1.7	1.6	2.3	3.0	2.5	3.0	n.a.	3.0
Current account balance (% of GDP)	-6.7	-6.7	-3.3	-3.6	-4.1	-4.3	-5.3	-5.7	n.a.	-6.3

Sources: Pre-Accession Economic Programme (PEP) 2011, Commission 2010 Autumn Forecast (COM)

Real wage growth per employee is expected to have been 2% in 2010 and to drop to 0.5% in 2011 and to increase again to 1.5% in the remaining programme period.

### **Real sector**

Like in the previous programme, the medium-term scenario expects a rather broad based economic recovery, mainly driven by increased investment and to a lesser extent private consumption, but also supported by external demand. Overall, GDP growth was forecasted to reach 2% in 2010 and to accelerate continuously towards 5.5% by 2013. Employment is expected to increase by some 3-4% annually, which should help to support consumption driven growth. Investment growth was expected to drop by 7% in 2010 but to accelerate from 8.5% in 2011 to 12.5% in 2013. Due to strong employment increases of some 3-4% annually during the programme period, unemployment is expected to drop significantly, from 32% in 2010 to 27.6% in 2013. Compared to the Commission's autumn forecast, the PEP framework expects a consistently slightly more favourable development of the country's demand components. In particular in 2012, the last year where Commission estimates are available, the country's GDP growth expectations are 2 percentage points above the Commission's estimates, resulting from stronger growth of both, domestic but also external demand.

### **Inflation**

Consumer price inflation is forecast to remain rather moderate, increasing from 1.6% in 2010 to a stable 3% in the remaining programme period. The programme's estimates for the CPI are higher than the Commission's autumn forecast, which might be related to the programme's the stronger underlying economic growth. However, overall, the CPI's profile seems not to fully reflect the dynamics of import prices and domestic food prices, as described in the programme. In particular in 2013, the programme's expectation of largely unchanged inflationary pressures appears optimistic, given the programme's expectation of GDP growth substantially above potential. The programme's assumptions on world import prices expect a decline of import prices in 2012, which is significantly lower than the Commission's assumptions and which might partly explain the rather low inflationary pressures that are expected despite strong GDP growth. Overall, the programme's price scenario looks rather benign, given expectations of GDP growth significantly above the authorities' potential growth estimates.

### **Monetary and exchange rate policy**

The monetary framework underlines 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. The peg to the euro also contributes to curtail balance sheet risks as a large share of assets and liabilities and denominated in euro. No changes to the current exchange rate regime are envisaged. Overall, the monetary framework is in line with the programme's objective of maintaining a nominally fixed exchange rate towards the euro.

### **External sector**

The programme's external assumptions envisage a rather moderate recovery of the country's main export markets during the programme period, which is in line with the current view of most international institutions. However, expectations on export growth are significantly above expected growth of the country's main trading partners, at some 7-8½% annually, implying important gains in export market shares. At the same time, the programme envisages a rather modest increase in imports (at some 6-7.8% annually), in particular in view of rather strong domestic demand, especially investment which is likely to lead to large imports of capital goods. As a result, the envisaged rise in current account deficit remains moderate too, from expected -2.8% of GDP in 2010 to -6.3% in 2013. Compared to last year, the expected deterioration in the external balance appears more realistic.

However, should the optimistic assumptions of the programme on sustained exports and moderate imports growth not materialise, the sustained growth profile in 2012-2013 would translate in a significantly higher current account deficit and additional external financing needs. The financing of the deficit appears to rely largely on FDI inflows and loans from International Financial Institutions. Important inflows of FDI, increasing from 3.6% of GDP in 2011 to 4.9% in 2013, appear to be a main financing factor. These expected FDI inflows are significantly higher than in most pre-crisis years. Unfortunately, the document does not provide much evidence on how such an increase will be achieved, except for a mention of further reforms in business environment.

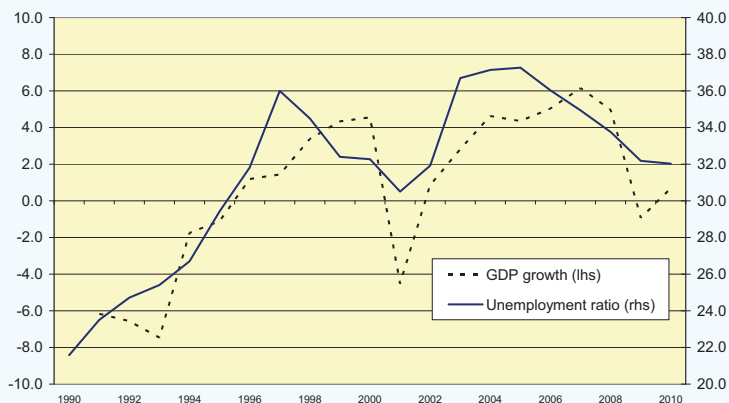
As far as the risks to the macroeconomic scenario are concerned, the main downward risks are probably related to a sudden and substantial drop of private transfers, less buoyant investment or higher than anticipated import. Also inflationary pressures could increase faster than expected. Concerning upward risks, private consumption could pick up faster than forecasted, reflecting improved consumer confidence. Overall, given the presented scenario, downward risks are probably more pronounced.



**Box II.2.1: The labour market: A persistent challenge**

The labour market situation was already precarious when the country became independent. As a result of the economic crisis in former Yugoslavia in the late 1980s, the country entered independence with an unemployment rate of slightly above 20%. The restructuring of the economy during the early 1990s led to a sharp increase in unemployment, as a low growth dynamics and the poor business environment failed to create a sufficient number of alternative job opportunities. In the second half of the 1990s, stronger growth helped to reduce the unemployment rate from 36% in 1995 to around 30% in 2001. However, the short recession of 2001 brought another steep rise in unemployment to 37% by 2005. The pre-crisis boom in 2006-2008 helped to reduce the unemployment rate to some 34%, which however continued to decline to 32% in 2009-2010, despite the sharp deceleration in growth.

**Unemployment rates and GDP growth**



Besides a relatively weak growth dynamics, job creation was further hampered by a high tax burden on registered labour and the lack of flexibility of the labour legislation to allow for part-time and fixed-term jobs. As a result, many unemployed sought income in the informal economy. In recent years, the legal, fiscal and institutional framework has improved. The labour law has been made flexible, the tax wedge on labour has been lowered, incentives have been created for registering so far informal employment and labour inspections have been increased. The employment agency, which after its establishment in 1997 mainly dealt with unemployment registration, has started to implement active labour market policies, like training and developing employment schemes.

However, a high share of youth unemployment, accounting for some 20% of total unemployed, unemployment rates of some 50% in this age group and a high share of long-term unemployment, with some 65% of total unemployed being unemployed for longer than 4 years, point to deeply entrenched structural weaknesses, such as an educational system failing to provide the required skills and a weak business climate, impeding the creation of jobs accessible and attractive for long-term unemployed.

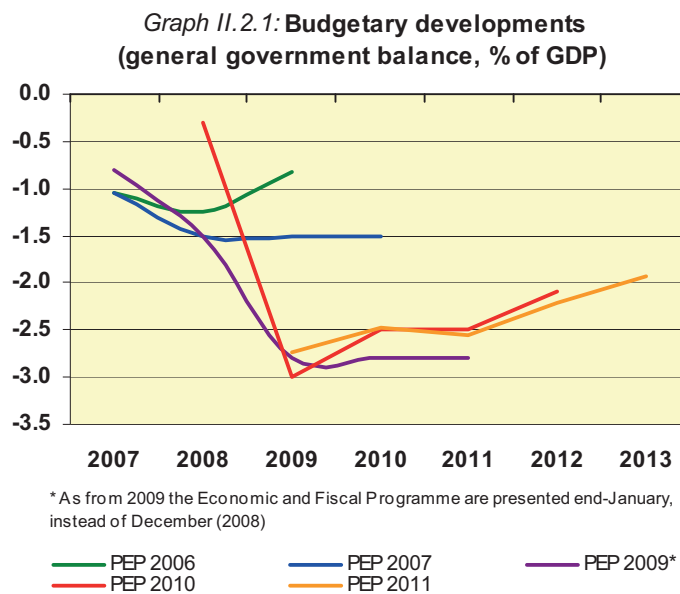
Private transfers from abroad, amounting for up to 20% of GDP and informal employment are probably cushioning the social consequences of unemployment. However, structural unemployment and weak growth have led to a situation where nearly 1/3 of the population is considered to live below the poverty line.

## 2.5. PUBLIC FINANCE

The fiscal framework for 2011-2013 plans to improve the quality of public finances, while keeping deficits low and public sector debt on a sustainable level. In the short term (2011), the fiscal policy would continue to act in a counter-cyclical way, supporting the recovery from the crisis, while in the medium-term the authorities intend to tighten expenditure, in order to maintain moderate and declining deficits and debt ratios.

In order to stimulate the domestic economy, the authorities intend to lower the tax burden, mainly by further lowering social security contributions which should lead to reduced general government revenues, by about 2% of GDP, from (estimated) 34.8 % of GDP in 2010 to 32.8% in 2013. On the expenditure side, the programme envisages a reduction by 2.5% percentage points of GDP. As a result, the deficit is expected to decline by 0.6% of GDP, from 2.5% in 2010 to 1.9% in 2013.

Overall, the authorities have a solid track record in realising their deficit targets. However, in the past, fiscal projections were often overly optimistic, requiring frequent budget revisions in order to adjust spending to available resources. Furthermore, de-facto budgetary spending appears often to be more oriented towards short-term developments than the officially adopted budget. As a result, the quality of public spending tends to be significantly lower than planned, with investment spending usually being reduced in exchange of increased transfer payments.



Like in the past, the programme is still very parsimonious when it comes to explaining the underlying reasons for certain revenue and expenditure developments. Overall, on the revenue side, VAT revenues are expected to increase less than nominal GDP, in particular in 2012 and 2013, while the strong increase in domestic demand would suggest a different pattern. At the same time, income and property taxes appear to rise quite strongly. Unfortunately, the programme does not provide any information on any planned measures, which would have helped to understand the dynamics of those revenue assumptions. On the expenditure side, the main noteworthy feature is a strong increase in gross fixed capital formation, in particular in 2011, when public investment is supposed to increase by 24¼%, following a (planned) increase in investment by nearly 32% in 2010. In the following years, investment growth is expected to drop again below nominal GDP growth, although its nominal growth is planned to remain higher than that of the other spending items. As a result, investment spending as

a percentage of GDP will increase by 0.7 percentage points, from (planned) 5.3% in 2010 to 6.0% in 2013. This is in strong contrast to the other spending items, which are all expected to decline as a percentage of GDP, reducing overall public spending by 2.5 percentage points of GDP. Like in the previous programme, foreign loans are supposed to be the main financing source of public investment.

#### 2.5.1. Budget implementation in 2010 <sup>(8)</sup>

In 2010, changes to the budgetary implementation were less drastic than in 2009, requiring only one supplementary budget, which was adopted in June 2010. However, like in the past, the differences between the initially adopted budget for the coming year and the actual realisation seem to have been substantial. The original budget proposal for the year 2010 was based on expected real GDP growth of 2% and projected inflation of 2%. Revenues and expenditures were planned to increase by 3.4% and 2.8%, respectively, leading to an increase in total revenues from 33.2% of GDP in 2009 to 34.8% in 2010, while spending was planned to rise from 36% of GDP in 2009 to 37.3% in 2010.

Provisional data for the full year point to a revenue collection largely in line with the level realised in 2009, at some 31% of GDP, while spending was slightly lower than a year before, at some 33¼% of GDP. Thus, despite a significant underperformance of revenue and expenditure (by some 3% of GDP), the deficit target of 2.5% of GDP was achieved. On the revenue side, VAT revenues appear to have been slightly higher than a year before, by some ½% of GDP, and largely in line with budgetary projections. On the expenditure side, capital spending appears to have been slightly higher than a year ago, by some ¼% of GDP, but around 2% of GDP lower than originally planned. Current spending appears to have been about ¾% of GDP lower than in 2009, and about 1½% of GDP lower than originally planned.

The main reasons for the deviations from the original budget plan seem to be overly optimistic revenue and expenditure estimates. On the revenue side, estimates of direct taxes and non-tax revenues appear to be subject to a particular degree of uncertainty. On the expenditure side, spending on capital investment usually tends to be significantly lower than anticipated, possibly playing the role of an adjustment variable.

#### 2.5.2. Near-term and medium-term budget strategy

The parliament adopted in December 2010 the central government budget for 2011, envisaging maintaining a central government deficit of 2.5% of GDP. The authorities expect real GDP growth of 3.5%, while inflation is projected to be 3%.

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<sup>(8)</sup> The programme presents fiscal targets for 2010 based on the supplementary budget, adopted in June and realisations during the first nine months.

Table II.2.3:

Composition of the budgetary adjustment (% of GDP)						
	2009	2010	2011	2012	2013	Change: 2010-13
<b>Revenues</b>	33.2	34.8	34.8	33.8	32.8	-2.0
- Taxes and social security contributions	28.0	27.3	27.4	27.3	26.6	-0.7
- Other (residual)	5.2	7.5	7.4	6.5	6.2	-1.3
<b>Expenditure</b>	36.0	37.3	37.4	36.0	34.7	-2.5
- Primary expenditure	35.4	36.5	36.7	35.3	34.1	-2.5
<i>of which:</i>						
Gross fixed capital formation	4.2	5.3	6.2	6.2	6.0	0.7
Consumption	13.3	13.2	13.0	12.2	11.7	-1.5
Transfers & subsidies	17.6	18.0	17.5	17.0	16.4	-1.6
Other (residual)	0.3	0.0	0.0	0.0	0.0	0.0
- Interest payments	0.6	0.7	0.7	0.7	0.7	-0.1
<b>Budget balance</b>	-2.7	-2.5	-2.6	-2.2	-1.9	0.6
- Cyclically adjusted	-2.5	-1.9	-2.2	-2.3	-2.5	-0.6
<b>Primary balance</b>	-2.1	-1.7	-1.8	-1.5	-1.3	0.5
<b>Gross debt level</b>	23.7	24.0	26.0	26.1	25.5	1.5

Sources: Pre-Accession Economic Programme (PEP) 2011, ECFIN calculations

The programme does not provide much quantitative information on the central government budget for 2011. With respect to the general government accounts, the fiscal framework envisages for 2011 an increase in total revenues and spending in line with expected nominal GDP growth, leaving their share in GDP unchanged. On the revenue side, the authorities expect an increase in income from property taxes, by some ¼ % of GDP, while income from "other revenues" is envisaged to drop by ½% of GDP. No explanation is provided for this change in the revenue composition. On the expenditure side, the most noteworthy feature is the planned increase in capital spending by about 1% of GDP, from (planned) 5.3% of GDP in 2010 to 6.2% of GDP in 2011. This increase is mainly compensated by a relative decline in spending for public consumption, social transfers and subsidies, by about ¼% of GDP, each. For example, current spending is planned to rise by 3.9% only, with a planned increase of public sector wage spending by 1.2% only.

As in the past, revenue and spending plans are based on a rather optimistic growth scenario. In particular, the strong increase in investment appears rather unlikely, given the country's tradition in underperforming with respect to their investment targets.

In 2012 and 2013, the authorities appear to return to their overall fiscal strategy of lowering deficits, while at the same time reducing both the tax burden and public spending. The former seems to be achieved mainly through lowering rates for social security contributions and the latter mainly through lowering current spending while increasing capital spending. Thus, for 2012-2013 the programme envisages a lower share of revenues to GDP by 1 percentage point each year. In 2012, the main reason for this decline will be lower revenues from property taxes (by ½% of GDP), while in 2013 the authorities appear to expect a rather low growth of indirect taxes, dropping by about ½% of GDP. This reduction in revenues from indirect taxes is surprising, given the underlying scenario of domestically driven growth acceleration. On the expenditure side, total spending is planned to drop by 1¼% of GDP each year. Spending on collective consumption is supposed to decline by nearly 1 percentage point of GDP in 2012 and by ½% percentage point in 2013. Furthermore, spending for social transfers is planned to be cut by ½% of GDP in both years. Here again, the programme would have benefitted from a concrete description of the envisaged measures to achieve these goals.

With respect to the presentation, the programme would have benefitted from more detailed information on the reasons behind the budgetary performance in 2010, on the main features of the budget for 2011, which has been adopted in December 2010, and on the key measures to achieve the 2012-2013 revenue and spending targets. The overall setup of the fiscal framework is rather back-loaded, with the main spending cuts envisaged in 2012 and 2013 only. Revenue assumptions for 2011

appear optimistic, when taking into account previous realisations. However, for 2012 and 2013, revenue estimated, in particular with respect to indirect taxes, seem to be on the conservative side.

The main risks related to the fiscal framework appear to be related to the revenue side in 2011, given the reliance of revenue estimates on an optimistic growth scenario. On the expenditure side, there is a risk that planned reductions in current spending, in particular related to social transfers, will not be feasible, which would either translate into higher deficits or require spending cuts in other areas, such as capital investment.

### 2.5.3. Structural balance

The authorities used two methods a Hodrick-Prescott filter approach and a production function approach to calculate the country's potential growth rate, arriving at a potential growth rate of around 3½% on average. However, from the programme it is not clear, which method actually has been used for calculating the cyclically adjusted deficits. According to the programme's estimates the country's potential growth shows significant fluctuations, from 3.8% in 2009 down to 3.0% in 2010, which then increases to 3.6% by 2013. This profile leads to negative, but declining output gaps in the crisis years 2009-2010 and increasingly positive output gaps for the programme period 2011-2013. When calculating cyclically adjusted balances, the authorities' estimates arrive at structural deficits between 1.9% of GDP (in 2010) and 2.5% (in 2013). With respect to the country's position in the business cycle, the fiscal stance appears to have been anti-cyclical during the boom in 2008, largely neutral in crisis year 2009 and pro-cyclical in the recovery year of 2010 and in 2011, largely neutral in 2012 and countercyclical in 2013.

The outcome of those estimations using the production function approach is subject to a large degree of uncertainty, as a result of the rather poor quality of the underlying data. For example, the high degree of unregistered activities probably leads to underestimated data on investment and employment and thus an underestimation of the country's "true" growth potential. The level of the structural deficit appears to be rather high.

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

The programme's concept of public debt is based on GFS methodology and not yet in line with the concept used in the EU's fiscal surveillance exercise, which impeded the analysis and comparability of the provided data. Overall, the public debt level appears to be low, at some 23.7% of GDP in 2009 according to the provided data [27% when calculating government debt + public enterprises]. In 2010, the debt ratio is expected to increase by about ¼ percent of GDP and by 2 percentage points in 2011. In the following year, the debt is supposed to remain stable and to decline by about ½ % of GDP in 2013. The main factors for the rather strong increase in 2011 are the primary deficit and "stock-flow" adjustment, which probably reflect the intended increased reliance on foreign loans. In 2012 and 2013, the planned primary deficits will continue to increase the debt level, but stronger real and nominal GDP growth with help to stabilise and even reduce the debt ratio. The programme also appears to expect debt reducing effects from stock-flow adjustments.

**Table II.2.4:**

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

	2009	2010	2011	2012	2013
<b>Gross debt ratio [1]</b>	<b>23.7</b>	<b>24.0</b>	<b>26.0</b>	<b>26.1</b>	<b>25.5</b>
Change in the ratio	3.1	0.3	2.0	0.1	-0.6
<i>Contributions [2]:</i>					
<b>1. Primary balance</b>	<b>2.1</b>	<b>1.7</b>	<b>1.8</b>	<b>1.5</b>	<b>1.3</b>
<b>2. “Snow-ball” effect</b>	<b>0.7</b>	<b>-0.2</b>	<b>-0.8</b>	<b>-1.1</b>	<b>-1.4</b>
<i>Of which:</i>					
Interest expenditure	0.6	0.7	0.7	0.7	0.7
Growth effect	0.2	-0.5	-0.8	-1.1	-1.3
Inflation effect	-0.1	-0.5	-0.7	-0.7	-0.7
<b>3. Stock-flow</b>	<b>0.2</b>	<b>-1.3</b>	<b>0.9</b>	<b>-0.3</b>	<b>-0.5</b>

Notes:

[1] End of period.

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

*Source: Pre-Accession Economic Programme(PEP) 2011, ECFIN calculations*

The programme presents a detailed description of the country's debt structure and of some key aspects of the country's debt strategy. However, the document does not provide much detail on expected debt developments in 2011, or for the remaining programme period. Furthermore, it does not mention any quantitative details neither on ongoing or planned privatisation projects nor other one-off measures.

The institutional and legal framework for the debt management has remained unchanged, with a central public debt management department located at the Ministry of Finance and the adoption of a medium-term public debt strategy, currently covering the years 2010-2012. Like previous ones, this document envisages to keep during the planning period the total public debt ratio (i.e., including Central Bank debt) below 40% of GDP, the state guaranteed debt below 10% of GDP and the share of euro denominated debt in total debt above 70%.

Due to a high share of foreign non-market lending, the financing conditions are currently still rather favourable. However, in the medium-term financial support from donors and multilateral institutions is likely to decrease, which would lead to higher average financing costs. In this view, the programme's estimates of the costs of debt servicing appear rather optimistic, envisaging only a moderate increase from 0.6% of GDP in 2009 to 0.7% in the remaining programme period <sup>(9)</sup>.

Independent from the uncertainty related to the actual level of general government debt, the programme's profile appears rather optimistic with respect to expectations of being able to contain and even reduce the debt ratio in 2012-2013, given the rather high reliance on sustained growth in order to achieve this stable pattern. Furthermore, it is not clear to which extent the debt projections include the rather ambitious government plans to use foreign loans for financing the long overdue modernisation of the country's infrastructure. The high share of foreign denominated debt (78% of total public debt

<sup>(9)</sup> Meanwhile, on March 23rd; the authorities announced to draw EUR 220 million from the IMF Precautionary Credit Line that was established in January, thereby significantly lowering financing costs in view of the low PCL interest rate.

in December 2010) exposes the country to a substantial exchange rate risk. Furthermore, financing costs of the debt are likely to increase substantially in the near term, given that the country intends to increasingly tap private capital markets. Compared to last year's, the programme expects a significantly lower debt increase in 2010 and a significantly higher rise in 2011. However, overall, the debt level still is relatively low, and hence an even continued increase in the debt ratio does not appear to threaten debt sustainability in the near term.

