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2018 Economic Reform Programmes of Albania, the former Yugoslav Republic of Macedonia, Montenegro, Serbia, Turkey, Bosnia and Herzegovina and Kosovo*

The Commission's Overview
& Country Assessments

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European Commission

Directorate-General for Economic and Financial Affairs

Directorate-General for Neighbourhood and Enlargement Negotiations

Directorate-General for Employment, Social Affairs and Inclusion

2018 Economic Reform Programmes of Albania, The former Yugoslav Republic of Macedonia, Montenegro, Serbia, Turkey, Bosnia and Herzegovina and Kosovo*:

The Commission's Overview and Country Assessments

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

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INTRODUCTION

Economic governance has become one of the three key aspects of the EU enlargement process over recent years, mirroring moves in the EU to strengthen economic policy coordination and multilateral surveillance under the European Semester. In its 2013 and 2014 enlargement strategies the Commission outlined a new approach to economic governance. It involved clearer guidance on the reforms needed to foster macroeconomic stability, deliver fiscal sustainability and support long-term growth and competitiveness. In the same vein, the Economic and Financial Dialogue between the EU and the Western Balkans and Turkey has provided targeted policy guidance for each enlargement country since 2015.

This dialogue is based on medium-term Economic Reform Programmes (ERP) submitted annually by enlargement countries. The ERPs include a macroeconomic and fiscal policy framework as well as structural reform plans to boost competitiveness and long-term growth. The ERP exercise also aims to help enlargement countries develop their institutional and analytical capacities and to prepare them for participation in the EU's multilateral surveillance and economic policy coordination procedures once they become Member States of the EU.

In 2018, enlargement countries submitted their fourth annual Economic Reform Programmes covering the period 2018-2020¹. They have been assessed by the European Commission and the European Central Bank. Based on these assessments, Joint Conclusions with country-specific policy guidance² were agreed and adopted at the Economic and Financial Dialogue between the EU and the Western Balkans and Turkey. The dialogue was held in the margins of the Economic and Financial Affairs Council meeting of 25 May 2018.

This paper contains the Commission staff's assessment of the ERPs for 2018-2020 submitted by Albania, Bosnia and Herzegovina, the former Yugoslav Republic of Macedonia, Kosovo*, Montenegro, Serbia and Turkey. The assessment also takes stock of the implementation of the country-specific policy guidance adopted last year. The cut-off date for the assessment was 17 April 2018.

The assessment reflects joint work by Commission staff from several Directorates-General. In particular, DG ECFIN analysed the macroeconomic and fiscal frameworks; DG NEAR was responsible for assessing structural reforms; while DG EMPL covered employment and social policy-related aspects.

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¹ Albania: http://www.financa.gov.al/files/userfiles/Programimi_EkonomikoFiskal/Ekonomia_ne_Fokus/2018/Economic_Reform_Programe_2018-2020.pdf
Bosnia and Herzegovina: http://www.dep.gov.ba/Default.aspx?langTag=en-US&template_id=139&pageIndex=1
Kosovo: <https://mf.rks-gov.net/page.aspx?id=2.28>
the former Yugoslav Republic of Macedonia: <http://www.finance.gov.mk/en/node/4832>;
Montenegro: http://www.gov.me/en/homepage/Montenegro_Economic_Reform_Programme/
Serbia: http://www.mfin.gov.rs/UserFiles/File/strategije/ERP%202017%20-%202019%20final_Eng.pdf
Turkey: <http://www.mod.gov.tr/Pages/content.aspx?l=da71bf51-cd71-420a-bfc8-9dfba104e918&i=153>

² This paper includes at the end of each country assessment the country-specific policy guidance adopted in May 2018.

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Part I

Overview

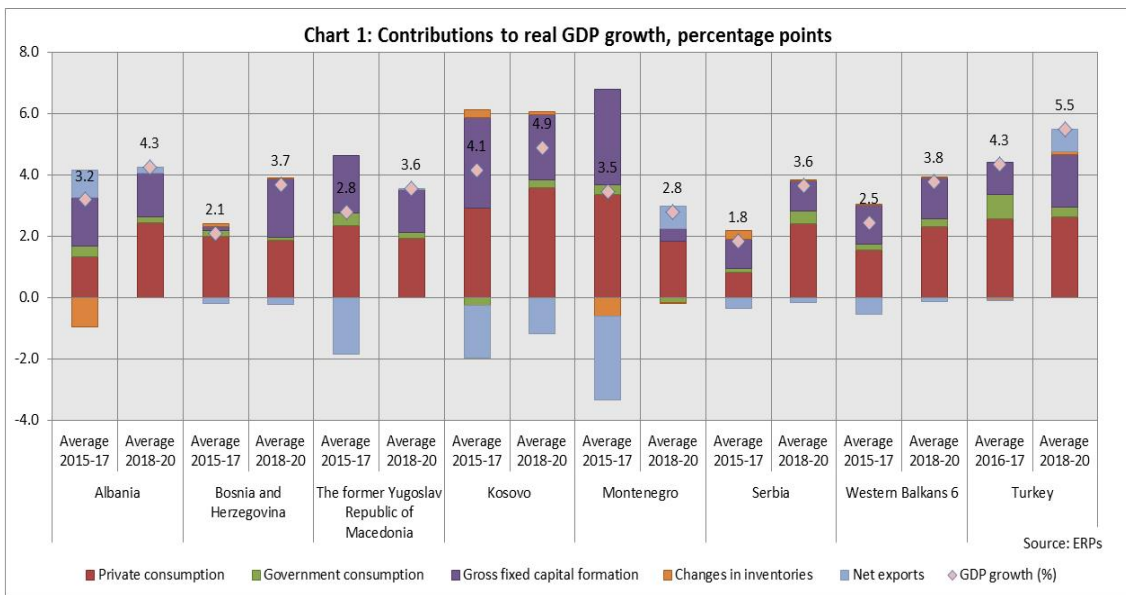
1. Overview of the 2018 programmes

1.1. ECONOMIC OUTLOOK AND CONTEXT

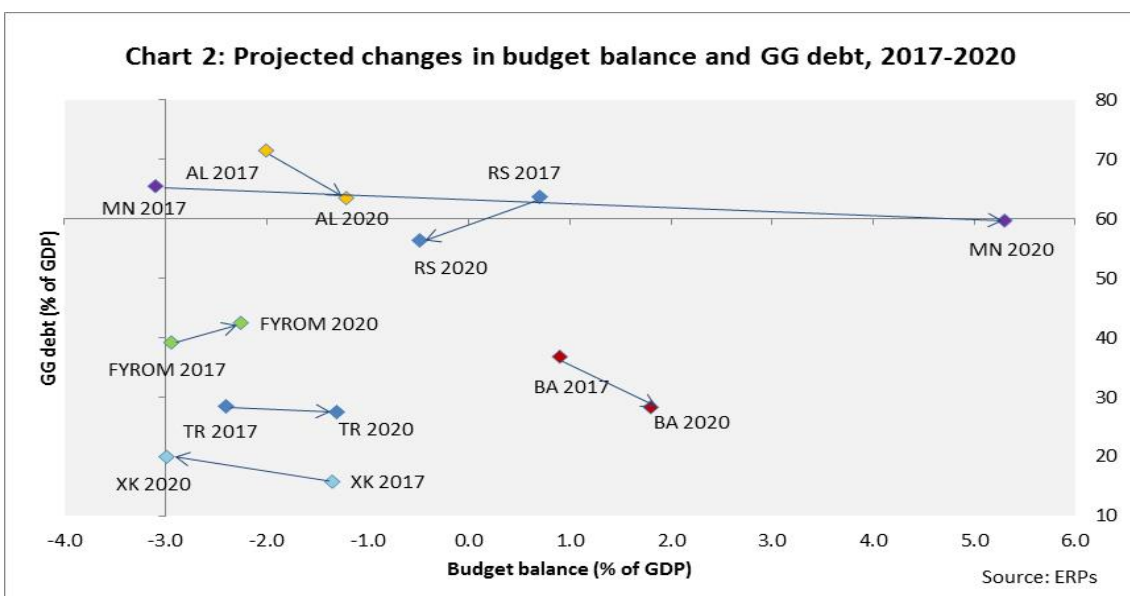
According to the projections of the economic reform programmes (ERPs), economic growth is to strengthen in the Western Balkans and remain high in Turkey. In 2017, the Western Balkans witnessed an economic slowdown owing to temporary supply-side shocks in Serbia, the largest economy in the region, and a prolonged political crisis in the former Yugoslav Republic of Macedonia¹. The underlying cyclical recovery is expected to take hold in the region as the impact of these negative shocks dissipates. Based on the ERP forecasts, average annual GDP growth in the Western Balkans is to accelerate to 3.8 % in 2018-2020 from the 2.5 % recorded in 2015-2017. This increase is driven mostly by private consumption, investment and a less negative contribution from net exports (Chart 1). The former Yugoslav Republic of Macedonia and Serbia foresee a solid recovery, although in the former country, growth projections have been revised slightly downwards compared to last year's ERP. In Serbia, the acceleration of private consumption is expected to be the strongest of the enlargement countries. Montenegro stands out for an expected moderation of economic growth as major infrastructure works come to an end. Albania, Kosovo and Bosnia and Herzegovina expect a strengthening of economic growth from relatively solid levels. The growth projections are broadly plausible and not far from the Commission's forecasts, when available. Nonetheless, despite the cyclical upswing, economic growth is still insufficient to bring about a fast pace of convergence with EU income levels in the Western Balkans. **Turkey** registered a growth rate of 7.4 % in 2017, 3 percentage points higher than foreseen in last year's ERP. Turkey has revised upwards its growth forecast to 5.5 % for all of 2018-2020. High growth has been spurred by government incentives and is driven by private consumption, investment and exports. However, it is increasingly coupled with macroeconomic imbalances, and there are increasing risks of overheating.