#### 2.5.5. Budgetary implications of "major structural reforms"

The document presents a detailed matrix of policy commitments, with quantitative information on the impact of various reform measures on budgetary expenditures and revenues. It also contains information on the time schedule of the various measures. Overall, the presented data is plausible.

Overall, the fiscal framework appears to be optimistic for 2011, while for 2012 and 2013 revenue assumptions seem to be on the cautious side. However, the track record of chronically underperforming investment spending raises doubts, on whether this spending target has realistic chances of being implemented. As far as the risk assessment is concerned, the programme would have benefitted from a more elaborated analysis.

Compared to last year's submissions, the document presents a better integration of the various reform measures with the respective Accession Partnership priorities.

#### 2.5.6. Sensitivity analysis and comparison with previous PEP

Like last year, 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 deceleration of revenue growth by 20% compared to the baseline scenario and the third scenario assessed a one-off expenditure shock in 2012, which would lead to an increase in the growth of spending by 30%. In the low-growth and also in the revenue shock scenario the deficit would increase to around 3% of GDP in 2011 and 2012 and – due to the low baseline deficit - would drop to around 2½% in 2013. In the expenditure shock scenario, the budgetary impact would be nearly ½ percent of GDP, increasing the deficit to 2½ in 2012 and to 2¼% of GDP in 2013. The estimates for the revenue and expenditure shock scenarios are plausible. The plausibility of the growth shock scenario is difficult to assess, as the programme does not specify the sources of the growth decline, which however has important implications for tax revenues. Overall, the magnitude of the assumed revenue and expenditure shocks appears rather small, i.e., about ½% of GDP, in particular when compared to the regular revenue and spending adjustments taking place during the year, which in the last years amounted to some 2% of GDP.

The programme also includes a sensitivity analysis of debt with respect to changes in interest and exchange rates. According to the estimates, the costs of debt services are subject to a certain interest rate risk, reflecting the relatively high share of debt with variable interest. The analysis of the exchange rate risk points to a relatively low risk stemming from the volatility of non-euro currencies. However, the estimates appear not to have taken into account the hypothetical possibility of an end of the currency peg to the euro, which is the currency in which about 60% of the country's public debt is denominated.

#### 2.5.7. Quality of public finances and institutional features

During recent years the country embarked on a number of public administration reforms, which – with substantial support from the IFIs – intended 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 are in the process of implementing a

programme of administrative decentralisation, which envisages transferring to the local communities' competences and financial means in a number of areas (such as education, health, local cultural institutions, urban planning and construction, fire brigades, etc.). So far, mainly the responsibilities have been transferred, while financial competences to a large extent still remain with the central government. Overall, recent measures, such as the reform of the Public Revenue Office, have helped to improve the public administration's efficiency.

The consistently high differences between revenue and expenditure estimates and the frequent adoption of supplementary budgets points to a rather limited capacity in fiscal planning. So far, the actual planning horizon appears to be shorter than the fiscal year and fiscal measures are often taken on an ad-hoc base and without proper discussion in parliament, neither with the broad business community, nor the civil society. Like in the past, the programme plans to substantially increase capital spending, from some 4.2% of GDP in 2009 to 6% in 2013. At the same time, the programme intends to reduce current spending, in particular by lowering transfers and "unproductive" expenses. This structural change in the country's public spending structure would represent an important improvement.

#### 2.5.8. Sustainability of public finances

The programme presents as requested long-term estimates on the sustainability of public finances for the period 2000-2050. The scenario is based on stronger growth in the period 2010-2020, from 2% to 5% annually, and a deceleration of growth to 3.5% in the remaining period. Unemployment is expected to decline, from 32.1% in 2010 to 12% by 2050. Revenues and expenditures are expected to rise again after their projected drop in 2012-13 and to reach during 2020-2050 a level of some 33½% and 34% of GDP, respectively. This will lead to a decline in the fiscal deficit from 2½% in 2010 towards ¼% of GDP by 2050. Expenditures for pensions are expected to increase moderately from 8.2% of GDP in 2000 to 8.8% in 2010 and to stabilise at close to 9% of GDP during the remaining period. Health expenditures are set to decline slightly, from 5.0% of GDP in 2005 to 4.5% in 2010 and to return to 5% during the remaining period. Spending for education is projected to drop from 4.9% in 2005 to 4.6% of GDP in 2010, but to increase to 5¼% of GDP 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 risks, although a continued reform of the social security system appears to be necessary to keep public sector health spending under control. However, some of the spending assumptions on pensions, health and education appear rather low, given the expected significant increase in pension-age population (from 9.7% of the total population in 2010 to 13% in 2050). Provided that the current public sector reform agenda is fully implemented, the former Yugoslav Republic of Macedonia seems to be able to meet the costs of an aging population. However, in view of a rapidly increasing share of old-age population, costs of the pension and health-care systems should be monitored carefully.

## 2.6. STRUCTURAL REFORMS

The 2011 PEP presents a large variety of structural reform projects, which are in line with the country's overall structural challenges. There is also a strong link to those reforms necessary for meeting the criteria for EU membership. The document provides detailed information on the planned and sometimes also on the realised fiscal impact of the intended reform measures. However, the direct links to the fiscal framework are less clear, mainly due to the rather general presentation on intended revenue and expenditure profiles during the programme period. Although the nominal level of the planned net-budgetary impact remains largely unchanged, the programme's scenario of rather strong



nominal GDP growth leads to a declining share of net-spending in GDP over the programme period (from 0.3% of GDP in 2011 toward 0.2% of GDP in 2013).

Overall, the authority's overarching policy priorities are not completely clear, which in the document translates into a rather encyclopaedic list of measures without stringent links between the various policy fields. The level of net-budgetary effects is rather low, although the level of involved spending and revenue is substantially higher. Furthermore, one has to take into account that a large part of structural reforms is financed by international financial institutions and donations, among others also from the EU budget, which by definition is not included in the presentation of a net-budgetary impact. However, compared to last year, the presentation of structural reforms has significantly improved, both in terms to presented information but also with respect to being more concise.

### 2.6.1. Product and capital markets

The document presents a large number of structural reform areas targeted to improve the efficiency of product and capital markets. The main measures in this area are related to improve the competitiveness of the industrial sector by promoting cooperation and the formation of clusters, to facilitate access of SMEs to financial capital, to increase efforts to fight unfair competition, to strengthen and improve the alignment of the financial banking and non-banking sector regulation and supervision with European standards.

Overall, most of the presented measures are important steps towards improving the country's business environment and are in line with the country's key challenges. The overall budgetary allocations for capital and financial market reforms appear to be on the low side. However, the majority of presented reforms is related to legal matters, while the main financial cost are probably related to building up necessary administrative capacities of the public administration and of regulatory and supervisory institutions. In the area of the financial sector, the alignment with newly adopted EU *acquis* appears to be rather high. In the area of product market reforms, the actual implementation and positive impact on the functioning of the country's product markets is more difficult to verify. For the sake of completeness, the programme could have presented the current state and plans related to privatisation.

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

	2011	2012	2013
Labour market	10.4	10.9	11.4
Public administration	3.9	3.7	3.8
Education	2.1	2.3	2.6
Agriculture	1.6	0.2	0.0
Industrial policy	0.2	0.4	0.5
SMEs	0.1	0.3	0.5
Other reforms (knowledge-based society, judiciary, environment, public procurement etc)	0.3	0.5	0.3
Total impact on the budget	18.51	18.40	19.00
Total impact on the budget (in % of GDP)	0.3	0.2	0.2

*Source: 2011 Pre-accession Economic Programme (PEP), ECFIN calculations*

### 2.6.2. Labour market

In order to address the country's structural unemployment problem, the authorities intend to strengthen the labour market institutions, such as the employment agency and the labour inspectorate, to implement and to improve the effectiveness of active labour market measures and to foster the dialogue with the civil society. Furthermore, the programme presents a series of measures to improve the level of education for the young and training for adults.

Compared to last year's programme, the document contains more information on recent and planned reforms on the labour market and on intended measures in the education sector. However, given that more than 30% of the labour force is registered as unemployed, one would have expected a more detailed analysis of the underlying problems and bolder measures than those presented in the document. In particular, the programme does not contain any concrete quantitative targets with respect to addressing the unemployment problem. This impression of an insufficient attention to this problem is also reinforced by the fact that in recent years the authorities failed to fully tap available financial support for labour market related measures, such as component IV of the IPA funds.

### 2.6.3. Other reform areas

The document presents a significant number of other reform projects, related to the electricity sector, public administration, infrastructure, trade liberalisation etc. There are frequent references to the EU accession requirements. However, like in other areas, the presentation would have benefitted from devoting more room for presenting the conceptual framework behind those reform measures.

## 2.7. OVERALL ASSESSMENT OF FORMAL REQUIREMENTS

### Macro framework

The programme presents a clear picture of past economic developments. Compared to last year's submission, the provided data is more complete and presented in a more consistent way. Overall, the macro framework is sufficiently comprehensive.

### Fiscal framework

The fiscal framework is largely in line with the macroeconomic framework and incorporates accession related challenges, such as improving the quality of public finances. However, the document would have benefitted from providing more concrete background information on the main reasons behind the dynamics of revenue and spending categories. The data are not in line with ESA 95 and there is no indication of a timeframe for better aligning fiscal statistics with ESA 95 standards. Consistency with the latest reporting in the fiscal notification has improved.

### Structural reforms

The presented structural reform framework is sufficiently comprehensive, with numerous references to EU accession requirements. Compared to last year's submission, the structural reform part is more concise and concrete. However, the presentation would have benefitted from being more explicit on the government's reform priorities and the conceptual framework behind the various reform measures as well as from more detailed description of the sources of financing of the envisaged measures.

Annex table 1: Structural indicators

Table II.2.6:

Annex: Structural indicators

	The former Yugoslav Republic of Macedonia					EU 27				
	2006	2007	2008	2009	2010	2006	2007	2008	2009	2010
<b>General economic background</b>										
Real GDP <sup>1</sup>	4.0	5.9	5.0	-0.9	1.3f	3.2	3.0	0.5	-4.2	1.8
Labour productivity <sup>2</sup>	56.6	56.4	58.9	58.4	n.a.	100	100	100	100	100
Real unit labour cost <sup>3</sup>	6.2	-12.9	2.6	5.8	n.a.	-1.1	-0.7	0.8	2.9	-1.6f
Real effective exchange rate <sup>4</sup>	n.a.	n.a.	n.a.	n.a.	n.a.	115.0	121.7	123.7	120.7	n.a.
Inflation rate <sup>5</sup>	3.2	2.3	8.3	-0.8	1.6	2.2	2.3	3.7	1.0	2.1
Unemployment rate <sup>6</sup>	36.0	34.9	33.8	32.2	31.9f	8.2	7.2	7.0	8.9	9.6
<b>Employment</b>										
Employment rate <sup>7</sup>	39.6	40.7	41.9	43.3	n.a.	64.5	65.4	65.9	64.6	n.a.
Employment rate - females <sup>8</sup>	30.7	32.3	32.9	33.5	n.a.	57.3	58.3	59.1	58.6	n.a.
Employment rate of older workers <sup>9</sup>	27.9	28.8	31.7	34.6	n.a.	43.5	44.6	45.6	46.0	n.a.
Long term unemployment <sup>10</sup>	n.a.	n.a.	n.a.	n.a.	n.a.	3.7	3.1	2.6	3.0	n.a.
<b>Product market reforms</b>										
Relative price levels <sup>11</sup>	44.5	44.6	46.2	45.0	n.a.	100	100	100	100	100
Total trade-to-GDP ratio <sup>12</sup>	n.a.	n.a.	n.a.	n.a.	n.a.	10.7	10.7	11.5	9.7	n.a.
Net FDI <sup>13</sup>	6.8	8.5	6.1	2.0	n.a.	2.3	3.9	2.2	2.1	n.a.
Sectoral and ad-hoc state aid <sup>15</sup>	n.a.	n.a.	n.a.	n.a.	n.a.	0.6	0.5	2.2	n.a.	n.a.
Business investment <sup>16</sup>	n.a.	n.a.	n.a.	n.a.	n.a.	18.2	18.7	18.4	16.2	n.a.
<b>Knowledge based economy</b>										
Tertiary graduates <sup>17</sup>	4.3	4.6	6.1	n.a.	n.a.	13.4	13.8	13.9	n.a.	n.a.
Spending on human resources <sup>18</sup>	n.a.	n.a.	n.a.	n.a.	n.a.	5.0	5.0	n.a.	n.a.	n.a.
Educational attainment <sup>19</sup>	75.8	79.2	79.7	81.9	n.a.	77.9	78.1	78.4	78.6	n.a.
R&D expenditure <sup>20</sup>	n.a.	n.a.	n.a.	n.a.	n.a.	1.9	1.9	1.9	2.0	n.a.
Broadband penetration rate <sup>21</sup>	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	18.2	21.7	23.9	n.a.

1. Growth rate of real GDP in %. 2. Labour productivity per person employed - GDP in PPS per person employed relative to EU-27 (EU-27=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 (1999 = 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 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. 11. comparative price levels of final consumption by private households including indirect taxes (EU-27=100). 12. Trade integration - Average value of imports and exports of goods divided by GDP.

13. Average value of inward and outward FDI 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. Number of broadband access lines per 100 inhabitants.

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

Source: Commission services, national sources

## 3. ICELAND

### 3.1. EXECUTIVE SUMMARY

Iceland's first Pre-Accession Economic Programme 2011 -2013 (PEP) submitted in January 2011 presents a medium-term macroeconomic scenario with a somewhat optimistic pattern of economic recovery, and a comprehensive, ambitious and sound fiscal framework, particularly for the year 2011. The document appears broadly consistent with earlier key policy documents and the 2011 budget plan. Given that it is Iceland's first PEP there is scope for improving the fulfilment of formal and data requirements. Moreover, the quality of the programme would benefit from adding alternative growth scenarios and a sensitivity analysis to the baseline fiscal programme to better understand and quantify potential risks.

Following a long and deep recession, the Icelandic economy started to recover mildly in late 2010, based on stronger private consumption and exports, but unemployment continued to increase. Exchange rate stability and lower inflation allowed the central bank to gradually reduce the key policy rate. However, the easing of financial conditions has so far not been transmitted to a revival of demand for credits, as a large number of private households and enterprises are still in the process of debt restructuring and balance sheet repair. Improvements in external trade have led to the emergence of a sizeable surplus in the trade in goods and services, and official foreign currency reserves increased to 44% of GDP. However, achievements in macroeconomic stabilisation have been made under the shelter of extensive capital controls and their gradual removal remains a key challenge.

The PEP presents a slightly optimistic growth scenario with a modest but robust recovery primarily driven by a marked strengthening of investment growth, though from a very low base. Projected investments largely depend on a few large energy projects and risks of delayed implementation cannot be overlooked. Also, the projected recovery of private consumption seems somewhat upbeat, in view of the huge domestic debt overhang, high unemployment and limited prospects for a swift recovery of disposable incomes. Given risks on the downside, the programme would benefit from presenting alternative growth scenarios. The inflation outlook appears broadly reasonable, particularly under the policy assumption of preserving exchange rate stability, but upside risks are related to higher energy and commodity prices. The programme would further benefit from a more detailed analysis of projected labour market and balance of payments developments.

The fiscal programme is clearly a demonstration of the government's commitment to continued fiscal consolidation over the medium term and an appropriate response to the vulnerabilities arising from a high stock of public debt. The envisaged fiscal adjustment is ambitious with a strong, frontloaded focus on expenditure restraint in 2011, following up on the fiscal consolidation successfully implemented in 2010. The 2011 budget seems sufficiently backed by concrete fiscal measures and risks seem particularly related to a less benign revenue performance, also taking into account that revenues in 2010 benefited from one-off factors. The credibility of the fiscal programme beyond 2011 could be strengthened by providing more information on expenditure measures and their quantitative effects. The link between structural reform priorities and the realisation of fiscal targets could be further strengthened. Finally, the programme contains little evidence that the structure and composition of spending will change to support a more growth-oriented public finance strategy.

The PEP covers a broad range of potential structural reform areas. However, the presentation is largely backward looking with a strong emphasis on legislation. Looking forward, the PEP presents little concrete structural reform measures to address the key structural priorities and policy objectives of the programme. Future submissions would benefit from a somewhat more detailed exposition of the

policy matrix, possibly based on and inspired by the recently adopted government's 2020 reform agenda.

*Table II.3.1:  
Comparison of key macroeconomic and budgetary projections*

		2009	2010	2011	2012	2013
Real GDP growth (% change)	COM	-6.8	-3.5	0.7	2.1	n.a.
	PEP2011	<b>-8.5</b>	<b>-2.5</b>	<b>2.2</b>	<b>2.9</b>	<b>3.0</b>
Consumer price inflation (%)	COM	16.3	5.5	2.5	2.3	n.a.
	PEP2011	<b>12.0</b>	<b>5.4</b>	<b>2.5</b>	<b>2.6</b>	<b>2.4</b>
General government balance (% of GDP)	COM	-9.9	-6.2	-4.2	-3.2	n.a.
	PEP2011	<b>-9.9</b>	<b>-6.0</b>	<b>-2.6</b>	<b>0.1</b>	<b>2.8</b>
Primary balance (% of GDP)	COM	-3.3	1.2	3.8	5.2	n.a.
	PEP2011	<b>-3.4</b>	<b>0.6</b>	<b>4.0</b>	<b>6.7</b>	<b>9.4</b>
Government gross debt (% of GDP)	COM	87.8	91.5	93.5	92.8	n.a.
	PEP2011	<b>92.5</b>	<b>96.3</b>	<b>100.8</b>	<b>94.4</b>	<b>88.7</b>

*Sources: Pre-Accession Economic Programme (PEP) 2011, Commission 2010 Autumn Forecast (COM)*

## 3.2. INTRODUCTION

On 31 January 2011, Iceland submitted its first Pre-Accession Economic Programme, following government adoption and earlier consultation of social partners. The programme covers the period 2011-2013. It builds on earlier policy documents, such as the government's medium term fiscal programme from mid-2009<sup>(10)</sup>, the 2020-strategy adopted in January 2011<sup>(11)</sup> and on policy commitments taken in the context of the IMF programme<sup>(12)</sup>. The key policy objectives of the programme are to lay the foundations for a sustainable economic recovery. To this end, a number of key priorities, such as a faster reduction of the private sector debt overhang, continued fiscal consolidation, a restoration of a healthy banking system, preservation of exchange rate and financial stability as well as of flexible labour markets are seen as the main cornerstones of the programme.

## 3.3. KEY CHALLENGES

At the current juncture, economic policy challenges in Iceland are manifold. A core challenge will be to lay strong foundations for an economic recovery based on a sustainable growth pattern, after Iceland has experienced the longest and most severe recession since its independence. To this end, tackling a huge domestic debt overhang which at present strongly impedes on growth, investment and income will continue to be of prime importance. A revised framework for advancing household and corporate debt restructuring was put in place end-2010 and needs now to be implemented vigorously. But repairing private non-financial sector balance sheets is a difficult process that takes time. Attention will have to be paid to limiting negative financial repercussions on the banking sector so as to allow the emergence of a healthier and stronger financial sector capable of pursuing its financial intermediation tasks in an efficient manner. Remarkable achievements in macroeconomic stabilisation have been made over the last two years, though under extensive capital controls. Their gradual lifting is a prerequisite for sustainable growth based on domestic and foreign investments and needs to be implemented in a careful manner, in close coordination with macro policies, to preserve price, exchange rate and financial stability. The severe economic downturn has seriously affected the labour market; unemployment rates have reached unprecedented levels and net emigration soared. Job creation will remain a challenge for some time, but a generally flexible labour market, if preserved, should support raising employment levels and disposable incomes. Last, but certainly not least, in

<sup>(10)</sup> [http://eng.fjarmalaraduneyti.is/media/Utgefın\\_rit/Measures\\_to\\_achieve\\_a\\_balance.pdf](http://eng.fjarmalaraduneyti.is/media/Utgefın_rit/Measures_to_achieve_a_balance.pdf)

<sup>(11)</sup> <http://eng.forsaetisraduneyti.is/media/2020/iceland2020.pdf>

<sup>(12)</sup> <http://www.imf.org/external/country/isl/index.htm>

order to ensure public debt sustainability, a core challenge will be to continue the implementation of the authorities' ambitious medium-term fiscal consolidation plan, supported by a set of growth-friendly revenue and spending measures. The PEP acknowledges policy challenges ahead and its fiscal targets can be regarded as sufficiently ambitious. The measures of the PEP's fiscal strategy for 2012/13 however would gain from being more developed so as to provide a sound basis for medium term policy design and implementation. They would need to be accompanied by a quantification of the impact of potential risks on the public deficit and debt positions.