The benign global economic environment, and in particular a stronger EU economy, has supported the economies of the Western Balkans and Turkey. At least half of all goods exported from the Western Balkans and Turkey are directly destined for the EU (with Kosovo being the only exception for which intra-regional trade is more dominant). Exports to the EU have grown steadily, outpacing the growth of total trade of these countries. In the last 3 years in particular, trade in these countries has benefited from their close association with the EU, and trade integration with the EU has increased further. Given the significant links through trade, investment and remittance flows, the strengthening of the EU economy has spilled over into the countries of the Western Balkans and Turkey. However, strong links also mean that the expected slowdown in the EU economy will weigh on growth in the enlargement countries. A broader change in external conditions, for instance the tightening of monetary conditions in advanced economies, trade disputes and geopolitical tensions, further increases the risks stemming from the external environment.

¹ Based on the ERP estimates, GDP growth in the Western Balkans slowed from 3 % in 2016 to 2.7 % in 2017. This, however, masks significant cross-country differences: in 4 out of the 6 countries in the region, economic activity accelerated.



Most enlargement countries expect a mild improvement in the general government budget balance over 2018-2020. However, Kosovo and Serbia project a worsening of the budget balance due to plans for large public investments in the former and a strong 2017 fiscal position in the latter. In Montenegro, by contrast, the implementation of an ambitious fiscal consolidation plan, in combination with the completion of major public infrastructure works, is expected to lead to a major improvement in the budget balance and a very high primary surplus in 2020. In most countries, deficit reduction, coupled with strengthening growth, is expected to lead to a gradual reduction of the debt-to-GDP ratio. Debt remains high as a share of GDP in countries such as Albania (whose ERP projects a decline from 71.5 % of GDP in 2017 to 63.5 % in 2020), Montenegro (from 65.1 % of GDP in 2017 to 59.7 % in 2020) and Serbia (from 63.7 % of GDP in 2017 to 56.3 % in 2020). Turkey foresees a further decline in its already relatively low debt level (28.5 % of GDP in 2017, 26.5 % in 2020) indicating there are no immediate concerns for the sustainability of its government debt (Chart 2).



External imbalances remain significant. All enlargement countries historically run significant current account deficits, which were at around 6 % of GDP in the Western Balkans and 5.5 % in Turkey in 2017, up from 5 % and 3.8 % respectively in 2016. Higher domestic demand boosted imports and led to a widening of the trade deficit in most countries of the Western Balkans and in Turkey in 2017, despite the increase in exports as well. Real effective exchange rates appreciated in all the countries of the Western Balkans in 2017, which is not unusual in the transition process. Due to the large depreciation of the lira, Turkey was the only enlargement country to experience a real effective depreciation despite its high inflation rate. On the positive side, the Western Balkan countries benefit from foreign direct investment inflows that largely cover their current account deficits. For these emerging economies, this suggests investors having a positive long-term view, with the caveat that inflows are still too much tilted towards the non-tradable sector. All enlargement countries except Kosovo foresee a decline in their current account deficit in the coming years despite the fact that domestic demand is expected to remain a major driver of economic growth.

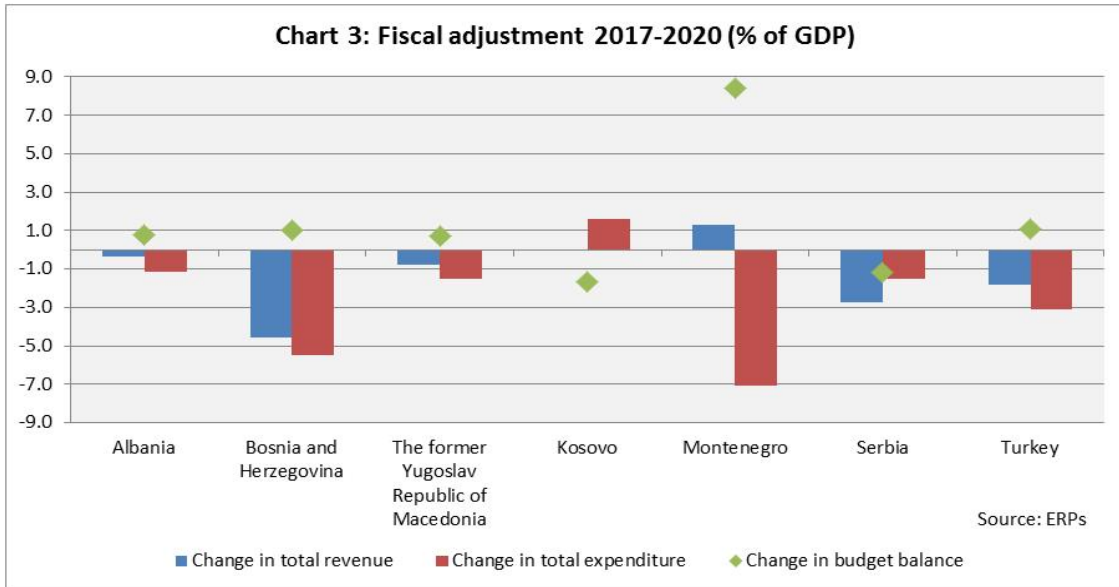
Consumer price inflation is projected to remain subdued in the Western Balkans, whereas Turkey expects a return to lower inflation rates from double digits. Inflation rates have been the lowest in the countries that peg their currency to the euro or are euroised (Bosnia and Herzegovina, the former Yugoslav Republic of Macedonia, Kosovo and Montenegro). In the inflation-targeting countries (Albania, Serbia and Turkey), the real interest rate was close to zero in 2017. In the case of Albania and Serbia, this is the result of persistently low inflation and the need for continued monetary stimulus. In Turkey, however, inflation reached double-digits in 2017 and significantly exceeded the 5 % target, which, together with a sharp fall in the lira and increasingly unanchored inflation expectations, would have justified a stronger monetary policy response. Going forward, the economic upturn is likely to generate greater inflationary pressures in the Western Balkans, but overall inflation is expected to remain subdued in the context of low imported inflation, still moderate growth prospects and well-anchored inflation expectations. Inflation-targeting countries may see some pressure from changes in the monetary policy stance in advanced economies. In Turkey, the ERP predicts a smooth return of inflation to its target over the coming years. However, this appears to be a rather optimistic projection given the upward shift in inflation expectations, low real interest rates, high reported economic growth and renewed pressure on the lira.

1.2. MAIN CHALLENGES

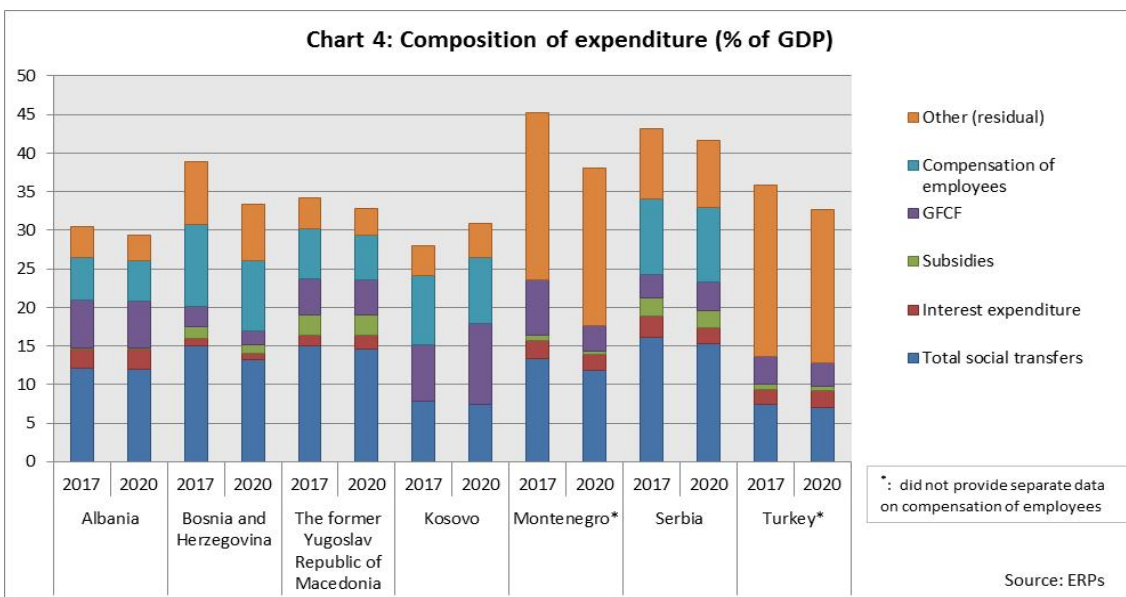
The current benign cyclical conditions offer a window of opportunity for ambitious economic reforms. The positive economic momentum, together with the increasing risks in the external sector, implies that these are among the best of times for an acceleration of public finance and structural reforms, which would in turn offer strong buffers against possible headwinds and risks down the road. A positive reform momentum would strengthen the domestic fundamentals and speed up convergence with the EU. Structural reform may also help to rebalance growth sources by tempering domestic demand and increasing competitiveness.