### **3.4. RECENT ECONOMIC DEVELOPMENTS AND MEDIUM-TERM SCENARIO**

#### **3.4.1. Recent macroeconomic developments**

Following the collapse of its financial sector in October 2008, the Icelandic economy went into a deep and long recession. Real GDP declined by 6.8% in 2009 and by a further estimated 3.5% in 2010, driven by strong adjustments in domestic demand. The recession seems to have bottomed out in the second half of 2010; the economy started to recover mildly, based on stronger private consumption and a stronger export performance on non-aluminium and non-maritime products. Seasonally adjusted quarterly GDP grew by 2.2% in the third quarter, but fell again by 1.5% in the fourth quarter of 2010, as stronger domestic demand was offset by higher imports. The recession had a serious effect on the labour market, though somewhat cushioned by elements of flexibility, such as real wage adjustments, increased part-time work and net emigration, partly offset by new entries of young people to the labour force. Nonetheless, average employment levels dropped markedly, particularly in sectors severely hit by the crisis, such as construction and financial services. The average unemployment rate continued to increase through 2010, to an unprecedented 7.6% (Labour Force Survey), compared to pre-crisis levels of around 3% and the share of long-term unemployed rose steadily to 1.7%. Weak domestic demand and a recent improvement in the terms-of-trade effects have supported annual inflation to gradually come down to 1.9% by February 2011, compared to 18% in 2008 and 7.5% in 2009. Exchange rate stability and lower inflation allowed the central bank to reduce the key policy rate in successive steps to a historical low of 4.25% by February 2011 which led to a fall in market interest rates. The easing of financial conditions has so far not translated into a revival of demand for credits, as a large number of private households and enterprises are still in the process of debt restructuring and balance sheet repair. Improvements in external trade, including a recent strengthening of exports, have led to the emergence of a sizeable surplus in the trade in goods and services of 10.6% of GDP in 2010. According to a recent release by the Icelandic central bank, balance of payments data have been significantly revised. The current account deficit stood at 7.8% of GDP in 2010, down from 10.3% in 2009, which is a marked revision as compared to the figures presented in the PEP (see table below). The "underlying" current account balance as calculated by the central bank (i.e. excluding accrued interest of banks in winding up proceedings) reached a surplus of 1.7% of GDP, down from 2.5% a year before. Official foreign currency reserves increased by 38% year-on-year to 44% of GDP (2009: 32%). The stock of gross external debt (excluding banks in winding-up proceedings) has come down to an estimated 213% of GDP at end-2010, compared to 242% at end-2009. However, the economy has been shielded by an extensive regime of capital controls.

Table II.3.2:

Comparison of macroeconomic developments and forecasts

	2009		2010		2011		2012		2013	
	COM	PEP	COM	PEP	COM	PEP	COM	PEP	COM	PEP
Real GDP (% change)	-6.8	-8.5	-3.5	-2.5	0.7	2.2	2.1	2.9	n.a.	3.0
<i>Contributions:</i>										
- Final domestic demand	-21.1	-20.6	-	-1.6	0.6	2.4	1.7	3.9	n.a.	3.9
- Change in inventories	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	n.a.	0.0
- External balance of goods and services	14.7	12.1	0.4	-0.9	0.1	-0.2	0.4	-1.0	n.a.	-0.9
Employment (% change)	-6.0	-9.8	-0.6	-0.2	0.5	0.7	1.0	2.1	n.a.	1.8
Unemployment rate (%)	7.2	8.0	7.8	8.1	7.3	7.2	6.3	5.6	n.a.	4.5
GDP deflator (% change)	8.9	11.3	6.8	5.9	1.8	2.4	2.2	2.7	n.a.	2.3
CPI inflation (%)	16.3	12.0	5.5	5.4	2.5	2.5	2.3	2.6	n.a.	2.4
Current account balance (% of GDP)	-2.2	-2.2	-4.5	-2.9	-4.9	-3.6	-4.6	-4.9	n.a.	-5.8

Sources: Pre-Accession Economic Programme (PEP) 2011, Commission 2010 Autumn Forecasts (COM)

### 3.4.2. Medium-term macroeconomic scenario

The PEP 2011-2013 presents a slightly optimistic growth scenario with a modest but robust recovery primarily driven by a marked strengthening of investment growth, though from a very low base. While the PEP assesses its projection for GDP and its demand components and inflation in a comprehensive manner, it would have benefited from a more detailed analysis of projected labour market and balance of payments developments.

The external assumptions of the PEP are based on the most recent IMF World Economic Outlook. On this basis, the PEP expects Iceland's trading partners' GDP to rise by 2.3-2.4% in 2011/12. Prices of aluminium are projected to rise by 6-7% in 2011/12 whereas maritime goods are expected to be subject to "modest price increases".

#### Real sector

The PEP projects the very mild economic recovery which started in the second part of 2010 to gain pace in 2011 and beyond. For 2010 as a whole, the economy is still projected to decline by 3%, but real GDP growth is set to accelerate to a modest 1.9% in 2011 and to around 3% in 2012 and 2013. The recovery is primarily driven by a resumption of domestic demand, in particular strong investment growth from extremely low levels. Real investments are set to rise by 15% in 2011 and to accelerate to 25% in 2012, supported by two major energy-intensive projects (Helguvik Greenfield, Straumsvik expansion), which amount to an estimated 1.5% of GDP in 2011 and 2.3% of GDP in 2012. The PEP projects private consumption to grow by 2.6% in 2011 (after an estimated fall of 0.2% in 2010) and to accelerate gradually to 3.7% by 2013 without explicitly mentioning the driving factors behind this expansion. After strong falls of international trade in 2009, both exports and imports are projected to increase in real terms in 2010 and to accelerate in 2011 and 2012. Total imports are set to grow more strongly than exports, leading to a negative contribution of net exports over the entire PEP period.

The PEP's growth scenario appears somewhat optimistic and does not provide a fully convincing explanation of the acceleration of private consumption and investment growth. The PEP rightly argues that a number of favourable factors may put the economy on a higher growth path, such as a competitive real exchange rate, expected progress in domestic debt restructuring and prospects for a normalisation of access to credit markets in the context of a gradual lifting of capital controls. However, given the rather high degree of uncertainty related to those factors they may not be strong enough to support the projected pace of recovery. The PEP itself points to the risks, primarily related to the high corporate sector debt, balance sheet problems, slow debt restructuring, which may continue to hold back business sector investment. Also, the pace of investment seems to heavily rely on two major energy-related projects and there may be a risk of delayed implementation with such big

projects. Moreover, the scope for private consumption may remain constrained over the short to medium term. The new framework for household debt restructuring approved in December 2010 will provide financial relief for a large number of households, but even after debt restructuring, households will be left with a significant debt burden. The level of unemployment is still high, employment levels will only slowly increase and, consequently, disposable incomes are unlikely to recover markedly over the PEP horizon, also due to higher indirect taxes and cuts in social transfers and family support. In addition, the expiry of the lengthening of the eligibility period for unemployment benefits in June 2011 may imply a reduction of replacement income. All these factors do not bode very well for widespread improvements of consumer confidence and optimism. So far, early withdrawals from private pension schemes have supported private spending, but this liquidation of savings cannot continue for an indefinite period. The PEP provides a balanced assessment of the medium-term scenario and fully acknowledges risks of a low growth scenario in general terms, which are however not explored quantitatively.

### **Inflation**

The PEP projects annual inflation to remain slightly below but close to 2% in 2011 and 2012 and to increase mildly to 2.3% in 2013. Thus, inflation is projected to remain below the current inflation target of 2.5%. The programme argues that inflationary pressures will remain low for a number of reasons. First, the initial strong pass-through effects following the major currency depreciation after the crisis has been fading out as evidenced by a rapid and continuous fall in inflation from close to 20% (post crisis) to below 2% in early 2011. Second, the PEP projects a stable nominal exchange rate and the persistence of a negative output gap over the PEP horizon, both factors contributing to lower inflation pressures. Finally, the PEP addresses the question whether a growing economy and rising employment could at some point lead to pressures on the labour market resulting in higher wages and prices. The programme perceives those risks as low and bases its arguments on the concept of the non-accelerating inflation rate of unemployment (NAIRU). The NAIRU for Iceland is estimated at 3% under normal conditions (based on the central bank's macro model). The PEP acknowledges that the equilibrium rate of unemployment may have increased somewhat following the major crisis and government policies to protect long-term unemployed. Nonetheless, the difference between the current unemployment rate of around 8% and the PEP's estimate of a (slightly higher) NAIRU would indicate some distance before labour market conditions become tighter. Consequently, the PEP argues that the inflation rate can still remain at or below the current rate if economic recovery moderately kicks in and unemployment start falling significantly.

The inflation outlook of the PEP appears broadly reasonable. Inflation risks over the medium-term seem relatively balanced. The dis-inflation process over the last two years has led to a stabilisation of inflation expectations. A modest recovery of growth and disposable incomes should not exert significant inflationary pressures. On the other hand, some mild price pressures could result from further tax increases, higher energy prices as well as from the recent surge of commodity and food prices. Although high unemployment and weak demand may generally not lead to very strong wage increases over the short term, demands for higher wages are emerging in the context of the current wage bargaining round. There is also a risk that wage increases in the profitable tradable sectors could subsequently spill-over into the non-tradable sector. Most importantly, the inflation outlook very much rests on the basic assumption of a continued exchange rate stabilisation, the prime focus of monetary policy since the outbreak of the crisis. Preserving krona stability in the context of the gradual lifting of capital controls will present a particular challenge.

### **Monetary and exchange rate policy**

The PEP recalls the rationale of the monetary policy framework adopted in the aftermath of the crisis in the context of the IMF programme. The prime focus on exchange rate stabilisation aided by a regime of temporary and extensive capital restrictions has helped bringing down inflation and interest



rates and bolstering foreign exchange reserves. The PEP reasonably argues that a stabilisation of the domestic currency via conventional instruments would have most likely required a significantly tighter policy stance primarily through higher interest rates, amplifying the recession. The recourse to capital controls was meant to prevent large scale capital outflows, including the repatriation of large domestic currency holdings of non-residents. Looking forward, the gradual removal of capital controls remains an important policy priority and requires a comprehensive liberalisation strategy. Another challenge will be to define the elements of the future monetary and exchange rate policy framework. The PEP itself remains rather vague on the possible elements of a future policy framework and their pros and cons. This is understandable, given that those issues were still in the process of deliberation at the time of the PEP submission, and due to their sensitivity. An internal discussion between the central bank and the government has been launched on the basis of a central banks' report to the government. The report essentially seems to suggest retaining an inflation targeting regime, though possibly with a stronger focus on asset price cycles and complemented with a broad set of macroprudential rules. An optimal use of macroprudential instruments may warrant changes to the current institutional architecture, i.e. the division of labour and responsibilities between monetary, fiscal and supervisory authorities for the maintenance of financial stability. The report also envisages more active forex interventions to smooth short-term fluctuations and strengthen forex reserves. A better coordination with fiscal policy is also deemed essential. Future submissions would certainly benefit from a more elaborated assessment of Iceland's monetary and exchange rate strategy, once the key policy decisions have been taken.

### External sector

The PEP's section on external developments is limited and rather backward looking, recalling the strong adjustment of the balance of goods and services from high pre-crisis deficits to post-crisis surpluses, primarily resulting from a sharp compression of imports. Recent trends during 2010 indicate a further increase in exports, including rising revenues from tourism, leading to a further gradual improvement of the balance of services. For the medium-term, the PEP projects the current account surplus (adjusted for net factor income of banks in winding-up proceedings) to gradually decline in line with economic recovery and stronger imports.

The PEP lacks a detailed assessment of the structure and financing of the current account and its sustainability over the medium term. Admittedly, projections about capital flows and their composition, including the role of FDI for growth, is a difficult task without knowing the main elements and the sequencing of capital account liberalisation. A brief assessment of the level of foreign reserves on the basis of usual liquidity and solvency indicators and, more generally of Iceland's net international investment position<sup>(13)</sup>, would have been useful to have some indications about the magnitude of Iceland's external vulnerabilities. Admittedly, estimates on external assets and liabilities have so far been subject to large fluctuations, mainly due to uncertainties about the balance sheets of the banks in winding-up proceedings which account for the bulk of external liabilities. Official data show gross external debt as high as around 900% of GDP, however, corrected for the banks in winding-up proceeding, the level of external debt stood at 213% of GDP at end-2010. The central bank has apparently started to re-estimate Iceland's net external position. Future submissions would benefit from presenting, on this basis, projections of external debt developments once more clarity about Iceland's international investment position has been achieved.

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<sup>(13)</sup> The international investment position shows the asset and liability position between residents and non-residents in Iceland. The international investment position is classified into direct investment, portfolio investment, other investment (deposits, loans, etc.) and the Central Bank of Iceland's foreign reserves

## Financial sector

The full restoration of the domestic banking sector, including a strengthening of balance sheets and improved regulation and supervision, ranges among one of the key objectives of the PEP. Since the collapse of the banking sector in October 2008, significant progress has been made with banking sector restructuring, one of the cornerstones of the current IMF programme. The market remains dominated by the three 'new' banks that emerged from the financial collapse in autumn 2008. They have been recapitalised by the state and are now much smaller in size compared to pre-crisis levels, focusing on domestic operations. The government retains majority ownership in one of the banks, and minority stakes in the other two banks; with the majority stakes (indirectly) owned by non-residents. The PEP acknowledges that banks are faced with vulnerabilities due to weak asset quality. Non-performing loan ratios are exceptionally high (estimated at 45%) and banks suffer from foreign exchange imbalances. In the context of debt restructuring operations for households and small firms recently agreed between the government, banks and other stakeholders, banks will be faced with the challenge to bear the financial implications. On the other hand, the three main banks' currently rather high capital adequacy ratios (16%), a relatively high level of loan loss provisions and the fact that assets were transferred to the "new banks" at large discounts should provide room to participate in debt restructuring and write-off schemes without damaging their capital base. A potential source of vulnerability is also to be seen in the current optimistic accounting treatment of future cash flows on restructured loans which could lead to an overestimation of capital adequacy in the short term. This highlights that loan portfolio restructuring should be accelerated with due attention paid to a cautious recognition of future incomes. Furthermore, the Supreme Court decisions declaring loans indexed to a foreign exchange clause illegal could potentially weaken the financial situation of the domestic banks, but the PEP reassures that the impact on the banks' capital base should be manageable for the three big banks. The restructuring and recapitalisation of the savings banks has further progressed, but some of them do not fulfil capital requirements, and there is room for further consolidation of the sector. Banks seem also faced with potential liquidity and funding risks. They are currently relying to a large extent on domestic deposits which have fallen in 2010 as a result of a rechanneling of savings to mutual funds. Looking forward, strengthening the deposit base continues to be challenging, in particular in the context of the future lifting of capital controls and the possible removal of the government's blanket deposit guarantee. At the same time, foreign direct investment and access to foreign credit still remains limited. Overall, the PEP provides a rather comprehensive and balanced assessment of the financial sectors' vulnerabilities and resilience factors, largely based on the central bank's financial stability assessments. While this is an important element in the context of the medium-term economic programme, the dimension of potential risks to financial sector stability as well as the capacity of the financial sector to support the PEP's growth scenario through lending for consumption and business investments remain somewhat unclear and could be further developed in future submissions.

## Main risks

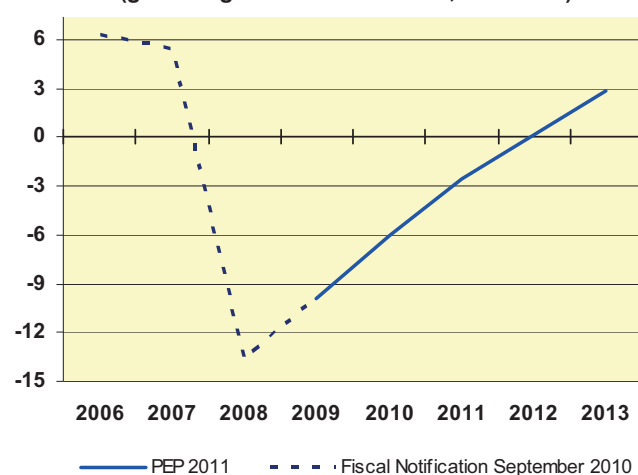
Obviously, key short-term risks are mostly related to factors that have been holding back the recovery so far. Slow progress with household and corporate debt restructuring would continue to impede a swift recovery of domestic demand and growth. Further delays in the implementation of large energy-intensive projects could endanger the realisation of projected investment growth. On the financial side, credit may continue to be a constraint as long as financial institution's balance sheet repair is not fully resolved, and litigation risks could add to attentive behaviour by banks.

## 3.5. PUBLIC FINANCE

The fiscal programme is clearly a demonstration of the government's commitment to continued fiscal consolidation over the medium term and an appropriate response to the vulnerabilities arising from a relatively high stock of public debt. The envisaged fiscal adjustment is ambitious with a strong,

frontloaded focus on expenditure restraint in 2011, following up on fiscal restraint measures successfully implemented in the context of the 2010 budget. The 2011 budget seems sufficiently backed by concrete fiscal measures and risks seem particularly related to a less benign revenue performance. Moreover, the credibility of the fiscal programme beyond 2011 could be strengthened by providing more information on expenditure measures and their quantitative effects. The link between structural reform priorities, envisaged reform implementation and realisation of fiscal targets is not obvious and could also be further strengthened. Finally, the programme contains little evidence that the structure and composition of spending will change to support a more growth-oriented public finance strategy.

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



The fiscal programme envisages a significant improvement of the consolidated general government balance by close to 9 percentage points of GDP, turning from an expected deficit of 6% of GDP in 2010 to a budget surplus of 2.8% in 2013. The primary deficit, defined as the budget balance corrected for net interest payment, is set to improve by the same magnitude (in % of GDP), namely from a deficit of 3% to a surplus of 6.1% of GDP. Fiscal consolidation is based on a reduction of the public spending ratio (including net acquisition of non-financial assets) by around 6.2 percentage points of GDP in the three-year period (from 49.2% of GDP in 2010 to 43% in 2013). In particular, public consumption (spending on wages and goods and services), social transfers, and – to a lesser extent – subsidies are programmed to be reduced, as a share of GDP, while public investment and interest expenditure are set to remain rather stable. At the same time, the revenue-to-GDP ratio is planned to increase by 2.7 percentage points from 43.2% to 45.9%, largely due to increases in tax revenues (in relation to GDP)<sup>(14)</sup>. The general government debt ratio is projected to decline by 7.6 percentage points, from 96.3% of GDP in 2010 to 88.7% of GDP in 2013.

### 3.5.1. Budget implementation in 2010

Public finances suffered a marked deterioration in the context of the October 2008 crisis and the severe recession, reflected in a significant increase in the general government deficit in 2008/09 (see

<sup>(14)</sup> It should be noted that the 2010 budget benefited from sizeable one-off revenues related to the so-called Avens Agreement, amounting to around 1.2% of GDP. Excluding this effect, the revenue to GDP ratio increases by 3.9 percentage points of GDP over 2010 to 2013, from 42% to 45.9%

graph)<sup>(15)</sup>. This prompted the government to launch a series of fiscal adjustment measures in the context of the IMF programme. The 2010 budget comprised a new set of revenue enhancing measures, in continuation of fiscal measures adopted in 2009 to contain the rapidly increasing deficit. The 2010 measures comprised further increases in personal income and social security taxes as well as higher VAT rates. Moreover, a new wealth and environmental tax was introduced. While the main focus of fiscal adjustment was on the revenue side, the budget also comprised significant cuts in current and capital spending, by around 10% year-on-year compared to 2009. In absolute amounts, cuts were broadly evenly distributed between operational expense (including in the health and education sectors), transfers (pension contributions, health care, parental benefits) and public investments. According to the PEP, consolidation measures helped bringing down the general government deficit by almost four percentage points, to 6% of GDP, broadly in line with fiscal targets. Following an initial underperformance, revenue gained pace towards the end of the year. Expenditures (at cash basis) remained somewhat below plans, particularly due to lower than budgeted unemployment benefits. However, although the performance of expenditure and revenues was largely in line with budget plans, it appears that contingent liabilities had a significant impact on the budget balance (according to ESA95 standards). Namely, according to Iceland's most recent "Reporting of Governments Deficit and Debt Levels" (of 14 March 2011), the general government deficit reached 7.8% of GDP in ESA95 terms. The deviation from the 6% of GDP deficit reported in the PEP seems largely related to the activation of central government's guarantees (amounting to ISK 22.5 billion, or 1.5% of GDP).

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

	2009	2010	2011	2012	2013	Change: 2010-13
<b>Revenues</b>	40.9	43.2	41.9	43.7	45.9	2.6
- Taxes and social security contributions	33.7	34.8	35.0	36.0	36.6	1.8
- Other (residual)	7.2	8.4	6.8	7.8	9.3	0.8
<b>Expenditure</b>	50.8	49.2	44.5	43.6	43.0	-6.2
- Primary expenditure	44.2	42.7	37.9	37.0	36.5	-6.2
<i>of which:</i>						
Gross fixed capital formation	3.5	2.6	2.3	2.4	2.5	-0.1
Consumption	26.4	24.8	22.9	21.2	20.5	-4.3
Transfers & subsidies	10.0	0.0	0.0	0.0	0.0	0.0
Other (residual)	4.3	15.3	12.8	13.4	13.5	-1.7
- Interest payments	6.6	6.6	6.6	6.6	6.6	0.0
<b>Budget balance</b>	-9.9	-6.0	-2.6	0.1	2.8	8.8
- Cyclically adjusted	-	-	-	-	-	-
<b>Primary balance</b>	-3.4	0.6	4.0	6.7	9.4	8.8
<b>Gross debt level</b>	92.5	96.3	100.8	94.4	88.7	-7.6

Sources: Pre-Accession Economic Programme (PEP) 2011, ECFIN calculations

### 3.5.2. Near-term and medium-term budget strategy

The PEP's fiscal scenario contains a detailed presentation of the operations of the central government. Fiscal projections for 2011 are based on the budget framework adopted in December 2010. The 2011 budget can be considered as the government's commitment to continued fiscal consolidation. It contains new fiscal consolidation measures, amounting to around 2.7% of GDP (see Box) with most of the adjustment on the expenditure side. This is obviously a change to the structure of fiscal adjustment in 2009 and 2010 which was largely based on revenue measures. Expenditure restraint measures in 2011 are projected at ISK 33 billion, or at around 2% of GDP. They include freezes of nominal wages and benefits as well as cuts in current and capital spending. This will be achieved through a rationalisation of health care costs, a 5% targeted reduction of welfare benefits (related to parental leave and child benefits), a 5% reduction of education and public order costs, and a 9%

<sup>(15)</sup> The 2008 deficit reflects mainly debt resumption by the Treasury, a large part of it related to the recapitalisation of the central bank

*Box II.3.1: New fiscal measures in the 2011 budget*

Revenue measures*	Expenditure measures**
• Capital gains tax (ISK 1.5 bn)	• Freeze on wages and benefits (ISK 5.0 bn)
• Corporate income tax (ISK 0.5 bn)	• Cuts in current spending (ISK 12.7 bn)
• Inheritance tax (ISK 1.0 bn)	• Cuts in transfers (ISK 11.4 bn)
• Net wealth tax (ISK 1.5 bn)	• Cuts in investment and maintenance (ISK 3.9 bn)
• Excises on tobacco and alcohol (ISK 1.3 bn)	
• Carbon tax (ISK 1.0 bn)	
• Automobile tax (ISK 0.2 bn)	
• Bank tax (ISK 1.0 bn)	
• PIT on pension withdrawal (ISK 3.0 bn)	
<b>Total effect on revenues: ISK 11 billion (0.7% of GDP)</b>	
<b>Total effect on spending: ISK 33 billion (2% of GDP)</b>	
* Estimated impact on central government revenues.	
** Estimated impact on central government expenditure.	
<i>Sources: PEP 2011</i>	

reduction of general administrative costs. Finally, capital spending (investment and maintenance) is planned to be reduced by 14%.

At the same time, the 2011 budget foresees an increase in spending on the interest rebate to alleviate the debt-burden of private households. The fiscal costs are estimated at annual ISK 2 billion in 2011 (and 2012). Moreover, as a discretionary measure to support growth, the authorities have decided to increase investment spending for high-return road infrastructure projects, financed through user fees. The total costs of the projects are estimated at 2.3% of GDP during 2011-2015, but the fiscal effects for the 2011 budget remain unclear. The public investment to GDP ratio slightly declines over the PEP horizon, suggesting that the new investment projects may be offset by a decrease in other public investments.

Revenue measures are set to yield ISK 11 billion, or 0.7% of GDP in 2011. They include, inter alia, an increase in the capital and corporate income tax rates (from 18 to 20%), the inheritance tax rate (from 5 to 10%), and the net wealth tax from (1.25 to 1.5%) as well as the introduction of a new bank levy. A relatively large part of additional revenues (ISK 3 billion) is projected to result from the taxation of pre-paid pensions.

Central government total expenditures in 2011 are projected to fall by 10% year-on-year, or by 6 percentage points of GDP, from 36.3 to 31.3%. Despite new revenue measures, total revenues are set to fall by around 1% or from 30.7% to 29% of GDP. The overall central government budget deficit declines by 3.3 percentage points from 5.6% in 2010 to 2.3% of GDP in 2011. The primary balance which is the core target of the fiscal programme, switches from a deficit of 2.8% in 2010 to a surplus of around 1% of GDP in 2011.

In 2012 and 2013, the fiscal balance of the central government is set to improve by 2.7 percentage points and 2.4 percentage points, respectively. While total spending over this period is projected to stay slightly above 30% of GDP (one percentage point lower as compared to the 2011 budget), total revenues are set to gradually increase by almost 4 percentage points during this period (to close to

33% of GDP). Thus, a frontloaded fiscal adjustment in 2011, driven primarily by expenditure restraint, is followed by a fiscal path with marked increases in the revenue ratios. At the same time, the PEP emphasises that the "revenue strategy for 2012 to 2014 relies on unchanged tax measures" <sup>(16)</sup>. The PEP seems to suggest that increases in revenue ratios could partly result from higher VAT (as the structure of consumption changes towards goods subject to the higher VAT bracket) or from the progressivity of the income tax system. Overall, the programme does not provide a fully convincing explanation of the marked increase in the revenue to GDP ratio. Implicitly, tax elasticities rise markedly and the elasticity of social contributions increases two-fold between 2011 and 2013 which is not explained by policy changes. Overall, revenue projections of the PEP for the latter part of the programme period seem rather optimistic, given that they are based on a no-policy change assumption (i.e. no further changes to the tax regime). Moreover, as mentioned, a less benign growth scenario would impact negatively on revenue performance. Finally, some of the tax measures taken in 2011 or before were of a temporary nature (net wealth and some environmental taxes), expiring in or at the end of 2012. Revenues from those temporary taxes accounted for an estimated 0.5% of GDP and the PEP does not provide precise indications, by which measures the expected loss in revenues could be compensated for.

The fiscal programme assumes a continuation of restrictive public sector wage policies. As of 2012, public sector wages are set to increase by 2% per year. Most other spending categories are set to rise in line with inflation. However, the programme foresees a 2% "structural increase" in child benefits and a 4% increase in the interest rate rebate as well as higher spending related to demographic changes (old age and disability pensions, cost of medication). The fiscal framework includes an ISK 5 billion contingency reserve to offset unexpected increases in commitments.

### Risks

The fiscal programme for 2011 is based on a credible budget framework, sufficiently backed by a set of concrete measures to support the achievement of fiscal targets. The strong focus on expenditure restraint in 2011 is appropriate, in view of containing the overall tax burden on the economy. At the same time, it is obvious that the projected cuts in spending appear very ambitious and require strong determination by the authorities. The current situation, in which many households are suffering from debt burden, unemployment, and low disposable incomes, could give rise to new requests for increased government transfers and social assistance. Moreover, despite the planned public sector wage freeze in 2011, currently ongoing private sector wage negotiations could, depending on their outcome, result in pressures on the government to accommodate higher public sector wages in the short term. Collective wage bargaining in Iceland usually implies public sector commitments for higher current or capital spending due to their "tripartite" nature. Finally, higher than projected interest costs could put an additional strain on the budget. Risks on the revenue side seem primarily related to a less favourable growth scenario and revenue shortfalls could particularly materialise in the second half of the PEP horizon, as GDP growth projections appear somewhat optimistic. Significant fiscal risks remain related to contingent liabilities, such as guarantees for the operations of the Housing Financing Fund and the repayment of the Icesave debt (see below).

### Structural balance

The programme does not contain an estimation of the structural balance.

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

The key objective of Iceland's economic programme is to bring the public debt ratio below 70% of GDP by 2014 and below 60% in the long term. The PEP projects the general government debt to

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<sup>(16)</sup> Page 42 of the PEP

slightly increase to around 100% of GDP in 2011, before it gradually declines to close to 89% by 2013. In other words, achieving the key 70% target in 2014 (which is beyond the scope of the PEP) would require a reduction of the debt ratio by 19 percentage points in a single year, which appears rather demanding, if not unrealistic.

Projections on the decomposition of changes in the debt ratio over the PEP period reveal that the primary balance as well as the so-called "snowball effect" (i.e. the combined effect of interest and nominal GDP growth) has a debt reducing effect which gradually increases over 2011 to 2013. In that sense, the deterioration of the debt ratio in 2011 is somewhat surprising. PEP data point to a major (residual) stock-flow adjustment (in the amount of 6.2 percentage points of GDP) in 2011 <sup>(17)</sup>, but the document itself provides no information on the further composition of stock-flow adjustments, i.e. to what extent other factors, such as the purchase of financial assets may be relevant for the increase in the debt ratio in 2011.

Future PEP submissions would certainly benefit from a debt sensitivity analysis to demonstrate how public debt would react to deviations of key economic variables from base assumption, such as GDP growth, inflation, exchange rates, interest rates (especially with a view to capital liberalisation).

The projected levels of public debt do not give rise to immediate concerns about debt sustainability, also in view of the decline of the debt ratio foreseen in the programme. However, the relatively high stock of debt and contingent liabilities in the form of government guarantees underline the need for a continuation of prudent fiscal policy and careful debt management. Progress in enhancing debt management capacity, smoothing the debt redemption profile, and improving access to markets are particularly welcome in this respect.

*Table II.3.4:*

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

	2009	2010	2011	2012	2013
<b>Gross debt ratio [1]</b>	<b>92.5</b>	<b>96.3</b>	<b>100.8</b>	<b>94.4</b>	<b>88.7</b>
Change in the ratio		3.8	4.5	-6.4	-5.7
<i>Contributions [2]:</i>					
<b>1. Primary balance [3]</b>		<b>3.0</b>	<b>-0.9</b>	<b>-3.9</b>	<b>-6.1</b>
<b>2. "Snow-ball" effect</b>		<b>0.3</b>	<b>-0.8</b>	<b>-1.7</b>	<b>-1.6</b>
<i>Of which:</i>					
Interest expenditure, net		3.0	3.5	3.8	3.3
Growth effect		2.7	-1.8	-2.8	-2.7
Inflation effect		-5.4	-2.5	-2.7	-2.2
<b>3. Stock-flow adjustment</b>		<b>0.5</b>	<b>6.2</b>	<b>-0.8</b>	<b>2.0</b>

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).

[3] As defined in the PEP: Budget balance corrected for net interest payments

Source: *Pre-Accession Economic Programme (PEP) 2011, ECFIN calculations*

<sup>(17)</sup> The table 39 in the ANNEX is somewhat misleading: as the primary balance in the PEP is defined as the headline balance corrected for net interest payments, the calculation on the contribution to the change in gross debt should be based on net instead of gross interest expenditure.

### 3.5.3. Budgetary implications of major structural reforms

The programme does not provide estimates of the fiscal impact of structural measures in various policy fields envisaged over the PEP horizon with the exception of the fiscal costs associated with a prolongation of interest rate rebate. Future submission would benefit from the presentation of a comprehensive policy matrix and estimates on net budgetary effects.

### 3.5.4. Sensitivity analysis

The programme does not provide a sensitivity analysis of the impact of changes to main economic assumptions (e.g. GDP growth, revenue growth, interest rates, exchange rates) on the fiscal position. The relevant chapter of the programme sketches potential risk stemming from contingent liabilities, i.e. Treasury guarantees, which have increased significantly over recent years to an amount equivalent to around 86% of GDP in November 2010. Guarantees for the State Housing Financing Fund represent the largest share, around two thirds, of total outstanding guarantees. Fiscal risks related to the operations of the Housing Fund have already materialised. As the PEP reports, asset quality has gradually deteriorated during recent years and loan write-offs soared in 2009 and 2010. As a result, the equity ratio declined to 2.1% at end-2010, significantly below the minimum threshold of 5%. This triggered a government recapitalisation (in early 2011), amounting to some 2% of GDP which was covered by the 2010 supplementary budget. The PEP refers to plans to improve the framework for operations of the Fund, including a comprehensive monitoring by the financial supervisory authority.

A bit more than a quarter of outstanding government guarantees have been provided for the borrowing of the public energy company (Landsvirkjun). According to the PEP, the financial situation and the refinancing conditions of the company are considered favourable, implying a low risk for public finance at this stage. Landsvirkjun was indeed the first Icelandic borrower to issue debt on international markets in 2010 following the crisis.

The so-called Icesave debt also constitutes a contingent liability. The PEP points out that the new Icesave agreement reached between the negotiation parties in December 2010 implied that only the interest costs would need to be borne by public finances (estimated at 3% of GDP over a 5 year period) whereas the principle of the debt could be redeemed by recovered assets from the failed estate (based on current estimates on recovery rates). However, following the no-vote on the new agreement in the public referendum held on 9 April 2011, the Icesave issue will have to be resolved in courts. The outcome of legal proceedings is highly uncertain and the eventual size of the liability impossible to quantify at this stage.

Future PEP submissions would benefit from a proper analysis demonstrating the sensitivity of the fiscal balance (and public debt ratio) to changes in selected and relevant economic variables. This would be useful in assessing the effects of possible deviations from the baseline macro-scenario, including a set of severe shocks on e.g. growth and revenues, on the realisation of the medium-term fiscal programme and its targets. Moreover, such an analysis could provide the base for the elaboration of possible counterbalancing measures to be taken in the event of risk occurrence. For now, it remains somewhat unclear how the fiscal strategy would respond in the medium term in case significant deviations from the outlined fiscal path occur.

### 3.5.5. Quality of public finance and institutional features

The PEP highlights recent and ongoing institutional reforms to strengthen public finance frameworks for central and local governments.

First, the 2011 central government budget included for the first time expenditure ceilings for two years (budget year plus following year). The ceilings are fixed in nominal terms and can be revised upwards



in case price developments deviate from assumption by more than 1.5%. As mentioned, an annual unallocated budget appropriation of ISK 5 billion provides a limited degree of flexibility in case of necessary deviations from the spending ceiling. Beyond this reserve, any excess spending would need to be compensated for by cuts in other categories.

Secondly, the PEP reports on progress in designing a strengthened framework for local government finances through the adoption of concrete fiscal rules for local budget balances and municipal debt. The new proposed framework requires the local budgets to be balanced over a three-year period to allow the working of automatic stabilisers. Moreover, municipalities will be required to limit debt to 150% of consolidated revenues. The framework also includes a system of enhanced monitoring including (non-financial) sanctions for local government exceeding the 150% threshold. The proposal is an ambitious and appropriate response to the marked deterioration of local government finances over recent years, in particular of larger municipalities. Therefore, if adopted and implemented as planned the new framework should contribute significantly to reducing medium-term fiscal risks.

The PEP does not explicitly discuss to what extent reforms of the Icelandic tax-benefits system could support the medium-term policy targets of the programme. No specific measures (beyond the changes introduced in the 2009-2011 budgets) are planned to overhaul the system with a view to improve income distribution, increase revenue mobilisation, enhance its growth orientation and make it more efficient in streamlining social benefits and transfer. Some of those challenges have been identified in a recent IMF study<sup>(18)</sup> and could be addressed in future submission. While the PEP does not explicitly discuss intentions to shift the composition of the budget toward growth-enhancing expenditure, major public investment project in road transport are foreseen, but the overall public investment ratio slightly declines over the PEP horizon. Overall, the PEP would benefit from presenting more details on the government's strategy to improve the quality of public finances through concrete revenue and expenditure measures.

### 3.5.6. Sustainability of public finance

The PEP 2011-2013 does not explicitly discuss long-term projections on population trends and age-related public expenditures. The relevant chapter of the programme contains a brief description of the health and social welfare system, which is largely backward looking. However, looking beyond, it remains unclear to what extent the current health and social welfare system present a challenge for the long-term sustainability and how the medium-policy strategy would respond to those challenges.

The outlook for the three-pillar Icelandic pension system is rather favourable. The PEP states that "challenges facing the pension funds in Iceland appear light in comparison with pension systems of most other developed countries". As a benchmark for comparison the programme looks at net assets of pension funds which, as a share of GDP, is one of the highest among OECD countries (close to 120%). Moreover, according to OECD estimates, Iceland has one of the lowest old-age dependency ratios in 2050. This combination supports the relatively favourable outlook for Iceland's pension system, in comparison with peer countries. However, as the programme rightly points out, an ageing population will nonetheless place an increasing financial burden on the pension system in Iceland, as well. A government committee was set up in 2010 to suggest possible avenues for future pension reforms and their impact on the long-term sustainability of pensions. It would be useful if the PEP 2012 could report on the findings of the committee and policy intentions in this area.

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<sup>(18)</sup> IMF (2009), Improving the Equity and Revenue Productivity of the Icelandic Tax System

### 3.6. STRUCTURAL REFORMS

The PEP covers a broad range of potential structural reform areas. However, the presentation is largely backward looking with a strong emphasis on legislation. Looking forward, the PEP presents little concrete structural reform measures to address the key structural priorities and policy objectives of the programme. Future submission would benefit from a somewhat more detailed exposition of the policy matrix, possibly based on and inspired by the recently adopted government's 2020 reform agenda.

#### 3.6.1. Product markets and financial sector reform

The PEP 2011-2013 touches upon a number of potential structural reform areas related to the functioning of product markets, such as privatisation, competition and energy policy, FDI support, and corporate debt restructuring, the latter being a particular challenge in Iceland. The programme reports that the state has retained a majority ownership in 18 listed public companies, four of which belong to the energy sector. There is no information about the share of government assets in total assets to grasp the size of government ownership. The PEP confirms that there are no plans for privatisation. It points out that competition policy in Iceland is to large extent already based on EU rules and therefore concludes that changes to the policy framework and legislation are not necessary.. On energy policy, the PEP recalls broad guidelines and key objectives of a future energy strategy (using resources in a sustainable way; reduction of the use of fossil fuels and carbon emissions, increase in the proportion of renewable energy). An interesting issue (which is not addressed in the programme) would have been to assess the potential role of FDI in the energy (production) sector and its effects on long-term growth. The PEP refers to Iceland's FDI framework as one of the world's most restrictive ones and reports that possible changes are currently being studied by the government. It would be useful for the 2012 PEP to provide a more strategic view about the potential future role of FDI and its impact on growth and diversification and necessary requirements to attract a stronger flow of direct investment from abroad. In this context, policies envisaged to improve the overall investment climate by removing existing barriers to entrepreneurship (permits, regulations) in addition to the restrictions on FDI should be addressed.

The corporate sector debt overhang constitutes an important bottleneck for investment and growth. A new framework has been adopted to accelerate the debt restructuring of small and medium-sized enterprises (SMEs), 7,000 of which are reported to suffer from negative net equity. On the basis of a (non-binding) agreement between the government and the financial sector, banks are expected to provide debt write-offs to viable small and medium-sized companies (SMEs) on the principle that gross debt does not exceed the estimated value of the firm. The government supports the initiative by removing tax-related obstacles. Debt restructuring for SMEs is expected to become fully operational in June 2011. The restructuring of the debt of large corporations remains difficult and complex, and continues to be dealt with on an individual basis between banks and firms.

On financial sector policies, the PEP reports on recent legislative and institutional changes to enhance banking supervision and risk management system and confirms that the main Icelandic banks meet Basel III capital requirements. At the same time, the programme fully recognises the need to further strengthen prudential regulations and supervision frameworks. New emphasis is put on stronger coordination on financial stability issues within the government as well as between the government and the central bank, which is welcome.

#### 3.6.2. Labour market

The Icelandic labour market has provided elements of flexibility to cushion the effects of the severe recession, notably through substantial real wage adjustments, increased part-time work, and a reduction of labour supply, as manpower emigrated and employees temporarily left the labour market to study. Moreover, it is estimated that without a significant increase in net emigration in 2009 and

2010 the unemployment rate would be 1-2 percentage points higher, other things being equal. Nonetheless, unemployment increased to unprecedented levels and long-term unemployment rose markedly, too. The government reacted by extending the eligibility period for unemployment benefits (which expires in June 2011) and providing financial incentives for part-time work on a temporary basis. Various training schemes are being offered, including special programmes for the youth and for long-term unemployed. Looking forward, the PEP does not suggest particular changes to labour market policies and would generally benefit from taking a more strategic forward looking view.

### 3.6.3. Household debt restructuring

Based on a rigorous framework, the authorities developed a reasonable package of measures to effectively address most distressed households. It includes debt write downs of qualified mortgages to 110% of the collateral value, the possibility of further voluntary debt mitigation to 100% based on debt service capacity, a temporary increase in the tax interest rebate, as well as general interest rate subsidies (regardless of the income situation of the household, but based on the household's net worth). Fiscal costs for the tax interest rebate are projected at ISK 2 billion per year in 2011 and 2012. Costs of the interest subsidy will be borne by banks (through a new bank levy). Financial measures are being complemented by strengthened institutions, such as the Debtors' Ombudsman as well as public information campaigns. Overall, a good basis for advancing household debt restructuring has been established, but implementation risks remain a concern.

### 3.6.4. Other reform areas

Other reform areas cover the agricultural sector, public administration, research and development, information society and telecommunication. The presentation is often backward looking, providing information on past and ongoing reform measures and initiatives with a strong emphasis on legislative action. The programme would have benefited from discussing the relevance of envisaged reforms in the context of its key policy objectives.

## 3.7. OVERALL ASSESSMENT OF FORMAL REQUIREMENTS

### Macro framework

Chapter 2.1 presents a concise description of real sector and price developments, but future submissions should also capture key external and financial sector variables in a more comprehensive manner. The medium-term macroeconomic framework in chapter 2.2 would benefit from a more detailed assessment of projected labour market and balance of payments developments. Alternative growth scenarios would enhance the quality of the programme. Weaknesses remain with respect to data on sector's savings-investment balances.

### Fiscal framework

Historical data on budget balances and debt are consistent with data provided in the context of the September 2010 fiscal notification. The PEP has a strong emphasis on central government instead of general government operations. Future submission would benefit from more complete data (e.g. on general government expenditure by function, long term fiscal projections, cyclical budget balance). A sensitivity analysis could be added to the baseline fiscal programme to better understand risks to the scenario.

### Structural reform

This part of the programme would benefit from a more forward looking, strategic assessment of concrete structural reform measures planned over the medium-term, how they are seen to fulfil the key objectives of the PEP and impact on the fiscal programme, including estimates on the net budgetary effects.