First, public finances need to be put on a sustainable footing by implementing fiscal consolidation and re-building fiscal buffers. The economic outlook has improved compared to last year, but this has led to only limited increases in ambition to improve public finances. Given elevated debt levels in some countries, high public investment needs, limited monetary policy freedom and fiscal risks in the form of contingent liabilities, enlargement countries should use the current benign cyclical position to continue re-building fiscal buffers through the elaboration and implementation of ambitious consolidation plans. Countries foreseeing an improvement in their balance are relying on reductions in the expenditures ratio (on average 3.7 % of GDP between 2017 and 2020) exceeding reductions in the revenues ratio (1.2 % of GDP), although the underlying measures are often unspecified or unclear (Chart 3). In some cases, such as Montenegro, an ambitious fiscal consolidation is already underway, but sustained commitment to it will be key. In Albania, fiscal adjustment plans have been attenuated and pushed back compared with last

year's programme. In Serbia, the budgetary position has improved greatly in recent years, and the challenge now is to cement these gains while addressing lingering fiscal risks through reforms of the public sector.



The rebalancing of public spending towards a more growth-enhancing pattern remains a key challenge. The enlargement countries are confronted with large needs for public investment. Still, most of the countries foresee either a decline or stabilisation of public investment (Chart 4). Only Kosovo, due to the planned large investment in the new power plant, and Serbia are planning to significantly increase their public investments. Expenditures will continue to be tilted towards social transfers, public wages and subsidies according to the ERP budgetary scenarios, thus leaving ample room for shifting to a more growth-friendly composition of public finances.



There is scope for a strengthening of fiscal frameworks and fiscal oversight to support the pursuit of sound public finances. Enlargement countries have generally made efforts over recent years to foster

the institutional underpinning of public finances. Most countries have adopted domestic fiscal rules (see Table 3 in the Annex for an overview), taken measures to increase fiscal transparency and made efforts to improve medium-term budgetary frameworks. Serbia established a fiscal council to oversee compliance with fiscal rules and to assess fiscal forecasts. At the same time, fiscal frameworks in the region remain generally weak. Existing fiscal rules have been subject to frequent changes and are often not strong enough to sufficiently contribute to improving the credibility of fiscal policy. Moreover, enforcement remains generally weak, partly due to escape clauses or a lack of cost of non-compliance. Fiscal oversight bodies are not in place or lack the advisory and/or enforcement capacities required to play a useful role in guiding public finances. Medium-term budget frameworks, where available, also remain generally weak, which constrains the longer term orientation of fiscal policy. Finally, fiscal reporting and transparency, e.g. the timely assessment of fiscal risks and contingent liabilities, would need to be improved substantially across the enlargement countries. This is all the more important as some countries plan to resort to public-private partnerships or concessions to meet significant public investment needs or have a large unreformed state-owned enterprise sector which benefits from explicit or implicit state subsidies and guarantees.

Second, external imbalances, reflecting the saving-investment gap, have increased and require more urgent action. The expected domestic demand-led growth is in principle not conducive to lowering external imbalances. Nonetheless, except for Kosovo all enlargement countries expect, optimistically, a decrease in their current account deficits, which would still remain sizable. In the case of Turkey, the ERP also expects a less likely combination of stronger domestic demand with a lower current account deficit. A more likely increase in the current account deficit will add to the existing external vulnerabilities like the already high foreign currency indebtedness of Turkish firms and the reliance on more volatile forms of capital flows to finance the current account deficit. Combined with already high foreign debt, net international investment positions in the enlargement countries are commonly around -50 % of GDP and in the case of Serbia 100 % of GDP. This makes the set of countries vulnerable to changes in foreign financing conditions.

Foreign direct investment can help broaden the production base. However, as the case of the former Yugoslav Republic of Macedonia shows, such investment also needs to benefit the broader domestic economy. All countries, except Turkey, have been able to attract most of the foreign financing already in the form of foreign direct investment. However, in most Western Balkan countries, this investment has largely focused on the non-tradable sector, which is less conducive to raising competitiveness and exports and to creating sounder growth fundamentals. A comprehensive strategy, including structural reforms to improve the business environment, is needed to make the region attractive to foreign direct investment in the tradable sector. This would help to diversify output and exports and move up the value chain.

Third, risks to financial stability are being addressed, but challenges remain. Strategies to reduce non-performing loans (NPLs) are bearing fruit in the Western Balkans. NPL ratios have come down considerably in these countries, whereas in Turkey it was already low. The profitability of the banking sector is relatively sound across the countries as is capital adequacy. Still, foreign currency-denominated loans constitute around half or more of total loans in some countries, such as Serbia and Albania. This creates credit risks in the case of a large depreciation of the domestic currency. Moreover, in most Western Balkan countries loan growth to the corporate sector was still subdued. This partly reflected structural weaknesses, such as a large informal economy and inefficient enforcement procedures to foreclose collateral. Turkey registered very high growth in lending both to the non-financial corporate sector and to the total economy, and it was bolstered by government initiatives as well as high inflation.

Fourth, impediments to a business environment supportive of private sector development remain. Despite some progress, informality, weak institutions, corruption, excessive use of distortive subsidies, legal unpredictability, unclear property rights and slow legal procedures still hamper the establishment of functioning markets and the growth potential of businesses. These basic problems are present in all the countries of the Western Balkans and Turkey, even if they vary in intensity and precise nature. They

come with a deterrent effect for potential investors and carry social costs through an impaired price formation process. They also discourage or even disable local businesses and undermine the countries' tax bases. On top of this, the administrative burden on businesses remains high, albeit to different degrees. There is a strong need for swift implementation of more ambitious reforms, recognising the positive impact on the economy of a proper functioning legal framework and strong institutions. Promotion and facilitation of innovation activities would be beneficial for companies across all sectors. The smart specialisation methodology is only now gaining ground in the region and should be supported. It has the potential to promote innovation and raise competitiveness throughout the region.

The liberalisation of energy and transport markets is lagging behind, reforms in the agricultural sector are too modest in scope and the services sector attracts very little attention in the ERPs. While it is important to build and maintain infrastructure (especially when contributing to diversification), the focus should be on fully opening electricity markets to competition, abandoning subsidised energy tariffs and creating incentives for energy efficiency, in particular in the private sector. Underperforming logistics are broadly recognised as an obstacle to growth in general and trade specifically. Unclear land property titles and fragmented land plots are a legacy from the pre-transformation era in the Western Balkans that are hampering productivity gains in agriculture. There is growing awareness of this key issue, but still too few resources are being allocated across the board for the time-consuming process of clarification of ownership, defragmentation, consolidation and – possibly – cooperation. Despite the considerable economic weight of the services sector for all the economies and the potential for increasing productivity through e-solutions, only a few reforms are targeting this sector, and they are focusing only on tourism, while construction, IT and financial services, for instance, are ignored.

Fifth, structural challenges persist on the labour markets despite some positive developments. High levels of inactivity, gender employment gaps and over proportionate youth unemployment are common features across the region. Structural reforms in labour market policies should be stepped up. In the Western Balkans, a lot more needs to be done to ensure that active labour market policies benefit larger numbers of jobseekers and the inactive. This requires modernisation of public employment services, which has started in some countries. At the same time, disincentives to work stemming from the prevalence of passive measures should be removed by adjusting the social benefit systems to encourage employment. In Turkey, job creation support should be more targeted to specific categories. Overall, more resolute and comprehensive policy action is required to reduce the persistently high levels of informal employment. In the case of Serbia and Bosnia and Herzegovina, labour taxation is also unsupportive of employment growth.

Sixth, education systems in the Western Balkans and Turkey are weak, reflecting insufficient investment in human capital. Starting from early education, enrolment in pre-school education remains low, and the poor results of the PISA survey reflect the need for urgent quality reforms in primary education. Both are relevant for increased performance in higher levels of education. The skills mismatches remain the key obstacle to growth and competitiveness and are visible both at secondary and higher education levels. Because the education systems do not correspond to labour market needs and the link between education and the economy is weak, there are both vertical and horizontal mismatches. Efforts are also needed to improve the relevance and quality of vocational education and training and practical learning to increase school-to-work transitions.

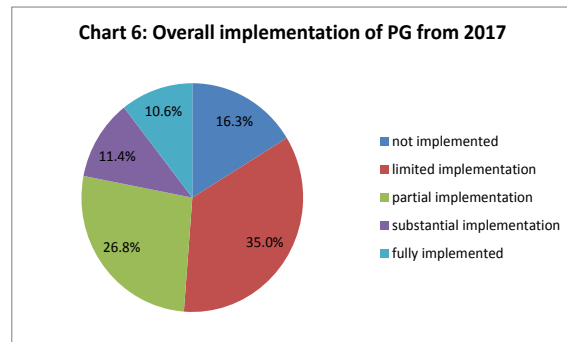
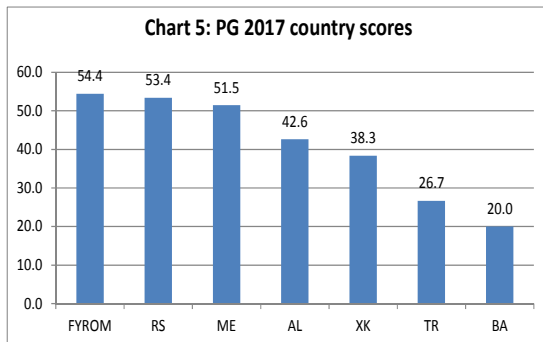
1.3. IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED IN 2017

The exercise of jointly adopting country-specific policy guidance and reviewing its implementation is still relatively new for enlargement countries. Since 2016, the Commission's assessment of the economic reform programmes has included information on the degree of implementation of the policy guidance (PG). In 2017, the Commission for the first time used a methodology similar to the European

Semester approach to calculate numerical scores for policy guidance implementation at country level². Building on the practice followed under the European Semester for Member States, this year's assessments did more to monitor the implementation of policy guidance by assessing progress in each individual subpart (policy action) of the policy guidance³. The country scores are calculated on the basis of these more granular assessments of implementation⁴.