**Table II.3.5:**

**Annex: Structural indicators**

	Iceland					EU 27				
	2006	2007	2008	2009	2010	2006	2007	2008	2009	2010
<b>General economic background</b>										
Real GDP <sup>1</sup>	4.6	6.0	1.0	-6.8	-3.5	3.2	3.0	0.5	-4.2	1.8
Labour productivity <sup>2</sup>	98.6	95.9	98.7	99.5	n.a.	100	100	100	100	100
Real unit labour cost <sup>3</sup>	n.a.	n.a.	n.a.	n.a.	n.a.	-1.1	-0.7	0.8	2.9	-1.6f
Real effective exchange rate <sup>4</sup>	n.a.	n.a.	n.a.	n.a.	n.a.	115.0	121.7	123.7	120.7	n.a.
Inflation rate <sup>5</sup>	4.6	3.6	12.8	16.3	7.5	2.2	2.3	3.7	1.0	2.1
Unemployment rate <sup>6</sup>	2.9	2.3	3.0	7.2	7.8f	8.2	7.2	7.0	8.9	9.6
<b>Employment</b>										
Employment rate <sup>7</sup>	84.6	85.1	83.6	78.3	n.a.	64.5	65.4	65.9	64.6	n.a.
Employment rate - females <sup>8</sup>	80.8	80.8	79.6	76.5	n.a.	57.3	58.3	59.1	58.6	n.a.
Employment rate of older workers <sup>9</sup>	84.3	84.7	82.9	80.2	n.a.	43.5	44.6	45.6	46.0	n.a.
Long term unemployment <sup>10</sup>	0.2	0.2	0.1	0.4	n.a.	3.7	3.1	2.6	3.0	n.a.
<b>Product market reforms</b>										
Relative price levels <sup>11</sup>	144.7	148.9	117.0	98.5	n.a.	100	100	100	100	100
Total trade-to-GDP ratio <sup>12</sup>	27.5	26.7	36.5	30.4	n.a.	10.7	10.7	11.5	9.7	n.a.
Net FDI <sup>13</sup>	28.1	42.1	-9.9	-18.1	n.a.	2.3	3.9	2.2	2.1	n.a.
Sectoral and ad-hoc state aid <sup>15</sup>	n.a.	n.a.	n.a.	n.a.	n.a.	0.6	0.5	2.2	n.a.	n.a.
Business investment <sup>16</sup>	30.1	24.3	19.9	10.3	n.a.	18.2	18.7	18.4	16.2	n.a.
<b>Knowledge based economy</b>										
Tertiary graduates <sup>17</sup>	11.3	10.2	10.4	n.a.	n.a.	13.4	13.8	13.9	n.a.	n.a.
Spending on human resources <sup>18</sup>	7.6	7.4	n.a.	n.a.	n.a.	5.0	5.0	n.a.	n.a.	n.a.
Educational attainment <sup>19</sup>	49.3	52.9	53.6	53.6	n.a.	77.9	78.1	78.4	78.6	n.a.
R&D expenditure <sup>20</sup>	3.0	2.7	2.7	n.a.	n.a.	1.9	1.9	1.9	2.0	n.a.
Broadband penetration rate <sup>21</sup>	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	18.2	21.7	23.9	n.a.

1. Growth rate of real GDP in %. 2. Labour productivity per person employed - GDP in PPS per person employed relative to EU-27 (EU-27=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 (1999 = 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 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. 11. comparative price levels of final consumption by private households including indirect taxes (EU-27=100). 12. Trade integration - Average value of imports and exports of goods divided by GDP.

13. Average value of inward and outward FDI 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. Number of broadband access lines per 100 inhabitants.

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

**Source:** Commission services, national sources

## 4. MONTENEGRO

### 4.1. SUMMARY AND CONCLUSIONS

Montenegro submitted its fifth Economic and Fiscal Programme (2011 EFP), covering the period 2011-2013, on 28 January 2011. Like in the previous programme, the key objective is to reduce the fiscal deficit so as to reach a balanced budget by 2012. The programme has become a policy coordination instrument and has for the first time been fully integrated in the preparation of the main national fiscal documents. Overall, the EFP broadly follows the requirements on format and content of the European Commission. However, it would benefit from further efforts to develop a more detailed underlying analysis, notably of medium-term projections.

After a sharp contraction of 5.7% in 2009, the Montenegrin economy started to recover from the effects of the crisis, growing by an estimated 1.1% in 2010 according to recent government and IMF projections; the external deficit narrowed while inflation remained subdued. The programme's macro economic baseline scenario projects real GDP growth to further increase to 2.5% in 2011 and reach 4% in 2013. Initially driven by net exports, growth would become more broad-based over the programme period as domestic demand is supported by the recovery of bank lending and inflows of FDI. While broadly plausible, this growth path is not immune from downside risks stemming from the international economic situation that may in particular affect exports and investment. The programme acknowledges risks and provides two alternative scenarios leading to a higher or lower growth path of the economy. All three scenarios converge towards a 4% real growth by 2013.

The fiscal deficit in 2010 (3% of GDP) was lower than the EFP projection by one percentage point despite a decrease in revenues and higher pension and social benefits expenditures, offset by reductions in other categories of public spending, including capital expenditures. Moreover, no budget rebalancing was needed in 2010. The medium-term fiscal scenario focuses on an expenditure-based consolidation in 2011-2013 to avoid jeopardizing the incipient recovery. The adjustment will take place gradually, with the budget reaching equilibrium in 2012 and a surplus in 2013. Following the outbreak of the economic crisis, public debt has been driven by budgetary financing needs and is expected to peak in 2011 at 43% of GDP before decreasing to pre-crisis levels by end-2013. The programme also presents the effects of the two alternative macro-economic scenarios on the fiscal and debt projections.

The extensive structural reform agenda described in the 2011 EFP is an enhanced version of previous year's programme. The reforms aim to consolidate the stability of public finances and to strengthen the competitiveness of the economy. Preliminary quantitative estimates of their budgetary impact over the period 2010-2013 are provided. The programme presents a summary account of measures undertaken in 2009 - 2010 and foreseen in 2011, but fails to detail implementation plans for the outer years.

Macroeconomic risks to the programme are related to the pace of recovery of domestic demand. A weak economic situation in Montenegro's main partners would affect exports and FDI inflows, the main drivers of investment, while limited credit growth from the banking sector would also hamper private consumption. Risks also surround the external accounts, given the projection of rather subdued imports, even in the higher growth path scenario, despite the expected recovery of the economy. On the fiscal side, while tax revenues could be lower than foreseen, main risks are related to the accumulation of tax arrears as well as a contingent activation of state guarantees extended during the crisis. Negative economic and fiscal developments could also delay the implementation of some structural reforms.

Overall, the programme's reform agenda seems to a large extent aligned with the reform requirements in view of the country's European Partnership priorities originating from the implementation of the Stabilisation and Association Agreement, as spelled out in the latest Opinion and the European Partnership. However, the programme still requires additional efforts to fully articulate the reforms within the fiscal scenario, notably their impact on the revenue side of public finances.

## **4.2. INTRODUCTION**

Montenegro's fifth EFP, covering the period 2011-2013, was submitted to the European Commission on 28 January 2011. Given the recent recognition by the European Council of Montenegro as a candidate country, this EFP is the last one to be submitted by Montenegro to the European Commission and will be followed, next year, by a Pre-Accession Economic Programme (PEP) that is required from candidate countries. The programme was drafted entirely by the Ministry of Finance, including the macroeconomic scenarios which in previous programmes used to be elaborated by Central Bank staff. Meanwhile, the programme has become a policy coordination instrument and has, for the first time, been fully integrated in the preparation of the main national fiscal documents. Two alternative scenarios, considering a higher or lower growth path, have been elaborated, taking into account some main upside and downside risks facing the economy. The analyses of the recent and medium-term fiscal developments are based on the national accounting standards, in line with GFS 2001 on a cash basis.

However, further efforts to develop a more detailed underlying analysis of the medium-term macroeconomic framework are still required. Yet, the programme demonstrates sufficient plausibility to meet the fiscal medium-term targets. The pace of structural reforms has been amplified and some efforts made to improve the estimates of their fiscal impact, although mainly on the expenditure side of the budget.

## **4.3. KEY POLICY CHALLENGES**

The programme's key policy challenge is to reinforce the sustainability of public finances, returning to budget surpluses as of 2013 without threatening the recovery of the economy. To this end important measures to contain public expenditures have been adopted, like the reduction of the public services' payroll, a new financing scheme for municipalities and a pension reform increasing the retirement age. Yet, the overall strategy of the EFP relies on the reactivation of still morose bank lending and on maintaining a substantial inflow of FDI to counter-weighting the low share of domestic savings, while financing a still sizeable external deficit.

The programme's structural reforms agenda addresses a number of challenges reported in the Commission's Opinion on the country's application for EU membership, like vulnerabilities in the regulation of the banking sector, increasing public indebtedness, rising unemployment, weaknesses in education as well as insufficient energy and transport infrastructure.

## **4.4. ECONOMIC DEVELOPMENTS AND OUTLOOK**

### **4.4.1. Recent macroeconomic developments**

After a sharp contraction of 5.7% in 2009, the economy slowly recovered in 2010 from the effects of the global crisis. The latest estimates for 2010 point to a real expansion close to 1%, compared with the initial estimate of 0.5% presented in the EFP. The first signs of revitalisation appeared in the second quarter of 2010 after 18 months of continuous contraction. The turnaround of the global metal

market gave an additional boost to the recently restructured local industries, raising total manufacturing output. The recovery of the industry contributed to the increase of total merchandise exports by 19% year-on-year (exports of aluminium contributing 37% of the increase and oil derivatives 47%). At the same time, merchandise imports increased marginally by 0.2% in 2010. As a result, the trade gap decreased to 43.5% of GDP, from 46% a year earlier. After a successful tourism season, the surplus in services increased by 16% year-on-year. These positive developments brought down the current account deficit to 25.6% of GDP, from 30% a year earlier. Net FDI reached 18% of GDP in 2010 despite the lack of major privatisation deals. Yet, net errors and omissions represent a sizeable 13.4% of GDP. The recovery of domestic demand in the second half of the year pushed inflation up to 0.7% by the end of 2010. The unemployment rate still rose to 12.1% by the end of the year, although the construction industry expanded by 61% year-on-year in the last quarter of 2010, raising the number of workers employed in this sector. The weak dynamics of the labour market were reflected in the moderation of wages, which increased by 3.5% in 2010, notwithstanding the inclusion of some allowances into the base salary. Moreover, the reduction by 4.1% of public administration wages reflected a redistribution of personal income tax payments, higher for employees and proportionally lower for the employer (i.e. the State).

The EFP provides a broadly realistic, though not very detailed, overview of macroeconomic developments in 2010, based on available data for part of the year. A major upgrade is the introduction of quarterly GVA growth profiles by economic sector. Moreover, data discrepancies observed in previous exercises have been reduced.

Table II.4.1:  
Macroeconomic developments

	2009	2010	2011	2012	2013
Real GDP (% change)	-5.7	0.5	2.5	3.5	4.0
<i>Contributions:</i>					
- Final domestic demand	-28.8	-4.4	-2.2	3.2	3.9
- Change in inventories	n.a.	n.a.	n.a.	n.a.	n.a.
- External balance of goods and services	23.1	4.9	4.7	0.3	0.1
Employment (% change)	0.4	0.2	1.3	1.8	2.0
Unemployment rate (%)	11.4	11.6	11.1	10.3	9.2
GDP deflator (% change)	2.4	1.0	2.2	2.5	2.5
CPI inflation (%)	3.4	0.7	2.5	2.5	2.5
Current account balance (% of GDP)	-30.1	-24.6	-19.3	-18.2	-17.3

Sources: Economic and Fiscal Programme (EFP) 2011

#### 4.4.2. Medium-term macroeconomic scenario

This year's EFP macro scenarios were prepared for the first time by the Ministry of Finance instead of the Central Bank. This first attempt results in a less detailed analysis for the forecasted period (2011-2013), and will need to be reinforced in the next programmes. In addition to a baseline scenario, two alternative scenarios are provided which lead to higher or lower growth paths depending on the evolution of three factors: exports, FDI inflows and the pace of recovery in bank lending. All scenarios converge towards a 4% real GDP growth by 2013. The GDP deflator rate remains the same for all scenarios, despite their inherent differences.

The medium-term central macroeconomic scenario is broadly plausible. The outlook is somewhat more cautious than in the previous programme, translating into lower employment growth. However, the projection of a declining, though still very significant, current account deficit is largely based on rather optimistic assumptions concerning exports' growth and imports stabilisation. The EFP draws on the IMF growth forecasts available at the time of preparation as regards the external environment. The base scenario assumes a gradual economic recovery in the EU and in neighbouring countries which

impacts positively on exports, tourism and FDI. However, no references are made to commodities' price dynamics, despite their very large potential impact on trade flows and inflation, nor to exchange rates, still important for regional and commodities trade. Taking into account the absence of a proper monetary policy, the fiscal scenario is geared towards allowing higher growth in the medium term through a continuous reduction of the very high level of public expenditures which peaked at 51% of GDP in 2009. Therefore, while revenues are expected to grow in line with the nominal expansion of the economy, expenditures would remain close to their 2011 level in nominal terms and thus gradually decline in real terms to 40% of GDP in 2013. This strategy was already successfully implemented in 2010.

### **Economic activity**

According to the baseline scenario, the main contribution to growth during the foreseen recovery should come from the expansion of services, mostly tourism. The recovery is expected to be mostly driven by net exports in 2011, as the contribution of domestic demand to GDP growth is still assumed to remain negative despite the resumption of bank lending after two years in negative territory. As a result of the economic improvement, employment should grow by 1.3% in 2011 while the annual expansion of salaries at 2.2% remains in line with the GDP deflator. Domestic demand is foreseen to gradually take over and be the main contributor to growth in 2012 and 2013. Private consumption's share in GDP in 2013 would remain stable at around 84%, and contribute with 3.4% to the overall expansion of the economy, mainly supported by credit growth and the gradual increase of employment. Investment, in particular in construction, is also expected to contribute to the recovery, supported by a revival of bank lending, as well as a significant and sustained inflow of FDI (above 17% of GDP annually, similar to pre-crisis levels). As a result, unemployment should decrease to one-digit rates by 2013, from 12% in 2010. The programme also lists other factors contributing to the expansion of the economy, such as the improvement of the business environment, as well as credit arrangements of some 4.3% of GDP committed by international financial institutions for infrastructure projects. On the other hand, due to the contention in government consumption, the contribution of public spending to growth will be slightly negative.

### **Inflation**

The 2011 EFP does not provide any estimation of consumer prices for the medium-term period (2011-2013). It only provides GDP deflators without any underlying analysis explaining their stability in all three growth scenarios. The lack of a proper analysis of potential price dynamics may result in the underestimation of inflationary risks. Some of these risks are linked to the external environment, as evidenced by recent developments in oil prices (above 100 USD/bl) and in food prices, which account for 37.5% of the consumer price index in Montenegro, and can also contribute to a widening of the trade deficit. Others are domestic, considering the expected GDP growth and the increases in domestic demand and employment. Thus, the inflation rate appears to be subject to significant upside risks in all scenarios.

### **Monetary and exchange rate policy**

Unilateral euroisation implies that there is only limited scope for the use of domestic monetary policy instruments. Moreover, despite some restricted capabilities of the Central Bank as lender of last resort, the ultimate stability of the financial system relies on the soundness of the government fiscal policy. This is essential to build up Montenegro's limited reserves, enhance credibility and borrow on international capital markets at a reasonable cost. The banking system seems to have somewhat stabilised in 2010, although the financial intermediation role of banks, especially the largest ones, remains morose as they finalise the consolidation of their balance sheets. According to the EFP the extent of credit growth recovery will be one of the key factors to determine the pace of revitalisation of the economy in the coming years. This is a crucial variable as lending activity since December



2008 until the end of 2010 has contracted by 21% and the quality of assets has deteriorated. The share of non performing loans represented 21% of total loans at the end of 2010. The baseline scenario foresees a 5% annual increase of credit activity for 2011 and 2012, reaching 8% by 2013, an assumption that the high-growth scenario also retains. The lower growth scenario also estimates a positive increase of bank lending at some 3% per year. However, the EFP fails to explain upon which premises this credit growth is based. In order to limit banking risks, and their subsequent strain on the fiscal position, the authorities will continue strengthening the supervisory capacities of the Central Bank, aligning domestic legislation with EU directives as well as adopting the International Financial Reporting Standards (IFRS).

### External sector

The programme estimates the current account deficit to contract, on the basis of increased manufacturing and tourism exports, from 24.6% of GDP in 2010 to 17.3% by 2013. However, given the limited diversification of the economy, and the very low coverage of merchandise imports by exports, there is limited scope to reduce these high levels without shifting substantially the production base towards tradable goods and services. In addition, the baseline scenario seems optimistic when extrapolating recent trends of exports growth, due to the recovery of heavy industry to full capacity, and a stabilisation of imports growth at a similar level as in 2010, when domestic demand was substantially weakened by the crisis. The latter assumption does not seem to be consistent with the programme expectations for domestic consumption and investments as engines of growth, which should translate into higher imports, in particular of capital goods. Overall, the current account deficit will remain high in the coming years.

### Main risks to the macroeconomic scenario

The EFP presents a matrix or "map of risks" including an estimation of the potential impact of each one of them on growth dynamics for each scenario. Overall, after a severe economic crisis, the main downside macroeconomic risk would be a strong weakening of the recovery momentum induced by unexpected external shocks or a lethargic banking sector. External risks are focused on trade and FDI. Exports are mostly exposed to external shocks from tourism and international metal price developments, which could impact GDP by about one percentage point. Imports, which according to the programme should remain stable at 60% of GDP, are not exempt from global price shocks, not to mention the high reliance on imports of the domestic economy. As a result, the sustainability of the current account deficit which is projected to decline in all three EFP scenarios could be further threatened. So could be the sustainability of its financing since FDI inflows are foreseen to return to their pre-crisis levels. On the other hand, FDI could be underestimated in case some of the announced large infrastructure projects were to materialise. The risk of lower credit growth from the banking sector would negatively impact households' consumption and private investments.

## 4.5. PUBLIC FINANCE

The key objective of the fiscal policy presented in the programme is to establish a sustainable fiscal framework facilitating a balanced budget through an expenditure-based consolidation. Overall, the adjustment will take place gradually, reaching budget balance in 2012 and a surplus in 2013 as expenditures decrease in real terms while revenues remain constant until 2013, when they will reach their nominal pre-crisis 2008 level. The programme maintains the policy of developing a tax-competitive environment and avoiding raising fiscal pressure, especially during the early stages of the economic recovery, notwithstanding the risks of underperforming fiscal revenues. It does not envisage major shifts in the composition of revenues except for municipalities, as from 2011 some local taxes are abolished and revenues further diversified through a combination of several state-level

revenues<sup>(19)</sup>. Fiscal consolidation measures are concentrated on the expenditure side through the contention of public employment and the reduction of wages, but also the implementation of major reforms like the pension system. Following the outbreak of the economic crisis, public debt has been driven by budget financing needs and should peak in 2011 at 43% of GDP, to decrease to pre-crisis levels in 2013. The main risks in this area concern rising tax arrears as well as a contingent activation of the state guarantees extended during the crisis. Two alternative medium-term frameworks provide for the fiscal impact of the higher and lower growth macro economic scenarios.

#### 4.5.1. Budget implementation in 2010

Budget revenues in 2010 were some EUR 30 million (or 1% of GDP) lower than planned. The effects of the crisis were evident on the stagnation of VAT revenues, the major source of tax revenues, which remained at a level similar to that of 2009, or 8.7% lower than planned. Similarly, the corporate income tax underperformed, recording revenues 9% lower than planned. Other smaller budget items like duties and fees also declined by some 10% against the plan. On the positive side, personal income tax, social security contributions and local taxes revenues overshot the plan by 8.7%, 21% and 9.4% respectively. Overall, current revenues totalled 42% of GDP. On the expenditure side, public expenditures reached 45% of GDP, two and a half percentage points lower than planned. Current expenditures decreased (5.5% compared to the plan), despite a rise of 2.4% on gross wages due to increased rates of social security contributions and an increase by 4% of social protection transfers. Subsidies contracted by 12% compared with the annual target. Capital expenditure accounted for 5.4% of GDP, still 2 percentage points of GDP lower than planned, as the highway works did not proceed. The final outcome resulted in a consolidated budget deficit of 3% of GDP, or 1% of GDP lower than originally foreseen in the budget 2010, and half of the deficit recorded in 2009. Given this favourable outcome the government did not need to have recourse to any budget rebalancing last year. Yet, despite an overall budget performance better than expected, the rise of tax arrears remains a cause of concern, totalling 1.7% of GDP so far. The share of these arrears which could be recuperated in the coming years is fraught with uncertainties.

In the context of lower fiscal revenues, a key factor for the financing of the budget was the successful placement of the EUR 200 million Eurobonds maiden issue, performed in a very uncertain international bond market.

#### Medium-term budgetary strategy

The EFP section on the 2011 budget presents some outdated figures that reflect the original budget memorandum of October rather than the final budget as adopted by the Assembly later. Yet, the tables accompanying the EFP have been updated in line with the final budget before the submission of the programme to the European Commission in January. Compared with 2010, revenues should remain flat in real terms at 42% of GDP. After a fast rise in 2010 due to a one-off increase of their rates, revenues from social security contributions should expand more moderately in 2011 at 2.8% year-on-year, in line with the expected economic growth. However, the pace of overall tax revenues growth will be higher (7.3% year-on-year), resulting from additional VAT revenues stemming from stronger private consumption, higher excise rates in 2011, and to a lesser extent, an expected improvement from corporate income taxes. Other revenues, although expected to increase faster (by 13% year-on-year), only represent an additional 0.2% of GDP. Overall, fiscal revenues are planned to rise by 5.2% in nominal terms during 2011, while consolidated expenditures will rise by 1.6%, less than the projected inflation rate, thus decreasing to 44.4% of GDP. Capital expenditures will remain at 5% of GDP, broadly the same level as in the previous year. Overall, the fiscal deficit should decline to 2.4% of GDP in 2011.

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<sup>(19)</sup> For more details, please see point 3.4., Quality of public finances and institutional features.

**Box II.4.1: The budget for 2011**

- \* The draft budget for 2011 was approved by the government and submitted to the parliament on 21 October 2010. It was adopted on 2 November, before the statutory term of 30 November.
- \* The budget targets a deficit of 2.4% of GDP. It also contains, like the programme, two alternative scenarios depending on a higher or lower growth path and henceforth, a deficit ranging between 1% and 4% of GDP.
- \* The main measures are concentrated on reducing the expenditure side of the budget (see table below). Current revenues are expected to remain at 42% of GDP although increasing in nominal terms, mostly as a consequence of economic recovery rather than the adoption of any significant revenue measures this year, except for a rise in excises rates on tobacco.
- \* In 2011 there will be a reclassification of State Funds workers' wages expenditures, recorded until 2010 under Transfers to institutions and individuals. From 2011 on, payments to the health fund workers will be classified under Gross wages.

Table: Main measures in the budget for 2011

<b>Revenue measures*</b>	<b>Expenditure measures**</b>
<ul style="list-style-type: none"> <li>• Increased excises rates (+0.5% of GDP)</li> </ul>	<ul style="list-style-type: none"> <li>• Increased debt interests payment (+0.5% of GDP)</li> <li>• Reduction of current spending (-0.16% of GDP) <i>Of which, rationalisation state admin. (-0.13% of GDP)</i></li> <li>• Reduction of capital budget (-1.3% of GDP)***</li> <li>• Pension system reform: savings (-0.25% of GDP)</li> </ul>

- \* Estimated impact on general government revenues.
  - \*\* Estimated impact on general government expenditure.
  - \*\*\* Compared with 2010 budget plan.
- Sources: *Economic and Fiscal Programme 2011*

In line with their policy of maintaining a tax-competitive environment favourable to investments and avoiding the likely adverse effects of a higher tax burden in the early stages of recovery, the authorities do not envisage any increase in tax rates apart from the rise, as of January 2011, of excises rates on tobacco. Therefore, budgetary measures will be concentrated on the expenditure side during 2011, maintaining the previous year's policy of freezing public wages and capital spending in real terms.

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

	2009	2010	2011	2012	2013	Change: 2010-13
<b>Revenues</b>	45.4	41.8	42.0	42.2	42.0	0.2
- Taxes and social security contributions	37.0	36.5	36.9	37.1	37.0	0.5
- Other (residual)	8.4	5.3	5.1	5.1	5.0	-0.3
<b>Expenditure</b>	51.1	45.8	44.4	42.2	40.3	-5.5
- Primary expenditure	50.3	44.9	42.9	40.7	38.8	-6.0
<i>of which:</i>						
Gross fixed capital formation	8.4	5.2	5.1	5.0	5.1	-0.1
Consumption	18.8	19.3	23.2	21.8	20.5	1.2
Transfers & subsidies	15.6	15.5	15.1	14.0	13.1	-2.4
Other (residual)	7.5	4.8	-0.6	-0.1	0.1	-4.7
- Interest payments	0.9	1.0	1.5	1.5	1.5	0.6
<b>Budget balance</b>	-5.7	-4.0	-2.4	-0.1	1.7	5.7
- Cyclically adjusted	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
<b>Primary balance</b>	-4.9	-3.0	-0.9	1.5	3.2	6.2
<b>Gross debt level</b>	38.2	41.8	42.9	40.9	37.5	-4.3

*Sources: Economic and Fiscal Programme (EFP) 2011, ECFIN calculations*

The bulk of the budgetary adjustment will be more noticeable in 2012 and 2013, as the recovery of the economy gains speed and expenditures are kept frozen in nominal terms. As a result of the contention of public sector wages, government consumption should progressively contract to 20.5% of GDP in 2013 from 23.2% in 2011. Moreover, the reform of the pension system combined with the foreseen reduction of subsidies by half will contribute to a decline of social protection transfers and subsidies by one percentage point per year to reach 13% of GDP in 2013. Such a progressive decline of transfers and subsidies appears plausible and consistent with the assumed economic recovery and decrease in unemployment, taking also into account that the restructuring of the two metal industries should be over. As a result, total expenditures are expected to contract from 44.4% of GDP in 2011 down to 40.3% by end 2013 in real terms, while revenues remain stable during the same period at 42% of GDP. The fiscal adjustment will thus take place gradually, leading to budget equilibrium in 2012 and a surplus in 2013. The primary balance will turn positive in 2012 to expand quickly to 3.2% of GDP in 2013, as the total annual amortisation of the public debt remains constant at some 4.5% of GDP.

There may be scope for higher revenues towards the end of the programme as economic growth is expected to be faster accelerating. In particular, the envisaged decline in the ratio of tax revenues to GDP in 2013 appears conservative under the assumption of an unchanged tax policy. However, a lower than expected growth performance would have the opposite effect. Major downside fiscal risks range from a failure to curb tax arrears, to a potential activation of the state guarantees extended to distressed companies during the crisis (see below, general government debt).

Conversely expenditures could turn out higher than predicted. In particular, the ratio of gross fixed capital formation to GDP, lower over the programme period than in 2010, could be on the low side, considering the envisaged list of infrastructure projects to be launched in 2011, and progressively implemented in the next years.

#### 4.5.2. Budgetary implications of "major structural reforms"

The EFP provides a matrix with the net fiscal effects of the structural reforms agenda, which is commendable though the methodology is not described, and estimates for some years are missing. Overall, the net-effect of major structural reforms as presented in the programme tables will have a

limited impact on the country's fiscal position as most of these measures are already part of the 2011 budget. The reform of the pension system has by far the greatest impact on budgeted expenditures, accounting for half the impact of total reforms spending in the coming years. Social protection programmes, including child, disability and various family supports, account on average for an additional 23% of spending, followed by network industries and labour market measures (13% and 8% respectively). The net impact on the revenue side appears incomplete as revenue estimates for many measures were not provided. Only for the reform of the pension system have the budget impacts on both revenues and expenditures been calculated, leading to the net effect reflected in the table below. The reforms of the state administration as well as privatisation have a net positive impact, equivalent to 25% of total budget expenditures on structural reforms.

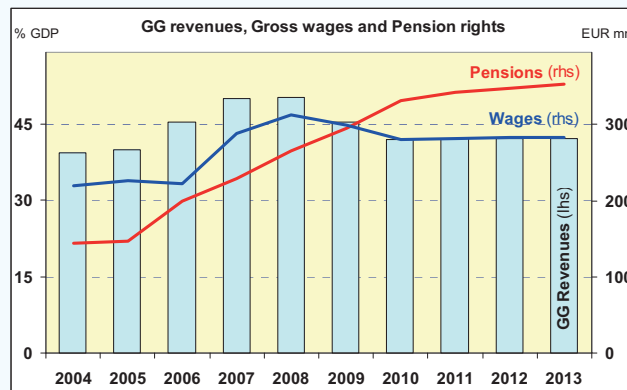
**Table II.4.3:**  
**Net direct budgetary impact of key reform commitments (in EUR million)**

	2011	2012	2013
Privatisation	56.8	29.2	25.1
Competition policy and state aid	-0.2	-0.2	-0.3
Business environment and Tax policy	-21.2	-0.15	-0.15
Network industries	-51.6	-22.2	-20.0
Labour market	-18.5	-18.4	-19.7
Education and Research	-1.2	-1.3	-1.4
Pension system	-124.7	-116.7	-108.7
Healthcare system	-11.1	-6.6	n.a.
Social protection	-53.3	-54.9	-56.5
State administration	24.0	24.0	24.0
<b>Total impact on the budget</b>	<b>-201.0</b>	<b>-167.3</b>	<b>-157.7</b>
<b>Total impact on the budget (in % of GDP)</b>	<b>-6.3</b>	<b>-5.0</b>	<b>-4.4</b>

*Source: Economic and Fiscal Programme (EFP) 2011, ECFIN calculations*

**Box II.4.2: The reform of the pension system**

\* The most important structural reform presented in the programme is related to the pension system. Following fiscal relaxation during the boom years, expenditures on gross wages and pensions expanded very rapidly in line with pro-cyclically rising budget revenues. However, while the authorities managed to curb wages from 24% of total spending in 2006 to less than 20% after 2010, pension expenditures remained untamed, surpassing the level of wages since 2010 and accounting for 24% of total budget expenditures since.

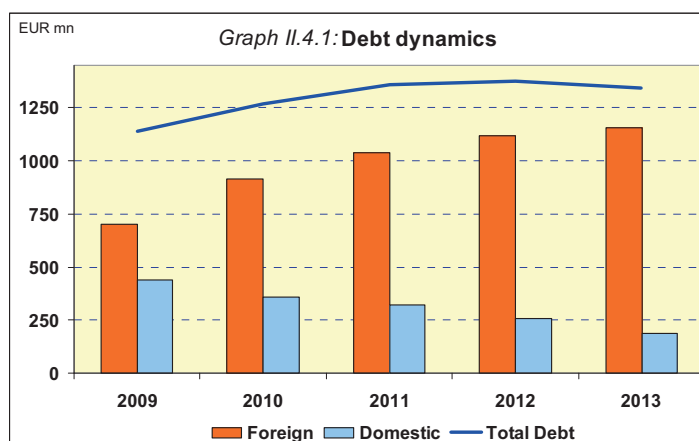


- \* Currently the average pension in Montenegro is one of the highest in the region. Contributions only cover 65% of the pensions disbursed, with the remainder 35% funded from the budget. Therefore, any increase in the number of beneficiaries, without a significant increase of the workforce, has a direct impact on the budget.
- \* These measures are intended as a disincentive for workers from applying too soon for early retirement, and should therefore sustain the activity ratio. Concerning the budget impact, the EFP estimates that these measures will already save some EUR 8 million per year to the budget.
- \* To ensure the long-term sustainability of the public pension system the parliament adopted on 22 December 2010 amendments to the Pension and Disability Insurance Law which increased the retirement age to 67 years for both men and women (currently set at 65 and 60, respectively). The Law also considers that workers with at least 40 years of service may retire before the 67 years threshold. The pension indexation method (i.e. Swiss formula) is revised, from former 50:50 ratio between consumption prices and wage rises, to 75:25, decreasing the weight of wage dynamics in favour of inflation.

**4.5.3. General government debt**

Following the outbreak of the economic crisis at the end of 2008, public debt dynamics have been primarily driven by budget financing needs as fiscal revenues declined noticeably. Two diverging trends are distinguishable. The domestic public debt has been continuously decreasing as the redemption of old obligations (i.e. restitution of expropriated property, repayment of old foreign frozen currency savings, and pension arrears) have been serviced faster than the acceptance of new obligations. Keeping this trend, the share of domestic debt should halve in 2013 to 14% of total public debt, or 5.3% of GDP, compared with 10.2% of GDP in 2010. On the other hand, foreign debt has been rising rapidly, driving total public debt to 42% of GDP in 2010 from 38% a year before. The main factor of this sharp increase was the emission of EUR 200 million Eurobonds to finance the budget, corresponding to 6.6% of GDP. Loans from international institutions (IFIs) for the construction of several infrastructure projects represent 1.5% of GDP. Foreign debt should according

to the EFP peak in 2012 at 33.2% of GDP. However, given the expected decline in the coming years of budget financing needs, a rising primary surplus, as well as the forecasted expansion of the economy, the total public debt should stabilise in 2011 at 42.9% of GDP, and decrease afterwards to more sustainable levels, of some 37% of GDP by end of 2013.



The main downside risk to public debt concerns the threat of activation of the sizeable amount of state guarantees which could endanger the state budget. The total amount of these guarantees was EUR 350 million, or 11.3% of GDP at the end of 2010. The largest share concerns foreign loans for some EUR 132 million to the troubled aluminium factory, which already delayed the servicing of one instalment in February 2011, triggering the activation of the corresponding state guarantee. Another warrant of EUR 26 million was extended to the distressed steel mill. On the upside, privatisation and concession programmes could prove more successful than planned.

Table II.4.4:

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

	2009	2010	2011	2012	2013
<b>Gross debt ratio [1]</b>	<b>38.2</b>	<b>41.8</b>	<b>42.9</b>	<b>40.9</b>	<b>37.5</b>
Change in the ratio	2.7	3.5	1.1	-2.0	-3.4
<i>Contributions [2]:</i>					
<b>1. Primary balance</b>	<b>-4.9</b>	<b>-3.0</b>	<b>-0.9</b>	<b>1.5</b>	<b>3.2</b>
<b>2. "Snow-ball" effect</b>	<b>1.8</b>	<b>0.4</b>	<b>-0.4</b>	<b>-0.9</b>	<b>-1.0</b>
<i>Of which:</i>					
Interest expenditure	0.9	1.0	1.5	1.5	1.5
Growth effect	1.7	-0.3	-1.0	-1.4	-1.5
Inflation effect	-0.7	-0.2	-0.9	-1.0	-1.0
<b>3. Stock-flow</b>	<b>2.6</b>	<b>0.1</b>	<b>0.6</b>	<b>0.3</b>	<b>0.8</b>

Notes:

[1] End of period.

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

Source: Economic and Fiscal Programme (EFP) 2011, ECFIN calculations

Overall, the government's debt strategy heavily relies on the economic recovery assumptions. This recovery should increase fiscal revenues in nominal terms, decreasing the needs for budget financing. As a result, the sizeable annual issues of foreign debt for budget finance should decrease from EUR

180 million in 2011 to EUR 72 million in 2013. Also, as a fall-back option, the government counts on a development policy loan from the World Bank (USD 80 million), to refinance its public debt.

#### 4.5.4. Quality of public finances and institutional features

The strategy to improve the quality of public finances aims to optimise the level and structure of public finances in order to reinforce their sustainability, and to promote a competitive fiscal environment favourable to investments. In support of these goals the programme presents a series of measures. The most important one is the reform of the public pension system, already mentioned. The second important change on the expenditure side concerns the streamlining of public employment. After the adoption of legislative reforms in 2010, spending units are to replace each two redundant civil servants, or three retiring ones, by a single new one. On the revenue side, the most important change concerns the financing of local self-governments. As of 2011 some local taxes are abolished (consumption tax, trade name taxes, taxes on games of chance), and municipalities revenues strengthened through a higher and more diversified share from several state-level revenues<sup>(20)</sup>. Overall, the structure of spending is oriented towards a broad consolidation of current expenditures, namely gross wages and pensions, while capital investments remain constant in real terms. Moreover, major infrastructure works are expected to be the object of public-private partnerships and concessions, or financed by international financial institutions rather than by the capital budget line.

Some administrative changes to improve the transparency and efficiency of the budgeting process were also adopted with the 2011 budget law, such as the introduction of effective mid-term budgeting to improve the realisation of fiscal goals. In addition, the capital budget preparation is being improved, capital projects being defined more precisely as well as subjected to prioritization criteria. The programme also announces the introduction of ESA95 accounting standards in the medium-term.

### 4.6. STRUCTURAL REFORMS

The broad structural reform agenda is a consistent continuation of previous year priorities as well as of past reforms. The introduction this year of quantitative estimates of the fiscal effects, at least on the expenditure side, of the different structural policies also supports the credibility of the EFP. However, further efforts will be necessary in future exercises to also calculate the fiscal effects of these reforms on the revenue side. The programme provides a detailed account of achievements in 2010 and of the measures envisaged in 2011. It could have benefited from more details when outlining plans for 2012 and 2013 and from more clarity in the timetable for implementation. Negative economic and fiscal developments could delay the implementation of some measures. The structural reforms package covers a wide range of economic sectors, including privatisation, key infrastructures, restructuring of strategic industries, strengthening financial markets, increasing labour market flexibility, reviewing the pension system, or streamlining public administration. This extensive approach should ensure a diversified support for economic growth.

#### 4.6.1. Product and capital markets

Although privatisation is in its final stage, it could still last some time before completion. The reform agenda contains a detailed privatisation programme focused on re-tendering those companies which failed to attract investors' interest in 2010. Expected revenues are relatively modest, and could finance the budget by some 2% of GDP in 2011, decreasing to 1% per year afterwards. The programme fails to advance an exit strategy for some industries partially renationalised (aluminium industry, bauxite mines, Piva electrode plant). In order to improve the business environment, the EFP foresees

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<sup>(20)</sup> i.e. concession charges on natural resources, tax on real estate and property, games of chance, use and registry of motor vehicles, personal income tax, and concessions from the state coastal management agency "Morsko dobro".



strengthening competition policy and state aid control, while streamlining tax policy. It announces a new Law for 2011 on Competition Protection including a 'Leniency programme' (i.e. reduction of fines for undertakings collaborating with the Agency for Protection of Competition). State aids remain concentrated on the two troubled metal industries. The aid consists mostly of subsidised electricity, to expire by law by end 2012, but also de facto in the accumulation of tax arrears, that are difficult to recover while these companies remain impaired. Other reforms concerns the completion of the administrative guillotine project, the establishment of one-stop shops for business registration, and the facilitation for obtaining construction permits. A single model of registration and collection of income taxes and social security contributions should also be implemented in 2011, as well as the abolition of some administrative custom fees, to be compensated by the increase on excises and property tax. An electronic system for registration and payment of taxes should become operational in 2012. The programme also provides a very detailed list of public investment projects on network industries (energy, transport, and telecommunications).

Reforms on financial and capital markets will continue with the development of secondary legislation to reinforce supervision capabilities as well as their alignment with EU laws. The Investment Development Fund will expand its activities in support of domestic enterprises from the current provision of credit support, to credit-guarantees and factoring. Another important project planned for 2011 is the amendment of the Law on Investment Funds allowing for the establishment of open-ended funds and a clearer definition of relations between the principal and the agent.

#### 4.6.2. Labour market

Apart from the usual active labour market policies (loans for self-employment projects, training, incentives to employ physically challenged individuals, etc.), reinforced during the crisis, the government also established two new institutions: an Agency for Peaceful Resolution of Labour Disputes, and a Labour Fund called to play an important role in facilitating the restructuring of impaired companies through the payment of wage arrears to redundant workers. The Fund will be fully financed by workers contributions of 0.2% on gross wages. Another measure adopted in 2010 was to raise unemployment benefits to 40% of the minimum wage (EUR 64), instead of the previous minimum wage of EUR 55. The programme also includes a series of reforms addressing specific structural labour market weaknesses identified in the Opinion, like plans to better align the education system with the labour market needs (see section on education below), or the introduction of legislative amendments to allow the establishment of temporary work agencies as well as facilitating the employment of foreigners, to further increase the flexibility of the market.

#### 4.6.3. Other reform areas

Social protection reforms are necessary to control spending while guaranteeing access to basic health care for all, especially the poor. In order to allocate the limited resources of the budget (some 2% of GDP) in a more equitable manner the authorities intend to implement mid-2011 the "Social Card" project, carefully targeting social protection rights to the vulnerable population. In addition, the social security reform strategy combines a top-down budget control, capping total health expenditures and imposing central oversight of the budget funds, with a bottom-up reform, improving budget efficiency through the control of costs and a bigger reliance on the private sector through public-private partnership, including the possibility of privatising some public health institutions.

The reform of the education system remains very important given the structural nature of unemployment and the need to improve competitiveness. Modalities on how to finance private tertiary institutions from the budget (PPP) will be defined in 2011, while state contributions to local governments for education expenditure will be rationalised and based on number of pupils. The government will also finance international graduation and experts' evaluations to ensure an objective evaluation of the quality levels.

The public administration reform will be accelerated with the twin objective of improving the quality of services delivered and rationalising costs. The new system will reduce the number of state administrations by merging several agencies and transferring staff between institutions. The number of employees is expected to be reduced (by 5% at state level and by 10% at local level) leading to savings on public wages by some 1% of GDP. Simultaneously, higher productivity and additional savings should result from the implementation of a modern system of electronic document management (e-government).

#### **4.7. OVERALL ASSESSMENT OF FORMAL REQUIREMENTS**

##### **Macro framework**

This year's macro scenarios were prepared by the Ministry of Finance instead of the Central Bank. While the scenarios still provide a sufficiently comprehensive overview of past macroeconomic developments, the analysis for the medium-term period offers scope for improvement and calls for a reinforcement of macroeconomic analysis capabilities. Main improvements are the introduction, for the first time, of quarterly growth profiles by economic sector, as well as an attempt to estimate the output gap. Like in previous exercises, the programme presents a reference macroeconomic scenario and two alternative ones, considering upside or downside risks. Data discrepancies observed in previous exercises between the different sections have been reduced.

##### **Fiscal framework**

The fiscal framework seems coherent with the overall policy objectives and sufficiently comprehensive. While the programme does not mention explicitly last year's EU Opinion, it refers to the national prime objective of EU and NATO integration. The key measures on the revenue and expenditure side are explained for 2010 and in a less explicit way for 2011, while specific measures for the last two years (2012-2013) remain vague. Data is based on GFS, although the Ministry of Finance has already applied for an ESA95 national accounts training project with Eurostat to prepare the fiscal notification and PEPs according to this accounting standard.

##### **Structural reforms**

An important effort was made in the 2011 EFP to improve the quality of the structural reforms section. The various sub-sections are better structured and their content more focused on the impact on the budget. Major innovations are the introduction of tables listing the fiscal effects of structural policies, the evaluation of measures adopted in support of the banking sector during the crisis, or the detailed impact of labour market reforms. A few sections still failed to evaluate the fiscal impact of reforms, while most of them did not report yet the reforms' impact on the revenue side of the budget. There is still scope for improvement as regards the concreteness of reform measures and their implementation in 2012-2013.

# 5. TURKEY

## 5.1. EXECUTIVE SUMMARY

Turkey's tenth Pre-Accession Economic Programme (PEP 2011-2013), submitted on 10 March 2011, is consistent with other economic policy documents, such as the ninth National Development Plan (2007-2013). It presents a medium term macroeconomic and fiscal framework prepared on the basis of the Medium Term Programme (MTP, 2011-2013) published in October 2010 and elaborated upon already in summer 2010. The programme largely complies with the requested standards in terms of content, form and data and demonstrates a high degree of familiarity with the technical tools and analytical requirements of this exercise. At the same time, significant updating in the light of recent developments and further analysis in some key areas would enhance its role in guiding economic policy.

Similar to last year's PEP, the programme's key objectives are to ensure sustainable growth, in tandem with a rapid convergence of per capita income towards the EU-average. To this end, the monetary and fiscal policy mix aims at price stability and continued fiscal prudence while structural reforms are to enhance the role of the private sector, and to improve financial sector intermediation and increase the value of human capital.

Thanks to recent in-depth reforms, the Turkish economy, which contracted by 4.8% in 2009, has grown by a robust 8.9% in 2010. Headline inflation came down significantly from 9.2% in September 2010 to 6.4% in December 2010. The general government budget deficit has fallen from 5.5% in 2009 to about 3.5% in 2010 and the gross debt stock to GDP ratio is estimated to have retreated to 41.6% by the end of 2010. The unemployment rate declined to 11% by the end of- 2010 from 13% a year before. However, the current account deficit edged up rapidly from 2.3% of GDP to about 6.6% of GDP in 2010, in tandem with the widening trade deficit, pointing to a still fragile macroeconomic stability.