How effective policy guidance is in strengthening macro-fiscal stability and supporting structural reforms crucially depends on implementation. This, in turn, is in the hands of the enlargement countries. Last year, the Commission found that the 2016 policy guidance was on average only implemented to a limited extent and that there was 'a clear need to substantially step up implementation'.

Overall, the pace of implementation improved somewhat in 2017. Applying the methodology used in the European Semester points to partial implementation of the policy guidance adopted in 2017, with an average score across all countries of 41 compared to 34.3 in 2016⁵. However, cross-country differences are quite large, with the former Yugoslav Republic of Macedonia having the highest score, followed by Serbia and Montenegro, while Turkey as well as Bosnia and Herzegovina clearly lag behind (Chart 5). The latter two countries remain in the 'limited implementation' category while all others achieved scores equivalent to the 'partial implementation' category. It should also be noted that the former Yugoslav Republic of Macedonia significantly improved its score since last year, pointing to greater implementation. Also, Montenegro and Turkey recorded some improvements, though to a lesser extent, whereas the scores of Albania as well as Bosnia and Herzegovina deteriorated somewhat. Overall, around 16 % of all policy guidance subparts⁶ have not been implemented, with a further 35 % of them having seen only a limited degree of implementation. At the other end of the spectrum, 22 % of the total have been substantially or fully implemented (Chart 6).



² For a detailed description of the methodology, see Section 1.3 of *2017 Economic Reform Programmes of Albania, the former Yugoslav Republic of Macedonia, Montenegro, Serbia, Turkey, Bosnia and Herzegovina and Kosovo**: *The Commission's Overview and Country Assessments* available at https://ec.europa.eu/info/publications/economy-finance/2017-economic-reform-programmes-commissions-overview-and-country-assessments_en.

³ See Annex 1 of the Commission assessment of each country's ERP.

⁴ In the past, implementation was assessed at the more aggregate level of the policy guidance.

⁵ The highest possible score in case of full implementation of all policy guidance subparts is 100.

⁶ There were a total of 123 policy guidance subparts adopted for the seven enlargement countries in 2017.

Table 1:

**Economic Reform Programmes 2018
Key indicators**

	2014	2015	2016	2017e	2018	2019	2020
Real GDP growth (% change)							
Albania	1.8	2.2	3.4	3.9	4.2	4.3	4.4
The former Yugoslav Republic of Macedonia	3.6	3.8	2.9	1.6	3.2	3.5	4.0
Montenegro	1.8	3.4	2.9	4.0	3.0	2.7	2.6
Serbia	-1.8	0.8	2.8	2.0	3.5	3.5	4.0
Turkey	5.2	6.1	3.2	5.5	5.5	5.5	5.5
Bosnia and Herzegovina	0.2	3.8	2.9	3.4	3.4	3.8	3.9
Kosovo	1.2	4.1	4.1	4.3	4.6	4.9	5.1
Unemployment rate (% , LFS)							
Albania	17.9	17.5	15.6	13.9	12.9	12.0	11.2
The former Yugoslav Republic of Macedonia	28.2	26.1	23.7	22.4	21.5	20.5	19.5
Montenegro	18.2	17.8	18.0	17.0	16.7	16.6	16.6
Serbia	19.2	17.7	15.9	13.6	11.6	10.0	8.1
Turkey	10.1	10.5	10.9	10.8	10.5	9.9	9.6
Bosnia and Herzegovina	27.5	27.7	25.4	20.5	:	:	:
Kosovo	35.3	32.9	27.5	:	:	:	:
Current account balance (% of GDP)							
Albania	-10.8	-8.6	-7.6	-7.6	-6.7	-6.5	-6.5
The former Yugoslav Republic of Macedonia	-0.5	-2.0	-2.7	-2.0	-1.8	-1.8	-1.9
Montenegro	-15.2	-13.2	-18.1	-18.0	-18.0	-16.5	-14.5
Serbia	-6.0	-4.7	-3.1	-4.6	-4.2	-4.1	-3.9
Turkey	-4.7	-3.8	-3.8	-4.6	-4.3	-4.1	-3.9
Bosnia and Herzegovina	-7.1	-5.3	-4.2	-4.6	-4.3	-4.3	-4.4
Kosovo	-6.9	-8.6	-8.3	-9.0	-9.5	-10.1	-10.8
Inflation (CPI, annual % change)							
Albania	1.6	1.9	1.3	2.0	2.7	3.0	3.0
The former Yugoslav Republic of Macedonia	-0.3	-0.3	-0.2	1.4	2.0	2.0	2.0
Montenegro	-0.5	1.4	0.4	2.5	2.6	1.9	1.5
Serbia	2.1	1.4	1.1	3.1	2.7	2.8	3.0
Turkey	8.9	7.7	8.5	11.9	7.0	6.0	5.0
Bosnia and Herzegovina	-0.9	-1.0	-1.1	1.1	1.2	1.4	1.5
Kosovo	0.4	-0.5	0.3	1.7	1.3	1.1	1.2

Sources: Economic Reform Programme (ERP) 2018 for 2016-2020, CCEQ for 2014 and 2015.

Table 2:

Economic Reform Programmes 2018
Fiscal indicators

	2014	2015	2016	2017e	2018	2019	2020
Total revenue* (% of GDP)							
Albania	26.2	26.4	27.6	28.5	28.2	28.1	28.1
The former Yugoslav Republic of Macedonia	29.8	31.0	30.3	31.3	31.1	30.7	30.5
Montenegro	44.8	42.1	42.6	42.6	44.2	44.2	43.9
Serbia	41.5	41.9	43.2	43.9	42.4	41.8	41.2
Turkey	33.9	34.0	34.7	33.3	32.8	32.0	31.5
Bosnia and Herzegovina	41.2	40.9	39.7	39.8	38.1	36.6	35.2
Kosovo	23.9	25.3	26.5	27.2	27.1	27.2	27.1
Total expenditure* (% of GDP)							
Albania	31.3	30.5	29.4	30.5	30.1	29.8	29.4
The former Yugoslav Republic of Macedonia	34.0	34.4	33.0	34.2	33.8	33.3	32.8
Montenegro	47.9	50.4	46.2	45.7	45.8	44.1	38.6
Serbia	48.1	45.6	44.5	43.2	43.1	42.3	41.7
Turkey	33.7	33.1	36.0	35.8	34.8	33.8	32.7
Bosnia and Herzegovina	43.1	42.0	38.5	38.9	36.7	34.9	33.4
Kosovo	26.5	26.9	27.6	28.5	31.1	30.6	30.1
General government balance (% of GDP)							
Albania	-5.2	-4.1	-1.8	-2.0	-1.9	-1.7	-1.3
The former Yugoslav Republic of Macedonia	-4.2	-3.5	-2.7	-2.9	-2.7	-2.5	-2.3
Montenegro	-2.9	-8.3	-3.6	-3.1	-1.6	0.1	5.3
Serbia	-6.6	-3.7	-1.3	0.7	-0.7	-0.5	-0.5
Turkey	0.1	1.3	-1.3	-2.4	-1.9	-1.9	-1.3
Bosnia and Herzegovina	-2.0	0.6	1.2	0.9	1.4	1.7	1.8
Kosovo	-2.2	-1.6	-1.1	-1.4	-3.9	-3.4	-3.0
General government debt (% of GDP)							
Albania	70.1	73.1	72.4	71.5	68.7	66.4	63.5
The former Yugoslav Republic of Macedonia	38.1	38.1	39.5	39.2	42.4	44.6	42.5
Montenegro	58.6	62.3	63.3	65.5	66.5	66.1	59.7
Serbia	70.4	74.7	73.0	63.7	62.8	59.8	56.3
Turkey	28.6	27.5	28.1	28.5	28.5	28.0	27.5
Bosnia and Herzegovina	41.7	41.9	39.2	36.8	34.7	31.7	28.3
Kosovo	10.7	12.9	14.0	15.8	17.6	19.2	20.0

Sources: Economic Reform Programmes (ERP) 2018 for 2016-2020, CCEQ for 2014 and 2015.

*2014 data from ERP 2016, 2015 data from ERP 2017.