Over 2011-2013, the programme estimates that the Turkish economy will grow at rates around potential, i.e. at around 5%. As from 2011, growth would be driven by private sector-led gross fixed capital formation (9% annually on average) and to a lesser extent private consumption (4%). Exports are projected to accelerate gradually from about 5% annually in 2011 to over 8% in 2013, compared with a rather stable increase throughout the programming period by an average 8.5% for imports. The macroeconomic scenario tends, however, to ignore some major risks such as the widening of external imbalances and the intensification of inflationary pressures. It foresees a stabilization of the current account deficit around 5.3% of GDP. Not only has the current account deficit rapidly and substantially increased but its further widening is likely. Energy prices are significantly (about 12% in TRL-terms) higher than at the time the MTP was adopted and the outlook for Turkish exports has weakened given the political turmoil in the Middle-East and Africa Region, the destination of over 20% of the country's exports. Furthermore, the quality of the current account financing has deteriorated, increasingly shifting towards potentially volatile short-term capital. These developments, together with mounting inflationary pressures, may pose an additional threat to internal and external stability in 2012-2013 and may call for a more restrictive monetary and fiscal policy mix than what is presented. The PEP would thus greatly benefit from a more thorough analysis and quantification of risks.

In 2010, the general government budget deficit narrowed to 3.6% of GDP from 5.5% in 2009, thereby performing better than the 4.7% deficit envisaged in the budget planning, mainly due to the strong growth which resulted in higher budget revenues than originally anticipated. The PEP's medium-term fiscal programme envisages an improvement of the consolidated general government balance, from a

projected deficit of 2.1% of GDP in 2011 to 1.8% in 2012 and 1.1% in 2013, largely in line with the growth scenario. The public debt to GDP ratio is anticipated to fall gradually from 42.3% of GDP in 2010 to 36.8% by 2013. In the light of the programme's growth objectives, the fiscal policy objectives appear realistic, albeit not sufficiently ambitious. As in previous years, the document does not describe in great detail how to achieve the fiscal targets and therefore lacks some transparency. Turkey has accomplished a remarkable effort of fiscal consolidation in previous years, but ensuring a high-quality fiscal adjustment will be a key challenge in the coming years. In addition, the Turkish government has, on several occasions, turned to ad-hoc measures to achieve its fiscal targets. To prevent this in the future, a stronger fiscal anchor and an acceleration of key structural reforms would be highly beneficial, in particular as there is a risk that fiscal responsibility may weaken in view of the parliamentary elections in mid-2011, and presidential elections in 2012.

The programme's structural and institutional reform agenda, which covers a broad range of issues, is insufficiently linked to the fiscal scenario, and only partly aligned with the reform requirements in view of the country's EU accession perspective, as spelled out in the latest Progress Report and the European Partnership. The Turkish economy has benefited from recent in-depth reforms in areas such as banking, energy and education. However, reforms still have to be pursued in several important areas, such as labour markets and the investment climate. The programme is quite clear on what has been achieved but would benefit from a more precise strategy on future reforms and their expected implementation.

*Table II.5.1:  
Comparison of key macroeconomic and budgetary projections*

		2009	2010	2011	2012	2013
Real GDP growth (% change)	COM	-4.7	7.5	5.5	4.5	n.a.
	PEP 2011	<b>-4.7</b>	<b>6.8</b>	<b>4.5</b>	<b>5.0</b>	<b>5.5</b>
Consumer price inflation (%)	COM	6.3	8.5	6.5	5.5	n.a.
	PEP 2011	<b>6.5</b>	<b>6.4</b>	<b>5.5</b>	<b>5.0</b>	<b>5.0</b>
General government balance (% of GDP)	COM	-5.5	-3.7	-2.8	-2.2	n.a.
	PEP 2011	<b>-5.5</b>	<b>-3.7</b>	<b>-2.1</b>	<b>-1.8</b>	<b>-1.1</b>
Primary balance (% of GDP)	COM	0.2	0.7	1.3	1.8	n.a.
	PEP 2011	<b>0.2</b>	<b>0.9</b>	<b>2.0</b>	<b>2.3</b>	<b>2.4</b>
Government gross debt (% of GDP)	COM	45.4	42.8	42.1	42.0	n.a.
	PEP 2011	<b>45.5</b>	<b>42.3</b>	<b>40.6</b>	<b>38.8</b>	<b>36.8</b>

*Sources: Pre-Accession Economic Programme (PEP), Commission autumn 2010 forecast*

## 5.2. INTRODUCTION

The Turkish authorities submitted their tenth Pre-Accession Economic Programme (PEP 2011) covering the period 2011 to 2013 to the European Commission on 10 March 2011. Like in previous years, the Pre-accession Economic Programme was prepared under the lead of the State Planning Organisation and benefited from contributions by and consultations with all relevant institutions, in particular the Treasury, the Ministry of Finance, the Ministry of Agriculture, the Central Bank, the Privatisation Agency, the Banking Regulation and Supervision Agency. The document has been formally approved by the High Planning Board, which comprises the Prime Minister and representatives of key ministries.

The programme's overall objectives are to maintain macroeconomic stability, to ensure private sector-led sustainable growth, and to improve the standards of living of Turkish citizens. To this end, it presents a fiscal consolidation programme which aims at a gradual reduction of the general government deficit and public debt over the programme period. The structural reform agenda puts emphasis on increasing efficiency both in the private sector and in the public administration and on

strengthening market forces. The programme largely takes the objectives of the accession process into account, which are mentioned in the Progress Report and in the European Partnership documents.

### 5.3. KEY CHALLENGES

Due to strong economic recovery and growth in 2010 - on the back of robust domestic demand and higher imports in combination with higher commodity prices – pressures have recently emerged. In particular, the current account deficit has increased dramatically, and inflationary pressures have intensified. Under such circumstances, the main challenge for Turkey is to design and implement a balanced monetary and fiscal policy mix which preserves macroeconomic stability and ensures a sustainable growth path conducive to labour market improvements. The 2010 Progress Report had already emphasised that macroeconomic stability still remained fragile and needed to be carefully monitored, and that in particular a stronger fiscal anchor would be beneficial.

### 5.4. RECENT ECONOMIC DEVELOPMENTS AND MEDIUM-TERM SCENARIO

#### 5.4.1. Recent macroeconomic developments

The Turkish economy recovered strongly after having severely contracted in 2009. GDP tumbled by 4.7% in 2009, a sharp contrast to the 6% average annual growth rate in 2004-08. The global financial crisis hit the economy hard, thereby reducing fixed investment and external demand dramatically. Fiscal and monetary stimuli, combined with a healthy banking sector, helped to cushion the blow. In Turkey's case, the crisis had a silver lining as it highlighted the economy's enhanced resilience to external shocks. The economy has since shown steady improvement and grew by 8.9% in 2010. While fixed investment boomed and recouped the losses of previous years, all components of domestic demand showed positive year-on-year growth in 2010 (in part due to strong base effects). Labour market developments, credit growth, capacity utilisation, and consumer and business confidence point to a continuing and strong recovery in consumption. Domestic demand is thus expected to continue to drive growth close to potential (4-6%) over the programming period. The strengthening economy has been positively affecting the labour market. The unemployment rate which had risen to 14% in 2009 from 11% in 2008, decreased to pre-crisis levels (11%) by late 2010. It also had a positive impact on the budget, in particular on the revenue side. The budget deficit narrowed to around 3.5% of GDP in 2010 from 5.5% in 2009. Risks have however emerged. The current account deficit widened to 6.6% of GDP in 2010 from 2.3% of GDP in 2009, in large part due to stronger domestic demand and higher energy prices, which also led to a substantial increase in financial needs. Another key issue relates to inflationary developments and how they are to be reflected in a monetary policy whose conduct is complicated by strong capital inflows from the much slower growing developed economies. Risks may also stem from increased public expenditure ahead of the 2011 parliamentary elections and the 2012 presidential elections that would likely pressure interest rates and dent investor confidence, thereby slowing or even undermining the recovery.

#### 5.4.2. Medium-term macroeconomic scenario

As in previous years, the quantitative framework for the period 2010-2013 is well presented and contains detailed information on key variables. The link between the macroeconomic framework and the impact of structural reforms described in sections 3 and 4 deserves more attention in particular in a medium-term perspective. The programme's external assumptions are largely in line with international forecasts, including the EU Commission's autumn 2010 forecast. However, compared to these forecasts, the Turkish programme is more optimistic with respect to the pace of the country's disinflation and the widening of the external deficits. The PEP's projections for key macroeconomic variables seem overall somewhat outdated, and the policy mix has not been very adequately adapted.

Table II.5.2:

Comparison of macroeconomic developments and forecasts										
	2009		2010		2011		2012		2013	
	COM	PEP	COM	PEP	COM	PEP	COM	PEP	COM	PEP
Real GDP (% change)	-4.7	-4.7	7.5	6.8	5.5	4.5	4.5	5.0	n.a.	5.5
<i>Contributions:</i>										
- Final domestic demand	-	-5.2	-	8.1	5.9	4.9	3.5	5.4	n.a.	5.8
- Change in inventories	-	-2.1	1.4	1.0	0.1	0.6	0.9	0.2	n.a.	0.0
- External balance of goods and services	-	2.7	-3.0	-2.3	-0.3	-1.0	0.2	-0.6	n.a.	-0.4
Employment (% change)	0.4	0.4	6.2	5.6	0.9	1.0	1.4	2.2	n.a.	2.0
Unemployment rate (%)	14.0	14.0	12.2	12.2	11.7	12.0	11.3	11.7	n.a.	11.4
GDP deflator (% change)	5.2	5.2	10.3	8.0	5.3	5.8	4.5	5.3	n.a.	4.8
CPI inflation (%)	6.3	6.5	8.5	6.4	6.5	5.5	5.5	5.0	n.a.	5.0
Current account balance (% of GDP)	-2.3	-2.3	-5.5	-5.4	-6.6	-5.4	-7.1	-5.3	n.a.	-5.2

Sources: Pre-Accession Economic Programme (PEP), Commission Autumn 2010 forecast (COM)

### Real sector

The real sector scenario used in the programme is not so close to market consensus and shows significant differences compared with the Commission autumn 2010 forecast. Both sources assume that the Turkish economy will grow at rates - close to potential - of around 5% per annum through the programme period, driven by continuous rapid productivity growth. Unemployment rates are expected to fall and some -albeit modest - job creation is expected to materialise. The disinflation process is set to continue, but the PEP projects that the pace will slow down more rapidly. The different views on the external sector translate in the PEP projecting that the current account deficit will stabilise at rates around 5.5% of GDP as from 2010, while the Commission forecasts that the gap will grow to 7.1% of GDP in 2012.

The medium-term macroeconomic scenario envisages a 4.5% growth in 2011 increasing gradually to 5% in 2012 and 5.5% in 2013. Growth will continue to be mainly driven by domestic demand and in particular private investment that will increase on average by 10.8% over 2011-2013, due to increased demand, delayed investments and low interest rates. Private consumption will also positively contribute to growth, although to a lesser extent, while the contribution of net exports is expected to be negative.

Based on two methods used to calculate potential output, the programme considers that the output gap was closed towards mid-2010 and expects economic activity to reach its potential in 2012. There are upside risks to this growth pattern given the much better than anticipated growth performance in 2010 (real growth of 8% compared with 6.5% in the PEP) and the buoyant growth observed in early 2011. Therefore overheating may occur much earlier. The strong recovery observed in 2010 would have deserved a more detailed analysis and explanation. Conversely, downside risks include lower global growth, higher commodity prices and slowing capital inflows, which may stem from interest rates hikes in advanced economies, or an increased risk aversion towards emerging markets in general, or towards Turkey specifically. Regarding the contribution of the various production factors to growth, Turkey's output will be mainly driven, as in the past, by capital deepening, and to a much lesser extent by employment growth while the increase in TFP is expected to be very limited. In 2010, the value added in the industrial sector has already compensated the losses incurred in 2009, when Turkish large cars', white and brown goods' sectors were dramatically hit by the crisis. Throughout the programme period, the value added generated in the industrial sector is expected to increase by an average 5.2% annually. At the same time, the decrease of the agricultural sector's share relative to total value added is expected to be mitigated entirely by the relative growth in the services' sector. By 2013, the services sector, the industry and agriculture would represent respectively 64%, 27% and 9% of the overall value added in the Turkish economy.

## Inflation

At the end of 2010, the annual rate of increase of CPI and PPI stood at 6.4% and 8.9%, respectively. Thus, the consumer inflation came down by about 0.1 points compared to 2009 year-end, and reached the lowest year-end level in recent Turkish history, and remaining below the Central Bank 6.5% target, which should further come down to 5.5% by the end of 2011, and to 5% in 2012 and 2013. However, inflationary pressures have risen since the end of 2010 due to the increases in oil and other commodity prices, high rates of increase in unprocessed food prices (in particular, fresh fruits-vegetables and meat), an expiration of temporary tax reduction, as well as pass-through effects stemming from a TRL trade weighted depreciation of 9% in the November 2010-February 2011 period. Stronger inflationary pressures could also 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 or pressures stemming from growth above potential 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 2011 PEP presents a short description of the framework of monetary and exchange rate policy. The key objective of monetary policy is to ensure price stability, or – in other words – to support the disinflation process. As in previous years, Turkey's central bank will target inflation in the 2011-2013 period. By the end of 2011, the inflation target would have fallen to 5.5% from 6.5% in 2010. In 2012-2013, the inflation target amounts to 5%. These targets remained unchanged from the 2010 PEP. The ultimate, long-term target is to decrease inflation rate to levels complying with the Maastricht criteria. Since November 2010, the central bank started to very actively hike commercial bank reserve requirement ratios to curb the rapidly growing credit and contribute to tighter monetary policy. The combination of such hikes with cuts in the base lending rates (amounting to a cumulative 75 bps) was perceived by many observers as rather unorthodox and its efficiency questioned.

Due to improved fiscal discipline and structural reforms in the financial sector, the effectiveness of monetary transmission mechanisms has already significantly increased. Besides enhancing the overall transparency and predictability, a more credible management of expectations and more confidence are seen as key factors aiming at further improving monetary transmission. The free floating exchange rate regime remains in place. The interventions made so far aimed at smoothening excessive exchange rate volatility and to build reserves.

## External sector

In 2009, Turkey's current account balance has improved as imports fell proportionally much faster than exports. For the programme period, a stabilisation of the current account deficit is expected. The underpinning scenario comprises a rather plausible evolution of exports (8% growth over 2011-2013 as compared to 9.3% over 2002-2009), due to relatively slow growth in main partners. However, the pace of merchandise imports seems very subdued against the foreseen evolution of domestic demand, and the rise in energy prices is likely to affect overall import prices - and import values - significantly. The scenario is also - albeit to a lesser extent- upbeat on tourism revenues. The expected volume of workers remittances is forecasted to stabilize around USD 1 billion. As a result, the current account deficit is expected to increase from 2.3% of GDP in 2009 to stabilise around 5.2% - 5.4% in 2010 and beyond. This appears optimistic as the outturn for 2010 was 6.6% of GDP and pressures have been rising further. The programme does not anticipate any difficulties in financing the current account deficit, despite proportionally much more volatile capital inflows (mainly portfolio and bank credits) than in the pre-crisis period.

Furthermore, it tends to expect some rebalancing between FDI and portfolio investment. FDI is projected to increase gradually from USD 7.1 billion in 2010 to USD 11.9 billion by 2013, while portfolio investment is forecasted to fall by half - from USD 16.3 billion in 2010 to USD 7.3 billion - in 2011 and subsequently to roughly stabilize at USD 7 billion in 2012-2013. In contrast to the previous years, no alternative scenarios are included on energy imports. Given the high sensitivity of the Turkish current account to oil prices, the programme would have benefited from an in-depth analysis of the effect of a shift in oil demand combined with energy price volatility. In addition, and again unlike in previous years, the programme does not include a scenario whereby the TRL real exchange rate shows significant instability relative to the baseline scenario and its effect on the current account.

### **Main risks and challenges**

The PEP focuses on preserving macroeconomic stability and sustainable growth, maintaining price stability and sound public finances, improving competitiveness, and enhancing the labour market performance.

Conversely, the programme only very briefly touches upon main risks, all considered to stem from the external environment (lower foreign growth rates, oil and commodity prices, increase in ST capital inflows and exchange rate). It would benefit from a more systematic analysis of risks, possibly under the form of alternative macro scenarios.

The main risks to the macroeconomic framework are clearly associated with the very strong recovery the Turkish economy is currently undergoing. Real GDP grew by 8.9% in 2010 and expectations are that GDP will grow by 5-6% in 2011. Due to the strong economic growth - on the back of robust domestic demand and higher imports in combination with higher commodity prices - the current account deficit has increased significantly, and inflationary pressures have intensified. At the same time, the quality of the external financing has deteriorated. Under those circumstances, the main challenge for Turkey is how to design and implement a more balanced monetary and fiscal policy mix.

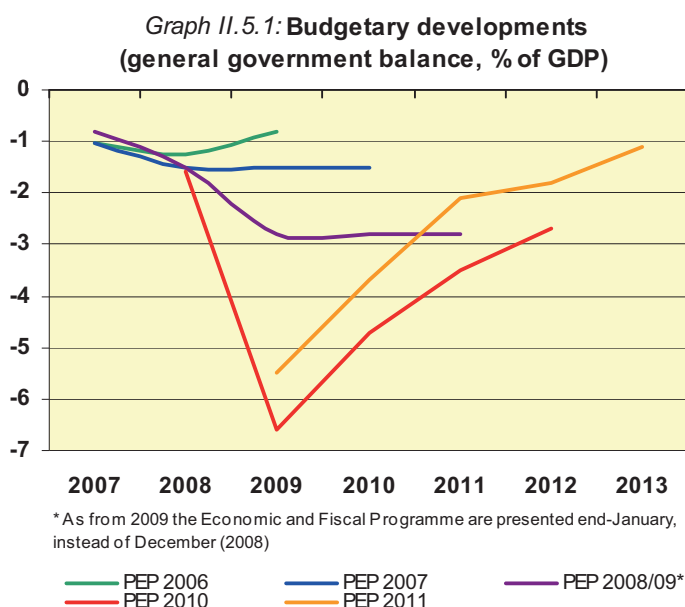
## **5.5. PUBLIC FINANCE**

The fiscal framework of the PEP 2011-2013 is presented as an integral part of - and supportive to - the overall medium-term economic policy framework. The overall objective of Turkey's fiscal policy is to contribute to establishing a sustainable growth environment and at the same time to support disinflation. The gradual reduction of the budget deficits is the main fiscal tool in this respect, contributing not only to disinflation but also to debt sustainability. As in previous years, the document does not describe in great detail how those targets to be achieved and therefore lacks some transparency. The presentation of the public finances would have gained significantly from a more in-depth discussion of various issues currently under discussion, in particular the fiscal rule, and its relationship with the presented objectives. Main revenue-related measures are an improvement of efficiency in tax collection and a broadening of the tax base. On the expenditure side, emphasis is put on reducing the social security (mainly health) deficits. Unfortunately, like in previous years, no quantitative estimates of the budgetary effects of the individually described measures are given. Budgetary objectives appear broadly realistic, in particular since real interest rates are falling faster than anticipated in a context of high growth. The 2011 programme comprises cyclically adjusted budgetary balances. The results point at a relatively low weight of the cyclical component in Turkish fiscal balances. It appears that the importance of structural determinants has started coming down due to lower interest rates in combination with high primary budget surpluses. The calculations also indicate that the growth of the Turkish economy during most of the programme period is very close to potential. The programme would benefit from some clarifications on the methodology used in the



individual sections. In particular, it is not always clearly stated why and when non-consolidated general government (ESA 95 based) data are used.

The fiscal part of the programme envisages a significant improvement of the consolidated general government balance by close to 3 percentage points of GDP, turning from an expected deficit of 3.7% of GDP in 2010 to a budget deficit of 1.1% in 2013. The general government primary balance, defined as the budget balance corrected for net interest payments, is set to improve from a surplus of 1% of GDP to a surplus of 2.4% of GDP. The key element of the fiscal consolidation consists of a reduction in public spending by 3 percentage points of GDP in the three-year period (from 39.1% of GDP in 2010 to 36.1% in 2013). In particular, all major expenditure categories (interest payments, current and investment expenditure, as well as transfers) are programmed to be reduced, as a share of GDP. At the same time, the revenue-to-GDP ratio is planned to remain broadly stable throughout the PEP-period at rates around 35% of GDP, with some volatility in indirect taxes, factor income and privatisation proceeds. The general government debt stock is projected to decline by 5.5 percentage points, from 42.3% of GDP in 2010 to 36.8% of GDP in 2013.



### 5.5.1. Budget implementation in 2010

Turkey does not publish consolidated general government budget reports on a regular basis. Furthermore, the 2011 PEP does not describe the budgetary developments of 2010 in great detail. In 2010, general government revenues increased by 0.4% of GDP in 2010. 83% of the revenues originated from taxes (in large part VAT) which increased by 1% of GDP, driven by the expanding economic activity, and a better VAT and Special Consumption Tax (SCT) collection. Total expenditure decreased by 1% of GDP in 2010: current expenditure fell by 0.5% of GDP, while investment expenditure increased by a similar amount. Interest payments fell by about 20% (more than 1% of GDP) in line with the fall in the domestic borrowing compounds interest rates. Current transfers (mainly agricultural subsidies and other sectoral support) dominate the budget as they account for over one third of total spending. Wages account for 21% of overall expenditure. The estimated budgetary outcome for 2010 of a consolidated deficit of 3.7% of GDP is below the target of 4.7% set in the 2010 budget and the previous PEP. This is mainly due to the faster than expected recovery.