Notes:

CCEQ: DG ECFIN publication 'EU Candidate and Potential Candidate Countries' Economic Quarterly'

EFP: Economic and Fiscal Programme

LFS: Labour Force Survey

PEP: Pre-accession Economic Programme

Table 3: Fiscal rules in the Western Balkans and Turkey

Country	Main elements of the fiscal rule	Year of adoption	Main shortcomings
Serbia	The general government debt limit is set at 45 % of GDP. There is an augmented deficit rule taking into account deviations from the long-term growth rate and from the medium-term deficit target of 1 % of GDP. In addition, there are limits on government expenditure on wages and pensions. There is an independent body (Fiscal Council) to monitor implementation.	2010	No sanctions are provided for in case of non-compliance, and implementation has so far been weak.
Kosovo	A deficit rule mandates that the deficit cannot exceed 2 % of GDP while a debt rule prescribes that public and publicly guaranteed debt cannot surpass 40 % of GDP. There are exemptions to the deficit rule (recession, natural disaster, etc.). Capital investment financed by privatisation proceeds is exempted from the headline deficit, provided that the government deposits amount to at least 4.5 % of GDP. New donor-financed capital projects are excluded from the headline deficit as long as debt level is below 30 % of GDP, for a period of 10 years (starting in 2016). There is a spending limit of 0.7 % of GDP on the war veteran pension programme. Starting in 2018, rises in the overall public wage bill are tied to nominal GDP growth.	2013 and 2015	Due to frequent changes in the recent past, the sustainability of existing rules cannot be predicted. There is no independent body to monitor compliance.
Montenegro	The fiscal rule adopts the Maastricht limits i.e. it caps the general government cash deficit at 3 % and public debt at 60 % of GDP. The growth in central government expenditures must be less than the projected real GDP growth rate, and local government deficits should not exceed 10 % of their projected revenues. State guarantees should not exceed 15 % of GDP. If public debt exceeds 60 % of GDP, the government is obliged to propose a debt stabilisation strategy with a 5-year implementation period.	2014	The State Audit Institution only reviews compliance. It has no authority to enforce it. There are no automatic spending caps and no deadlines for implementing fiscal measures.
Albania	The rule lays down a long-term debt ceiling of 45 % of GDP and budget balances that ensure a falling debt ratio until the target is reached. A 'buffer' clause ensures that 0.7 % of GDP is set aside as a budgetary reserve that can be used to compensate for forecasting errors and unforeseen changes in macroeconomic variables (e.g. lower growth than expected, changes in exchange rates, etc.). Macroeconomic assumptions used for budgeting purposes are drawn from the IMF's <i>World Economic Outlook</i> .	2016	There is neither a target deadline nor an independent body to monitor compliance. In economic upturns, the rule does not provide a strong anchor for fiscal policy.
Bosnia and Herzegovina	There is no fiscal rule for the consolidated general government. Fiscal rules are in place for the two constitutional and legal entities.		
The former Yugoslav Republic of Macedonia	No fiscal rule is in place yet. The authorities have announced that fiscal rules will be included in the new organic budget law that is under development.		
Turkey	No fiscal rule in place.		

Part II

Country analysis

1. ALBANIA

1.1. EXECUTIVE SUMMARY

Albania's economic expansion is expected to continue in 2018-2020. The economic reform programme (ERP) projects GDP growth will strengthen above the level of 4 % on the back of rising domestic demand. Consumer spending is seen as the major growth driver in a context of an improving labour market, rising confidence and growth-friendly financial conditions. Investment growth is expected to moderate as two large foreign direct investments in the energy sector are completed. Although Albania's exports are projected to increase at a solid pace as the EU economy expands, their contribution to GDP growth is expected to be fully offset by import growth. Nevertheless, the possibility of stronger-than-projected import growth in view of the expected acceleration in consumer spending seems to be the main downside risk to the programme's forecast of real GDP growth.

Sustaining the ongoing economic recovery requires further reform efforts and the tackling of macroeconomic weaknesses in relation to public finances and the financial sector. Helped by an International Monetary Fund (IMF) programme, the country has started to consolidate its public finances and an appropriately accommodative monetary policy has supported the economic upswing. Some important business-relevant reforms have been launched, such as the comprehensive overhaul of the justice system. Nevertheless, enduring macroeconomic weaknesses and structural obstacles to growth call for sustained efforts to address the following main challenges.

- **The public debt-to-GDP ratio has been reduced but remains a major source of macroeconomic vulnerability.** Public debt (including guarantees) is still close to the relatively high level of 70 % of GDP and is associated with significant rollover, interest rate and exchange rate risks. The country's fiscal adjustment plans have been attenuated and pushed back compared with last year's programme; this will delay achievement of the medium and long-term targets for public debt. The envisaged decline of the debt ratio relies mainly on favourable economic growth and restraint in public consumption. It is associated with significant downside risks from lower-than-expected GDP growth, contingent liabilities, and new public-private partnerships. There is considerable scope for raising more revenue by improving tax compliance and broadening the tax base.
- **Non-performing loans have been reduced, but bank lending to businesses remains sluggish.** Banks are well capitalised, highly liquid, and have a very low loan/deposit ratio. While lending to households has been rising at a decent rate, bank lending to the business sector is barely expanding. The stock of non-performing loans on banks' balance sheets has been reduced, mainly through mandatory write-offs, but still seems to constrain bank lending. The proportion of foreign exchange loans remains high and poses challenges to the stability of the banking system and the conduct of monetary policy.
- **Albania's competitiveness continues to be hampered by inefficiencies in the energy sector, including insufficient security of supply.** The ERP recognises this and again includes measures to further unbundle and liberalise the energy market following the adoption of the required legal basis. However, implementation of these measures was limited in 2017. Moreover, in pursuing the objective of diversifying energy sources, the ERP focuses on gasification and ignores the potential of renewable energy sources.
- **Issues related to property rights and land registration continue to affect the competitiveness of the Albanian economy. This is a cross-cutting issue affecting infrastructure and industrial development, agriculture, the property market and, importantly, access to finance.** Progress

towards establishing a comprehensive cadastre has been slow. The ERP maintains a narrow view of the issue, prioritising only agricultural land. There has been limited progress in establishing the legal basis for the creation of the much-needed e-cadastre.

- **Despite some improvements, employment and labour market participation remain low and the incidence of undeclared work significant.** A key bottleneck to competitiveness and growth is the lack of a workforce with the right skills for the labour market. There have been positive developments in improving the relevance and quality of vocational education and training, but entrepreneurial and soft skills are still underdeveloped. The narrow coverage of active labour market policies and the weakness of employment services are coupled with limited links with passive social schemes. There is still no comprehensive approach to addressing the high incidence of undeclared work. Poor and vulnerable households face limited access to education, jobs and social protection measures. There is a serious risk that the restructuring of the administration will reduce its capacity to progress with the design and implementation of employment and social policies.

The policy guidance jointly adopted at the Economic and Financial Dialogue of 23 May 2017 has been partially implemented. The fiscal deficit has been kept relatively stable, but the public debt-to-GDP ratio has been reduced less than planned. The budgetary framework has been complied with, but it does not provide a particularly strong anchor. There has been some limited progress in unbundling the electricity and gas markets with the preparation of an unbundling plan and the establishment of a new gas company. No progress has been made on promoting and monitoring energy efficiency measures. There has been some facilitation of registration of assets to simplify the registration of property, while no progress has been made on setting up the e-cadastre. Coverage of activation measures remains very low and work on linking them with social protection support has been limited. No progress has been made in reducing undeclared work or setting up a comprehensive approach to doing so. The structural reform measures planned for completion in 2017 in last year's ERP were only partially implemented.

Overall the programme's macro-fiscal framework is slightly optimistic. The reconfirmed commitment to lowering public debt is in line with the priorities identified by the Commission in previous years. Structural obstacles to competitiveness and the reform measures presented in the ERP to some degree match bottlenecks and reform needs identified by the Commission. The diagnostic focuses on access to finance, land ownership, the informal economy, business regulation, the skills gap and the overall quality of education. However, it neglects issues like the judiciary, property rights related issues and contract enforcement. The mix of structural reform measures is relevant overall, but the focus of some measures, especially in the field of employment, skills and social inclusion, is not clear.

1.2. ECONOMIC OUTLOOK AND RISKS

Albania's economic reform programme (ERP) projects a strengthening of domestic demand which will push output growth above 4 % in 2018-2020. Private consumption is set to accelerate based on moderate growth in employment, gradually increasing wages and rising consumer confidence. Additional support to consumer spending is expected from a higher rate of household borrowing promoted by an easing of banks' lending standards. It is also projected that private investment activity will be supported by improving financial conditions over the medium term. Public investment is planned to increase to 5 % of GDP. The level of investment growth is nevertheless expected to be relatively moderate compared to the double-digit growth rate in 2017, when the construction of two large energy projects (the Trans Adriatic Pipeline and the hydropower project on the river Devoll) was culminating. In line with medium-term budget planning, government consumption is projected to expand at less than half the rate of GDP. Export growth, which was extraordinarily strong during a catch-up phase in the past 2 years, is expected to moderate to a more sustainable pace. Import growth, too, is seen declining in parallel with import-heavy investments. The positive contribution of net exports to GDP growth is expected to vanish by next year. Seen from the production side, the ERP projects that all economic sectors will contribute to growth based on their average historical performances. Overall, annual GDP growth is seen rising slowly, but steadily, from 3.9 % in 2017 to 4.4 % in 2020. Without specifying the underlying determinants, the ERP projects — rather optimistically — a parallel increase in Albania's potential growth rate to 4.3 % in 2020. The output gap is to turn slightly positive by 2020.

Table 1:

Macroeconomic developments and forecasts

	2016		2017		2018		2019		2020	
	COM	ERP	COM	ERP	COM	ERP	COM	ERP	COM	ERP
Real GDP (% change)	3.4	3.4	4.0	3.9	3.8	4.2	4.2	4.3	n.a.	4.4
<i>Contributions:</i>										
- Final domestic demand	4.2	4.2	4.9	4.9	3.8	3.6	4.6	4.3	n.a.	4.3
- Change in inventories	-1.2	:	-0.3	:	-0.2	:	-0.1	:	n.a.	:
- External balance of goods and services	0.2	0.2	-0.6	0.8	0.2	0.6	-0.3	-0.1	n.a.	0.1
Employment (% change)	6.1	6.1	3.5	3.6	3.6	2.7	3.8	2.6	n.a.	2.5
Unemployment rate (%)	15.6	15.6	14.2	13.9	13.7	12.9	13.0	12.0	n.a.	11.2
GDP deflator (% change)	-0.2	-0.2	1.8	1.6	2.0	1.9	2.3	2.0	n.a.	2.3
CPI inflation (%)	1.3	1.3	2.0	2.0	2.4	2.7	2.7	3.0	n.a.	3.0
Current account balance (% of GDP)	-7.6	-7.6	-7.9	-7.6	-7.8	-6.7	-8.2	-6.5	n.a.	-6.5

Sources: 2018 Economic Reform Programme (ERP), Commission 2017 autumn forecast (COM).