### 5.5.2. Near-term and medium-term budget strategy

The PEP's fiscal scenario comprises a non-comprehensive presentation of the general government accounts. Fiscal projections for 2011 are based on the MTP's fiscal framework adopted in October 2010 and elaborated in mid-2010, and broadly in line with the central government 2011 budget adopted by the Parliament in late December 2010. The 2011 budget can be considered as the government's vow to further fiscal consolidation. In 2011, new and sizeable fiscal consolidation efforts amounting to around 1.6% of GDP are frontloaded, with the bulk of the adjustment on the spending side. Expenditure restraint is projected at around 1.2% of GDP. They include a frontloaded cut in investment expenditure of 0.6% of GDP and a significant fall of the interest expenditure, also by 0.6% of GDP. Little detail has been provided on how this will be achieved. Moreover, in the absence of either new measures or a strong fiscal rule, it is very unlikely that current and transfer expenditure would fall – albeit slightly in 2011 – in an election year, in particular since the government is adopting a comprehensive employment package, which is not mentioned in detail in the 2011 PEP and are likely to require some additional public resources.

At the same time, the 2011 budget foresees an increase in net revenues, amounting to 0.4% of GDP. According to the PEP, privatisation proceeds yield an additional 0.7% of GDP, and mitigate a 0.6% of GDP loss in factor income from public enterprises that will be sold off (mainly energy, transport and tobacco). Although the indicative sale price of the various enterprises are mentioned in the PEP, greater detail on the financial bearings of these operations would have been welcome, in particular since, as a general principle, ESA95 excludes privatisation revenues from the general government budget.

In 2011, general government total expenditures in 2011 are projected to fall from 39.1 to 37.9%. As a result of some new revenue measures, total revenues are set to rise by around 0.4% or from 35.4% to 35.8% of GDP. The overall general government budget deficit declines by 1.6 percentage points from 3.7% in 2010 to 2.1% of GDP in 2011. The primary surplus, which is the traditionally the core measure of the Turkish fiscal programme, almost doubles in 2011 and is estimated to amount to 1.9% of GDP compared with 1.0% of GDP in 2010.

The budgetary targets are plausible, albeit not overly ambitious and the underlying assumptions are not spelled out in the PEP. However, the Commission believes that the risk of fiscal slippages is not negligible. Turkey's fiscal policy can be called very successful in the previous decade. At the same time, elections are scheduled in 2011 and 2012, and fiscal targets were missed most election years. In addition, the risk has significantly increased and the fiscal anchor has weakened after the IMF programme expired in May 2008 in the absence of strong fiscal and transparent rules. . For 2012 and 2013, the general government budget deficit is projected to fall further to 1.8% and 1.1% of GDP. Both the spending on income side of the budget are programmed to contract by respectively a total 1.8% and 0.8% of GDP in respectively 2012 and 2013. All expenditure subcategories, except capital transfers, are projected to fall at broadly the same pace. On the revenue side, a better tax collection should be instrumental in gradually increasing the revenues from direct taxes and non-tax revenues. In particular direct tax revenues are very low in Turkey as they amount to a mere 6% of GDP, the lowest amongst all OECD Member States.

**Table II.5.3:**  
**Composition of the budgetary adjustment (% of GDP)**

	2009	2010	2011	2012	2013	Change: 2010-13
<b>Revenues</b>	34.6	35.4	35.8	35.4	35.0	-0.4
- Taxes and social security contributions	25.9	27.7	28.0	27.9	27.8	0.1
- Other (residual)	8.7	7.7	7.8	7.5	7.2	-0.5
<b>Expenditure</b>	40.1	39.1	37.9	37.2	36.1	-3.0
- Primary expenditure	34.4	34.5	33.8	33.1	32.6	-1.9
<i>of which:</i>						
Gross fixed capital formation	3.3	3.9	3.3	3.3	3.1	-0.8
Consumption	17.7	17.2	17.1	16.6	16.2	-1.0
Transfers & subsidies	6.7	6.2	6.4	6.3	6.2	0.0
Other (residual)	6.7	7.2	7.0	6.9	7.1	-0.1
- Interest payments	5.7	4.6	4.1	4.1	3.5	-1.1
<b>Budget balance</b>	-5.5	-3.7	-2.1	-1.8	-1.1	2.6
- Cyclically adjusted	-4.0	-3.3	-2.8	-2.7	-2.1	1.2
<b>Primary balance</b>	0.2	0.9	2.0	2.3	2.4	1.5
<b>Gross debt level</b>	45.5	42.3	40.6	38.8	36.8	-5.5

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

The fiscal risks addressed in the programme are short-term in nature and relatively minor, and the PEP does not provide structural answers or corrective measures. The main fiscal risks Turkey is facing are not in the PEP and relate to the current decentralisation of fiscal spending away from the central government and the ageing of population. In particular, the sustainability of the Turkish social security system may be at risk in the medium term as the social security deficit amounted to 2-3% of GDP annually in recent years. The PEP would greatly benefit from some in-depth analysis in this field. Upside risks include higher revenues as a result of the targeted broadening of the tax base.

### Structural balance

The PEP 2011-2013 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 the 2010 submission. As of 2010, the structural and actual primary budget balances would start to differ less and the actual budget deficit would recede. It is estimated that the cyclically adjusted primary budget surplus which was 2.2% of GDP in 2008, will stabilize at about 1% in 2009-2012. On this basis, one may conclude that fiscal policy has pro-cyclical effects in 2010-2013. Given the methodological weaknesses, the statements on the effects of fiscal policy certainly need to be taken with caution.

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

The PEP 2010-2013 projects a baseline scenario of a gradual decrease of general government debt from 42.3% of GDP in 2010 to 36.8% of GDP in 2013. 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 improvements of the primary balance in 2011 have a marked effect on the decrease of the debt ratio. The public debt sensitivity analysis presented in the PEP shows that the public debt ratio could increase by about 5.1 percentage points by 2013 under a scenario combining several shocks (see below). Public debt management aims at implementing accountable, transparent and sustainable borrowing policies which are compatible with the monetary and fiscal policies. Besides, strategic benchmarks are being used in order to ensure the optimal cost target in the medium and long term at a reasonable risk.

**Table II.5.4:**  
**Composition of changes in the debt ratio (% of GDP)**

	2009	2010	2011	2012	2013
<b>Gross debt ratio [1]</b>	<b>45,5</b>	<b>42,3</b>	<b>40,6</b>	<b>38,8</b>	<b>36,8</b>
Change in the ratio		-3,2	-1,7	-1,8	-2,0
<i>Contributions [2]:</i>					
<b>1. Primary balance</b>	<b>-0,3</b>	<b>-1,0</b>	<b>-1,9</b>	<b>-2,2</b>	<b>-2,4</b>
<b>2. “Snow-ball” effect</b>		<b>-1,8</b>	<b>-0,3</b>	<b>-0,1</b>	<b>-0,4</b>
<i>Of which:</i>					
Interest expenditure		4,7	4,0	4,0	3,5
Growth effect		-6,5	-4,3	-4,1	-3,9
<b>3. Stock-flow adjustment</b>		<b>-0,4</b>	<b>0,5</b>	<b>0,5</b>	<b>0,8</b>

Notes:

[1] End of period.

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

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

Since several years, Turkey's debt strategy aims at minimising the interest and exchange rate and rollover risks, by converting FX-denominated debt into TRL denominated debt, and floating rate debt into fixed rate debt, as well as lengthening the overall maturities. As of October 2010, 74.5% of the debt stock was financed domestically, while the share of the debt stock denominated in TRL increased by 2.5 percentage points in one year to 73.4%. At the same time, the share of debt with a fixed interest rate has increased from 53.4% in 2009 to 56% by the end of 2010. Conversely, the cost of TRL denominated discount borrowing decreased dramatically from 12% in 2009 to 8.1% in 2010. Although the average maturity of the domestic debt stock remains relatively low, it went up considerably from 25 months in 2009 to 31 months in late 2010. The average maturity of the foreign debt stock is significantly longer and amounted to over 126 months, up by 10 months from 2009.

### 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. It shows that the structural reforms presented in the PEP will have a significant impact on the country's fiscal position. The GAP rural development reform is expected to impose an additional burden of about 2.0% of GDP annually on the budget in 2011-2013. The energy reform would cost a similar 2.0% of GDP, albeit solely in 2011. However, the budgetary implications of various structural reform issues (i.e. labour markets, privatisation, banking, energy) is missing, and the link between the overall fiscal scenario and the accomplishment of the programme's structural policies is not always very clear.

#### 5.5.3. Sensitivity analysis and comparison with previous PEP

As in last year's PEP, various sensitivity analyses are presented. One scenario examines the sensitivity of public finances to lower growth and higher interest rates. According to the calculations presented in the PEP, the debt situation appears to be sustainable. The most critical scenario is that of a combined shock, with a depreciation of the TRL of 5% in effective terms, a 2 percentage points decrease in real growth and 500 base points increase in real interest rates compared to the baseline scenario, whereby the gross debt level would rise by 5.1 percentage points. While the analysis concludes plausibly that the sensitivity to shocks 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 of growth observed in 2009 worldwide.

#### 5.5.4. Quality of public finances and institutional features

The PEP 2011-2013 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 some new legislation, including a new Court of Accounts Law, which will enhance the overall accountability structure through improvements in the external audit system. In order to reduce the need for ad-hoc measures to reach fiscal targets, it also foresees intensified efforts to widen the tax base, better capture the unregistered economy, and decrease the number of tax exemptions. 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. Fiscal imbalances might emerge over the medium term, either as a result of past policy commitments, for example in education and health, or owing to a still pending reform agenda. In addition, more infrastructure investment may be needed in less developed regions, given the persistence of regional disparities in Turkey.

As public expenditures are already relatively high there is little room for Turkey to further increase expenditure in order to meet pressing convergence challenges. Expenditure should also be contained in order to make room for lower taxes in the long run while preserving a sound fiscal framework, supported by strong and credible fiscal rules. Policy would thus need to focus on trade-offs in expenditure allocations, possibly by reducing spending in functional areas (such as general public services and defence, public order and safety) where it appears to be oversized in comparison with other similar countries. At the same time, reforms should be implemented with the aim of improving the efficiency of expenditure programs in areas where expenditure pressures are being felt, such as health care, education, social protection. Horizontal reforms, focused on the modernisation of civil service pay and employment system and the rationalisation of the investment programme, would 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. In addition, tax laws and regulations will be amended in order to re-assess tax exemptions with the objective of a simplification and a rationalisation of the tax system.

#### 5.5.5. Sustainability of public finances

The 2011 PEP does not contain a separate section on the long-term sustainability of public finances. It would greatly benefit from some medium-term analysis, which should be predominantly based on demographic and macroeconomic scenarios. Turkey's situation differs dramatically from the 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 appears a crucial section in a PEP.

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 in the long-term. The future costs of the pension and health-care systems should therefore be monitored very carefully.

## 5.6. STRUCTURAL REFORMS

*Table II.5.5:*

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

	2011	2012	2013
Labour market	0.0	-	-
Agriculture and rural sector	-0.2	-	-
Regional development (GAP)	-2.2	-2.1	-2.1
Social security	0.7	0.9	0.9
Transportation	-0.1	-0.2	-0.2
Energy	-2.0	-	-
Other reforms (public administration, knowledge-based society, judiciary, environment, public procurement etc)	-	-	-
Total impact on the budget	-3.7	-1.4	-5.2
Total impact on the budget (in % of GDP)	-0.6	-0.2	-0.7

*Source: 2010 Pre-accession Economic Programme (PEP), own calculations*

The outlined structural reform agenda represents a mere continuation of the plans put in place over the last years. The general aim remains to increase the efficiency in the private sector and the public administration and to support the strengthening of market forces. The agenda covers a broad range of issues. Being an update from the plans put in place over the last years, the outlined reforms are at different stages of implementation in several important areas, such as privatisation and social security reform. The programme is quite clear on what has been achieved (i.a. the long-awaited adoption of the commercial code) and at pointing to delays that have been encountered in relation to the plans outlined in the 2010 PEP. However, in some areas, such as for labour market reform and improvements in the investment climate, it is less clear what is planned to be achieved over the programme period or the expected speed of reforms, as concrete targets are not communicated. In the area of privatisation, the government has modified its plans after the submission of the PEP, delaying privatisations in certain areas. The budgetary effects of reforms to be implemented are outlined for some major reform areas, although cost estimates are often lacking. The net costs for agricultural reforms have been drastically reduced compared to the last programme, without clear explanation. Overall, the structural reform agenda should be broadly supportive of further enhancement of Turkey's capacity of cope with competitive pressures and market forces within the EU. More emphasis should be put on labour market reforms, to support job creation during the economic transformation process, and improvements in the monitoring of state aid. 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 EU2020 agenda.

### 5.6.1. Product and capital markets

The PEP 2011-2013 touches upon main reform areas such as the strengthening of competition policy and state aid control, privatisation, improving the investment climate, agriculture and SME development. It also envisages a continuation of measures aimed at strengthening 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 2009-2010, which constitutes indeed a real achievement during the current crisis. However, delays have been encountered in certain sectors compared to what was envisaged in the previous PEP. Privatisation efforts are to continue during the programme period, for example in banks, energy, ports and activities related to the tobacco industry. There is a risk that further delays will occur during the programme period compared to the outlined plans. After years of 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.

Concerning the area of competition law and policies, major progress has been achieved as a new law has been adopted that should put in place a more consistent monitoring of state aids. Further steps are planned improve the business environment where a positive development has been the facilitation and simplification of the sectoral licensing process. A well-established policy framework, including for example via the Investment Advisory Council, continues to support the reform process and to identify 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 privatisation of the largest state bank, Ziraat Bank, has been delayed once more but overall, past and planned measures are supportive of the overall positive developments in this so far highly profitable sector. Despite the demonstrated improved resilience of the Turkish banking sector to severe market fluctuations, also thanks to a number of specific supervisory measures, 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 at aligning the financial sector legislation and in particular prudential regulations with EU requirements. This process appears to be well on track, and a milestone new capital markets law is scheduled to be enacted after the elections. The programme could have discussed in more detail the new challenges for domestic financial and capital markets stemming from possibly lower profitability as funding may become more expensive as commercial banks reserve requirement ratios have increased and as the monetary easing is likely to be reversed.

#### 5.6.2. Labour market

The programme points to 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 last PEP, little progress has been made. A new employment package is being prepared. However, no concrete measures have been taken, also since the provisions related to labour market flexibility which were in the "Omnibus Law", have been removed prior to the law's adoption in February 2011. Looking forward over the programme period, the PEP is quite vague on concrete measures that will be taken to further improve the educational standards. There is no information about the planned scope for active labour market policies or resources which will be put aside for this purpose.

The PEP puts only limited focus on the role of labour market regulations and the informal sector in addressing the existing problems. Non-wage labour costs remain relatively 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 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 the timing is not clear.

#### 5.6.3. 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 public financial management, which is yielding positive results, for example as regards the budgeting process and transparency. However, the PEP does not outline any further steps to be taken in this area. Local government 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.

In the agricultural sector, significant efforts have been ongoing to support restructuring and upgrading of production standards in preparation for future integration in the single market. For example, legislative alignment in the field of chapter 12 of accession negotiations, improvements in farm/animal and land registers, privatisation of agricultural State Owned Enterprises, modifications in inheritance laws and development of national rural development policy show such determination. However, the since the agricultural sector remains relatively inefficient and labour intensive, implying large scope for reforms yielding improvements. 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. Finally, best efforts should be made to progressively align the domestic support policies with the Common Agricultural Policy (CAP).

Further social security reforms are very important, particularly given that the large deficits in the social security contributions strongly contribute to Turkey's fiscal imbalances. In addition, due to demographic change, without reforms the situation would significantly worsen over the coming years.

## **5.7. OVERALL ASSESSMENT OF FORMAL REQUIREMENTS**

### **Macro framework**

The macroeconomic framework in the 2011 PEP is rather comprehensive. The underlying assumptions are broadly realistic. However, the recent macroeconomic performance is not adequately described and some relevant information available at the time of submission has not been included. The medium-term scenario is rather optimistic, and some key challenges are not properly assessed, for example on the large energy dependence of the Turkish economy in a context of rising oil prices and risks of a much higher current account deficit than anticipated. The framework should have been updated from the MTP, which was published in October 2010, and the lack of it hampers the analysis and lead to some inconsistencies in the whole document.

### **Fiscal framework**

Turkey does not regularly publish consolidated general government accounts. In addition, the ESA95 alignment has not been improved in the 2010 fiscal notification. The PEP often includes central government data instead of general government operations. Future PEP would benefit from more complete data (e.g. on general government expenditure by function, long term fiscal projections). A sensitivity analysis could be added to the baseline fiscal programme to better understand risks to the scenario, in particular the ones stemming from the social security deficits.

### **Structural reforms**

The reform areas that are described in the programme are in general supportive to the fulfilment of the Copenhagen economic criteria, as they aim at making some key parts of the Turkish economy more competitive, and the priorities appear right. However, concrete implementation measures and timetables remain vague and their fiscal impact is not always well elaborated. This part of the PEP would definitely benefit from a medium-term, more strategic assessment.



Table II.5.6:

Annex: Structural indicators

	Turkey					EU 27				
	2006	2007	2008	2009	2010	2006	2007	2008	2009	2010
<b>General economic background</b>										
Real GDP <sup>1</sup>	6.9	4.7	0.4	-4.5	7.5f	3.2	3.0	0.5	-4.2	1.8
Labour productivity <sup>2</sup>	61.3	63.3	65.0	61.6	n.a.	100	100	100	100	100
Real unit labour cost <sup>3</sup>	n.a.	n.a.	n.a.	n.a.	n.a.	-1.1	-0.7	0.8	2.9	-1.6f
Real effective exchange rate <sup>4</sup>	86.1	93.5	94.9	85.2	n.a.	115.0	121.7	123.7	120.7	n.a.
Inflation rate <sup>5</sup>	9.3	8.8	10.4	6.3	8.6	2.2	2.3	3.7	1.0	2.1
Unemployment rate <sup>6</sup>	8.7	8.8	9.7	12.5	n.a.	8.2	7.2	7.0	8.9	9.6
<b>Employment</b>										
Employment rate <sup>7</sup>	44.6	44.6	44.9	44.3	n.a.	64.5	65.4	65.9	64.6	n.a.
Employment rate - females <sup>8</sup>	22.7	22.8	23.5	24.2	n.a.	57.3	58.3	59.1	58.6	n.a.
Employment rate of older workers <sup>9</sup>	27.7	27.2	27.5	28.2	n.a.	43.5	44.6	45.6	46.0	n.a.
Long term unemployment <sup>10</sup>	2.7	2.3	2.3	2.8	n.a.	3.7	3.1	2.6	3.0	n.a.
<b>Product market reforms</b>										
Relative price levels <sup>11</sup>	66.4	70.1	69.1	64.1	n.a.	100	100	100	100	100
Total trade-to-GDP ratio <sup>12</sup>	21.6	21.4	22.7	19.8	n.a.	10.7	10.7	11.5	9.7	n.a.
Net FDI <sup>13</sup>	2.0	1.9	1.4	0.8	n.a.	2.3	3.9	2.2	2.1	n.a.
Sectoral and ad-hoc state aid <sup>15</sup>	n.a.	n.a.	n.a.	n.a.	n.a.	0.6	0.5	2.2	n.a.	n.a.
Business investment <sup>16</sup>	n.a.	n.a.	n.a.	n.a.	n.a.	18.2	18.7	18.4	16.2	n.a.
<b>Knowledge based economy</b>										
Tertiary graduates <sup>17</sup>	6.2	n.a.	7.6	n.a.	n.a.	13.4	13.8	13.9	n.a.	n.a.
Spending on human resources <sup>18</sup>	2.9	n.a.	n.a.	n.a.	n.a.	5.0	5.0	n.a.	n.a.	n.a.
Educational attainment <sup>19</sup>	46.0	47.7	48.9	50.0	n.a.	77.9	78.1	78.4	78.6	n.a.
R&D expenditure <sup>20</sup>	0.6	0.7	0.7	n.a.	n.a.	1.9	1.9	1.9	2.0	n.a.
Broadband penetration rate <sup>21</sup>	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	18.2	21.7	23.9	n.a.

1. Growth rate of real GDP in %. 2. Labour productivity per person employed - GDP in PPS per person employed relative to EU-27 (EU-27=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 (1999 = 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 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. 11. comparative price levels of final consumption by private households including indirect taxes (EU-27=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. Number of broadband access lines per 100 inhabitants.

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

Source: Commission services, national sources



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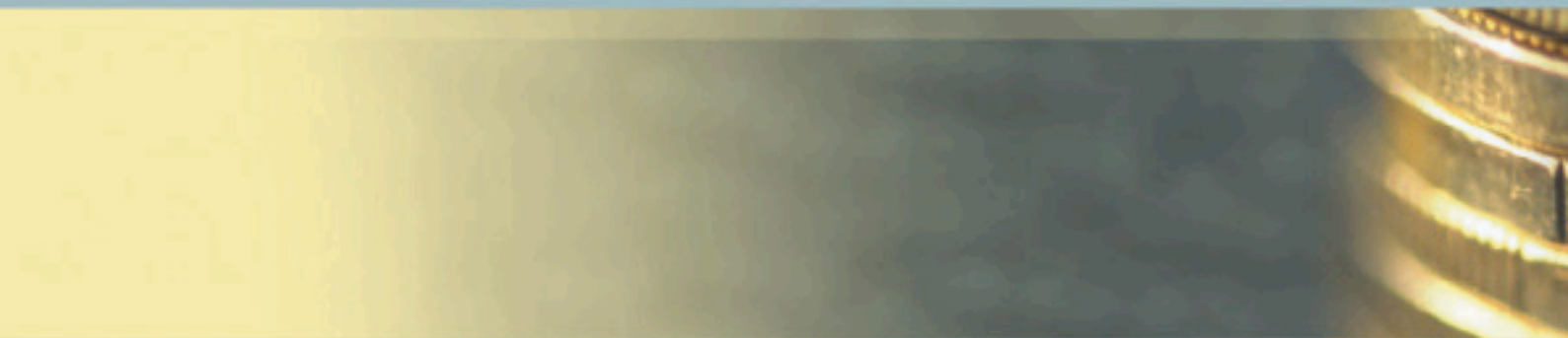
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