A baseline scenario with output growth of around 4 % is not implausible in the current context, but the projected trajectory appears slightly optimistic. Steady output acceleration in 2018-2020 is likely to be prevented by decelerating investment activity as the two large energy projects approach completion. Certainly, the negative effect on GDP growth is mitigated by the associated decline in import growth. However, it seems slightly optimistic to expect the remaining impact to be overcompensated by higher consumer spending and public investments. For this reason, the Commission's most recent forecast projects a dip in GDP growth of 0.2 percentage points (pps) in 2018. Similar growth moderations can be found in forecasts by international institutions. In addition to the baseline projection, the ERP presents two alternative growth scenarios. In the pessimistic scenario the baseline projection is shifted downwards by 1.5 pps over the programme period. In the optimistic scenario the baseline projection is shifted upwards by 1.0 pp. The scenarios are said to cover situations in which, respectively, downside and upside risks materialise regarding various internal and external factors. These scenarios are not developed in any

detail and should rather be considered as the lower and upper limits of an uncertainty band around the baseline projection.

Inflation remains below target and the central bank intends to keep monetary policy on an accommodative course. The annual average of the consumer price index rose by 2.0 % in 2017. Annual inflation has now run at below the central bank's 3 % target for 5 consecutive years. This reflects the absence of upward price pressures from a domestic economy that is still operating below potential, in combination with disinflationary impacts from the external environment. In this context, the central bank has kept its key policy rate at the historic low of 1.25 % since May 2016. The central bank expects average inflation to firm slightly to 2.2 % in 2018 and to return to target around mid-2019 as economic growth strengthens further. In this scenario, the central bank intends to maintain an accommodative monetary policy stance, but to remain flexible regarding the intensity of monetary stimulus. Specifically, it has signaled that it will not reduce the monetary stimulus before the fourth quarter of 2018. Interest rates for private borrowers have remained relatively stable at low levels, with an average lek-euro interest rate differential of around 2.5 %. Within Albania's floating exchange rate system, the lek remained on an appreciating path in 2017. Its average annual value against the euro increased 2.4 % in 2017. In nominal and real effective terms the currency's value was up by 4.5 % and 4.2 % respectively year-on-year in the fourth quarter of 2017. For 2018-2020, the ERP assumes constant nominal exchange rates.

The large current account deficit is expected to remain relatively stable over the programme period. Albania has a relatively narrow production base, resulting in a large structural deficit on the trade balance for goods. This is partially offset by revenues from foreign tourism and the export of manufacturing services for foreign-owned products. The current account also benefits from a large volume of remittances sent home by Albanians abroad. A revision of balance of payments data in September 2017 has lowered the level of the current account deficit. Based on the new methodology, the deficit has declined from 8.7 % in 2015 to 6.3 % of GDP in the 12 months to September 2017. This was mainly due to a sharp improvement in the services account, but also to a revival of goods exports. The ERP projects the current account deficit will remain at around 6.5 % of GDP over the programme period. This is some 4 pps lower than projected in last year's ERP. The difference is the combined result of the revised data methodology and the unexpected narrowing of the deficit in 2017 which is expected to be sustained. The value of goods exports is expected to grow at an annual rate of close to 10 %, which is not implausible given the expansion in Albania's export markets (mainly the EU). Goods imports are expected to decelerate temporarily in 2018 (as the construction phase of the two major energy projects nears completion). However, they will pick up in the following 2 years, to an annual growth rate of 6.4 %. Considering the expectation of strongly growing domestic demand over the next 2 years, this projection may be on the low side. Services exports are expected to benefit from continuing solid growth in foreign tourism and projected to expand at an average annual rate of 7.8 %. The essence of the ERP's forecast for the external sector is that a widening deficit on the trade balance for goods is offset by a growing surplus on the service balance, resulting in a relatively stable current account deficit over the programme period. Overall, the main risk associated with this projection seems to be that the expected strength of domestic demand will result in higher-than-projected import growth and hence a higher current account deficit.

Inflows of foreign direct investment are expected to finance the current account deficit fully. Over the past 10 years, foreign direct investment (FDI) inflows have financed 76 % of Albania's current account deficit. In the 12 months to September 2017, net FDI even exceeded the deficit by 41 % while the construction of the two large energy projects was peaking. The ERP projects that net FDI will remain strong and exceed the current account deficit by about 20 % in each of the programme years. The ERP recognises that FDI inflows associated with the two large projects, which are about to be completed, will diminish, but seems to expect — without any discussion — that this will be compensated by new FDI projects. However, Albania's success in attracting foreign investment in recent years has been heavily concentrated in non-tradable and natural resource-based industries. There is a risk that new investment opportunities in these industries will dry up and that investments in other sectors like tourism will be on a smaller scale. Attracting FDI to higher value-added activities would integrate the economy better into

global supply chains, boost productivity and create more and better jobs throughout the economy. This, however, would require wide-ranging structural reform to bring about substantial improvements in the investment environment. Gross external debt stood at 68.4 % of GDP at the end of September 2017, down from 73.5 % at the end of 2016. About 80 % of the external debt is long-term. More than half of the long-term debt is owed by the government and most of the rest consists of intercompany lending between direct investors and subsidiaries. Although sizeable, the composition of the external debt means that it does not give rise to immediate concerns. Foreign exchange reserves totalled EUR 3.0 billion (25.7 % of GDP) at the end of 2017 and are expected to rise by around 10 % annually over the next 3 years. Currently, the reserves cover about 6½ months' worth of imports of goods and services, providing an adequate safeguard against adverse shocks.

Banks are well capitalised, highly liquid and with a reduced stock of non-performing loans, but their lending remains subdued. The ratio of non-performing loans (NPL) to total gross loans declined to 13.2 % at the end of 2017, 5.1 pps lower than a year earlier, mainly as a result of mandatory write-offs. The declining NPL ratio is positive for bank lending to the business sector which has, however, remained sluggish. Bank lending showed only slight growth in the second half of 2017 when adjusted for loan write-offs. Financial intermediation is constrained by the high level of informality as well as weaknesses in contract enforcement and collateral recovery. The accommodative monetary policy has kept the lek-euro interest rate spread for new loans at the low level of 2.5 % and has continued to support a gradual shift towards lending in lek. The share of foreign-exchange loans in total loans fell slightly in 2017, mainly as a result of lek appreciation. Unhedged foreign-exchange loans, which carry the risk of lek depreciation, constituted 53 % of households' and 42.5 % of businesses' foreign-exchange credit in mid-2017. Overall, the banking system maintains adequate buffers to absorb shocks as capital adequacy and liquidity ratios exceed regulatory requirements and profitability has been improving. Banks are also not reliant on foreign-based parent banks for funding because the loan-deposit ratio is low and declining (see Table 2). However, the preponderance of short-term deposits among funding sources is leading to maturity mismatches and hindering long-term financing by banks. On the asset side, government securities account for around 25 %, exposing banks to sovereign risk.

Table 2:

Financial sector indicators

	2013	2014	2015	2016	2017
Total assets of the banking system, mEUR	9,877	10,872	10,728	11,906	11,873
Foreign ownership of banking system by asset, %	88.6	87.1	84.1	82.6	
Credit growth*, %	-0.2	0.2	0.3	-0.7	-0.2
Deposit growth, %	3.7	1.5	1.9	1.1	1.0
Loan to deposit ratio	58.4	57.7	56.8	55.8	54.8
Financial soundness indicators, %					
- non-performing loans to total loans	23.2	22.8	18.2	18.3	13.2
- core capital to risk weighted assets	18.0	16.8	16.0	15.7	16.6
- liquid to total assets	27.6	31.9	32.3	31.3	30.2
- return on equity	6.4	10.5	13.2	7.1	15.7
- forex loans to total loans	63.0	62.4	60.8	58.6	55.9

*: Adjusted for loan write-offs

Sources: 2018 Economic Reform Programme (ERP), Macrobond, Bank of Albania, ECFIN CCEQ.

1.3. PUBLIC FINANCE

In 2017, the fiscal deficit remained close to 2 % of GDP despite economic growth strengthening further. Total revenue increased by 5.7 % year-on-year, driven by higher tax revenues and social insurance contributions. The ratio of revenue to GDP increased from 27.6 % in 2016 to 27.7 % in 2017, which was better than planned in last year's ERP. Compared to the budget as revised in December 2017, total revenue was 2.8 % below target. Total expenditure increased by 6.4 % year-on-year based, in particular, on rising public consumption, social transfer payments and capital expenditure. The ratio of expenditure to GDP increased from 29.4 % in 2016 to 29.7 % in 2017. Compared to the revised budget, total expenditure was 2.7 % below target. The under-execution of expenditure was partly the result of an under-execution of capital spending following significant overspending the previous year. Public investment is crucial to addressing large gaps in infrastructure; a recurrent failure to adhere to spending targets indicates ongoing weaknesses in public investment management. Overall, the headline budget deficit increased from 1.8 % of GDP in 2016 to 2.0 % in 2017, which is identical to the projected deficit in the original budget and the two revised versions. The ERP projects that the primary general government surplus fell from 0.7 % of GDP in 2016 to 0.4 % in 2017. The new rule in the Organic Budget Law banning frontloaded public spending in election years was complied with.

For the programme period, the ERP projects back-loaded fiscal consolidation with a gradually declining debt-to-GDP ratio. Essentially, the current programme envisages budget stabilisation in the short term as the overall fiscal deficit is projected to remain at 2.0 % of GDP in 2018. Fiscal consolidation is planned to resume subsequently with an overall deficit of 1.7 % in 2019 and 1.2 % in 2020. The primary surplus is set to rise gradually to 1.5 % of GDP by 2020. Compared to last year's ERP, the new programme postpones and attenuates fiscal consolidation. For 2019 the targeted fiscal balance has been made 0.8 pps less ambitious with regard to both the overall and the primary balance despite a slightly more positive projection for GDP growth. The projected narrowing of the fiscal deficit is expected to be achieved through a combination of rising revenues (by 0.4 pps between 2017 and 2020) and a cutback in expenditure (by 0.3 pps over the same period) relative to GDP. The rise in the revenue ratio is the result of a gradual increase of tax revenues partly offset by lower social security contributions. The decline in the expenditure ratio is planned to be achieved primarily by keeping the average annual growth rate of public consumption (3.2 %) at half the growth rate of nominal GDP (6.4 %) in 2018-2020. This will require considerable spending discipline which has not been detailed in the ERP. The cutback is, however, more modest than in last year's ERP. The projected paths for the fiscal deficit and for nominal GDP growth would allow the debt-to-GDP ratio (including state guarantees) to decline gradually by 6.4 pps to 63.5 % over the 3 years to the end of 2020. Overall, the government's planned fiscal stance is sufficiently strict to reduce the debt ratio further, as required by the fiscal rule.

Table 3:
Composition of the budgetary adjustment (% of GDP)

	2016	2017	2018	2019	2020	Change: 2017-20
Revenue	27.6	28.5	28.2	28.1	28.1	-0.4
- Taxes and social security contributions	22.0	22.4	22.6	22.8	22.9	0.5
- Other (residual)	5.6	6.1	5.6	5.3	5.2	-0.9
Expenditure	29.4	30.5	30.1	29.8	29.4	-1.1
- Primary expenditure*	26.9	28.1	27.6	27.1	26.7	-1.4
<i>of which:</i>						
Gross fixed capital formation	5.4	6.2	6.5	6.2	6.1	-0.1
Consumption	9.5	9.3	9.0	8.8	8.5	-0.8
Transfers & subsidies	12.1	12.3	12.0	12.1	12.0	-0.3
Other (residual)	-0.1	0.3	0.1	0.0	0.1	-0.2
- Interest payments	2.5	2.4	2.5	2.7	2.7	0.3
Budget balance	-1.8	-2.0	-1.9	-1.7	-1.3	0.7
- Cyclically adjusted	-1.7	-2.0	-2.0	-1.7	-1.3	0.7
Primary balance*	0.7	0.4	0.6	1.0	1.4	1.0
Gross debt level	72.4	71.5	68.7	66.4	63.5	-8.0

*: Excluding arrears clearance

Sources: 2018 Economic Reform Programme (ERP), ECFIN calculations

The 2018 budget suggests stability in fiscal policy, but postpones the previous ambition of further consolidation. Parliament adopted the 2018 state budget on 30 November 2017. Fiscal plans assume that nominal GDP will grow by 6.1 % in 2018, which is slightly higher than projected in the Commission's autumn 2017 forecast. The budget deficit of 2.0 % of GDP is identical to the planned and realised deficit in 2017, but 0.2 pps higher than projected in last year's ERP. Compared to the 2017 outcome, the budget projects an increase in total revenue of 8.0 %. Revenues from VAT are expected to rise somewhat faster, partly because the threshold for VAT registration has been lowered to include many small, previously exempt businesses. This is to some degree mitigated by the reduction in the VAT rate applied to five-star hotels from 20 % to 6 %. Social insurance contributions are expected to be almost flat following an unexpected double-digit surge in 2017 which is credited to the fight against informality. Property tax revenues are projected to increase by two thirds due to the introduction of new property valuations as of 1 April. This is, however, expected to be almost fully offset by declining revenues from other local taxes, resulting in virtually no growth in overall revenues from local taxes. Compared to the budget outcome for 2017, total expenditure is projected to increase by 7.7 %. In contrast to the revenue side, the items on the expenditure side of the budget are not explained in the ERP. Interest payments and capital spending account for the bulk of the expenditure increase. A rise of 30.1 % in interest payments seems implausibly high given the on-going stability in euro and lek interest rates. The budgeted rise of 26.2 % in capital expenditure is the combined result of under-execution of this budget line in 2017 and the government's aim to raise public investment to around 5 % of GDP in the programme period (5.2 % in 2018).

Beyond 2018, plans for fiscal consolidation rely on spending restraint, but the underlying measures are unclear. The ERP does not provide information about fiscal measures or analytical support for the budget projections, which are presented as tables. Total expenditure relative to GDP is projected to decline by 0.7 pps between 2018 and 2020, mainly due to relatively moderate increases in public

consumption. Interest expenditure is projected to rise at a double-digit annual rate, reflecting an expectation of increasing interest rates in domestic and foreign markets. This would raise interest expenditure to 2.7 % of GDP in 2020. Social insurance outlays, the biggest expenditure item, are linked to the annual rate of inflation, and social transfers' share of GDP is expected to remain stable at 12 % of GDP. Total public investment is projected to remain relatively stable in line with the government's aim to keep capital expenditure close to 5 % of GDP. The major downside risk to the ERP's expenditure targets seems to be the absence of the disciplinary anchor provided by the IMF programme in 2014-2017. On the revenue side, risks stem mainly from the possibility that nominal GDP growth will fall short of the projection. In addition, without further revenue measures, meeting the target of keeping the revenue-to-GDP ratio stable will require sustained efforts to improve revenue collection. There is ample scope for this given the large informal economy.

The ERP's medium-term budgetary projections entail a number of additional risks which have not been fully evaluated in the programme. Apart from the risks inherent in implementing fiscal discipline under conditions of uncertainty, Albania's budget position may be affected by financial obligations for which the government can ultimately be held responsible. Public guarantees represent one such source of risk, even if they are fully accounted for in the public debt and were reported to amount to 3.2 % of GDP at the end of 2017, down from 3.6 % a year earlier. Around 83 % of total guaranteed debt has been issued in favour of the state-owned energy sector where reforms are still incomplete. A further long-standing risk to the budget outlook is the obligation, confirmed by international court rulings, to provide compensation to former owners of property expropriated in the communist era. The budget line dedicated to such compensation payments may be insufficient to cover all eventual claims. Most importantly, plans to increase the use of public-private partnerships and concession contracts entail significant fiscal risks in the form of contingent liabilities for the state budget. The government's control of these arrangements has to be tightened to mitigate these risks. Finally, there are continuing risks entailed in financial management by local governments; their expenditure represented 3.0 % of GDP in 2017.

Box: Debt dynamics

The debt ratio started to fall in 2016 as the primary balance moved into surplus. The ERP projects that the debt ratio will continue to fall on the back of a sustained primary surplus, rising inflation and a pick-up in real GDP growth. The implicit interest rate is expected to rise only moderately. The low level of stock-flow adjustments indicates that the government does not expect significant net flows of guarantees or exchange rate movements.

Table 4:
Composition of changes in the debt ratio (% of GDP)

	2016	2017	2018	2019	2020
Gross debt ratio [1]	72.4	71.5	68.7	66.4	63.5
Change in the ratio	-0.2	-0.9	-2.8	-2.4	-2.9
<i>Contributions [2]:</i>					
1. Primary balance	-0.7	-0.4	-0.6	-1.0	-1.5
2. "Snowball" effect	0.2	-1.3	-1.6	-1.4	-1.4
<i>Of which:</i>					
Interest expenditure	2.5	2.4	2.5	2.7	2.7
Growth effect	-2.4	-2.7	-2.8	-2.8	-2.7
Inflation effect	0.1	-1.1	-1.3	-1.3	-1.4
3. Stock-flow adjustment	0.2	0.9	-0.6	0.0	0.1

Notes:

[1] End of period.

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

Source: Economic Reform Programme (ERP) 2018, ECFIN calculations

The public debt ratio continued to decline, but it is still high and entails significant risks. At the end of 2017, Albania's public debt (including public guarantees) stood at 69.9 % of GDP. This was 2.5 pps below the debt ratio at the end of 2016 and marked the second consecutive year with a falling debt ratio. It was, however, also 1 pp. higher than projected in last year's ERP. Almost all of the public debt is owed by central government. In a benign interest rate environment, the debt generated interest payments worth 2.1 % of GDP in 2017, down from 2.7 % in 2015. The authorities have been able to lengthen the average

maturity of the public debt stock significantly and reduce the share of variable rate instruments. This shifting debt composition means that rollover and interest rate risks have been lowered. Almost half of the debt is denominated in foreign currencies, mostly the euro. Just over half of the public debt is held domestically, mainly by the banking sector, and much of it is still short-term and has to be refinanced frequently. Albania is vulnerable to changes in market sentiment and host-country regulatory requirements that could influence debt holders' willingness to hold Albanian securities. Further debt reduction is therefore essential to mitigate debt-related vulnerabilities and rebuild room for policy manoeuvre.

The current budgetary framework aims to achieve debt sustainability in the longer run but lacks a credible and operational anchor. The current fiscal rule mandates a debt ceiling of 45 % of GDP and annual budget balances that ensure a falling debt ratio until the target is reached. The rule is relatively soft as it does not set a deadline for the target to be reached or require an independent body to monitor compliance. At this stage the authorities do not plan to change the recently adopted budgetary framework. However, the current government has committed itself to reduce the debt ratio to below 60 % by 2021. The ERP's projection for the downward path of public debt is consistent with this medium-term target, but due to downside risks to growth and budget execution additional fiscal measures might be required to achieve it.

1.4. STRUCTURAL REFORMS

Albania faces several obstacles to improving potential growth and competitiveness. A weak judiciary, insufficient enforcement of property rights and burdensome administrative procedures are institutional weaknesses that have been only partially addressed so far. This is hampering both local businesses and potential FDI inflows, unfortunately these important weaknesses are not being taken into account despite ongoing reforms. Cadastral issues and still unclear land ownership continue to hamper access to finance, hurt public revenues and limit the consolidation and defragmentation of agricultural land. Albania has great potential for renewable energy production but the market is still not fully liberalised, the energy supply relies on hydropower and energy efficiency remains low. There was no improvement in the quality of the structural reform part of the ERP compared to last year's programme. Some key obstacles to growth and competitiveness are properly identified, but overall the quality of the area diagnostic and the design and description of measures varies significantly between the respective areas.

The reform measures included are mostly rolled over from last year's ERP (15 out of 17), and overall they respond to the challenges identified. This shows the stability and consistency of the government's medium-term economic planning. There is a mix of legislative, administrative and infrastructure reforms without overemphasising infrastructure, but rather looking at genuine structural reforms. Overall, the cost estimates, the respective budget impact and the links between sectors and measures given are not comprehensive, which makes this element more difficult to assess. Some measures, for example in the areas of research, development and innovation and water/waste water, are based on such low funding that there will be no impact on the economy at all. Many measures also depend heavily on co-financing by international financial institutions or donors. This raises questions about whether they will prove to be sustainable when maintenance funding is needed and about the capacity of the administration to design targeted reforms on its own. The Commission's assessment of last year's ERP has been partially taken into account. In most areas, measures are directly linked to the diagnostic provided in the respective section of the ERP. In many cases the evaluation of the measures' expected outcomes is not realistic enough or not clearly analysed.

Public finance management

Public finance management (PFM) in Albania has demonstrated several structural shortcomings such as a lack of transparency, weak ICT infrastructure and inefficient use of public resources. The current ERP lists the relevant shortcomings and correctly identifies the main obstacles hindering competitiveness and sustainable economic growth. It does not, however, specify issues related to the lack of transparency in public procurement and the work of public-private partnerships. It provides limited analysis of issues related to service delivery and government accountability.

The new measure establishing a fiscal cadastre addresses only a part of the PFM shortcomings identified and is highly ambitious in its implementation framework given the previous delays. The budgetary impact of the PFM reform strategy remains unexplored, in particular regarding cost per activity for 2018-2020 and the expenditures part. Nevertheless, the new fiscal cadastre is expected to bring additional revenue. The expected impact on competitiveness and employment is described in very general terms. The potential implementation risks are correctly identified but could be further elaborated. The measure under the 2017-2019 ERP aimed at developing a PFM strategy and internal control reforms was dropped without a justification being provided.

Energy and transport market reforms

Albanian's energy and transport sectors constitute a strategic resource for sustainable economic growth, given the variety of its energy sources and its geographical location. The main obstacles to competitiveness in the transport and energy markets include the lack of efficient rail transport, the

inefficient or inadequate capacity and operational structure of maritime infrastructure, the economy's low energy efficiency, the energy import dependency, and the climate change risks of electricity production from hydropower (100% of domestic electricity generation). The ERP diagnostic to a large extent recognises this. In the energy sector, the ERP identifies the need to fully implement commitments under the Energy Community and to diversify energy sources, including by better exploiting the country's renewable energy potential. With regard to improved energy security, it refers to reduced losses across the distribution network but misses to highlight the potential of energy efficiency for reduced consumption. In the transport sector, the ERP diagnostic focuses on the low quality of transport infrastructure as an impediment to Albania's integration into regional and global supply chains under the connectivity agenda. Such integration would contribute significantly to improving competitiveness.

All four reform measures included in this area are rolled over from the previous ERP and address to a large extent the key obstacles identified in the analysis. The two measures in the energy sector are highly relevant, but cover mainly the supply side, while the demand side is discussed less. On the supply side, it focuses only on gasification. There are no measures for realising the potential of renewable energy sources and accommodating renewable electricity into the grid (beyond hydro). Energy demand management, including measures to stimulate investment in energy efficiency and renewables (e.g. solar, wind energy), would contribute to improving the economy's competitiveness and energy security.

The measure to further liberalise the energy market is necessary and is in line with the obligations under the Third Energy Package and Albania's own strategies. The reform measure is not embedded in the overall framework of accompanying actions, like strengthening of the regulatory body, demand management, energy efficiency, or the need for price reforms. The price and tariff reform will require further efforts, while bill collection rates have improved significantly. The assessment provided, showing no budgetary impact, appears questionable. The overall impact on competitiveness is well developed while the impact on employment is provided in general terms. The potential risks to implementing the reform measures are well developed. The risk of lack of coordination with the authorities of Albania, as well as risks to the environment, may also be considered.

The measure connecting the country to the international gas network to create conditions for gasification in line with the development of the Trans Adriatic Pipeline project will promote energy diversification. However, activities planned in 2017 showed limited progress and are instead carried over to 2018. The cost of implementing the measure has not been properly accounted for. If efficiently implemented, the measure is expected to strengthen competitiveness in the long term by diversifying the supply, ensuring supply security and potentially lowering energy costs. The absence of potential risks is justified by the measure's secured funding, but ignores non-financial risks such as environmental risks and lack of coordination.

The two transport measures do not address regulatory and structural needs related to the connectivity agenda, which would have a more direct impact on competitiveness. Given Albania's shortcomings in infrastructure, the feasibility study for the extension of the Adriatic-Ionian corridor appears appropriate. However, the project is at a very preliminary stage and can hardly be considered a structural reform even if it does address a structural need. The expected impact on competitiveness is presented in broad terms, aiming at a reliable and safe transport system without figures for the expected increase in passenger or freight traffic. Potential social outcomes are not explained. Related issues, like the maintenance budget, have not been discussed. However, the potential risks are correctly identified.

The measure aiming at rehabilitating and extending the Durres-Airport-Tirana railway will allow the development of intermodal transport, but its estimated competitiveness impact appears over-optimistic. The construction project is broadly on track and its practical realisation is expected to start by 2019. However, there are no activities planned for 2019 and 2020 despite the complexity of the project. The main risks to implementation of the reform measure are outlined and mitigating measures are proposed.

Sectoral development

Agricultural sector development

The small average size of agricultural holdings, the absence of a comprehensive land register and unclear land ownership remain key obstacles to the development of the sector. The diagnostic section correctly points to these challenges, but still fails to flag other problematic areas such as phytosanitary issues, veterinary capacity and high informality. Moreover, the ERP does not assess the negative consequences of climate change for the agricultural sector. In view of agriculture's significant economic contribution to both GDP and employment in Albania, the consolidation and defragmentation of agricultural holdings remains a major priority. This should allow the development of a more efficient and market-oriented agriculture sector, enabling economies of scale.

The foreseen consolidation and defragmentation of agricultural land, rolled-over from the previous programme, still does not give consideration to creating the technical conditions for the land consolidation process. Nevertheless, the reform activities envisage a partial digitalisation of the agricultural land register. The activities planned in 2017 were only implemented to a limited extent; most were postponed until 2018. At the same time, further efforts should be made to clarify property rights and develop a comprehensive land cadastre. The adopted land consolidation strategy could be linked to the development of the land cadastre in general, which would require a further update. The budgetary impact and cost per activity are considered insufficient. The expected impact on competitiveness is properly described, yet it does not specify social outcomes, in particular the impact on gender given the high employment rate of women in the agricultural sector. The potential risks section correctly points out the possible opposition from land owners and rural communities. However, others, such as delays due to property rights disputes as well as lack of funding, should also be considered.

Industry sector development

In general, Albania's industrial sector is weak and exports are concentrated in a few product groups of low sophistication and value added. The ERP correctly identifies the main shortcomings, and its focus on developing the industrial sector's potential in line with the 'circular economy' perspective is welcome. However, by defining only the processing of different raw materials available in the country it fails to provide a comprehensive analysis of the industry sector. Other obstacles to competitiveness and growth as well as the scope for potential sector development should be elaborated upon. The ERP highlights water and waste water as key issues in the Albanian economy, particularly the insufficient and non-sustainable water supply which constitutes an obstacle to competitiveness, especially in the tourism sector. However, it fails to analyse the significance of the water sector for Albania's hydropower and other related sectors.

The proposed measure introducing a non-food industry development policy outlines some preparatory actions towards a more strategic policy approach, in particular in the processing industry. It covers a number of independent feasibility studies, the results of which are expected to promote investment in the copper industry and increase free mining and processing facilities. However, it does not determine the tools for achieving this objective, namely practical incentives for private companies to invest in this sector. The technical-economic studies on nickel-silicate industries and quartz industry were only partially implemented in 2017 and are planned to proceed in 2018. It remains unclear whether there is any interest from potential investors. The expected impact on competitiveness as well as potential social outcomes should be further developed. The cost per activity and the overall budget impact appear to conflict with the ambitious level of the reform and the expected outcomes. The potential risks to implementing the reform measure are widely covered and mitigation measures are presented.

Overall, the measure on water and waste water is in line with actions to combat informality and aims to ensure good governance and effective investments. The measure is well defined and highly

ambitious. The objectives set, in particular the complete abolition of informality in the water sector by the end of 2018, appear over-optimistic, however. The overall social outcomes of the reform measure are well developed, whereas the impact on competitiveness and growth could be extended through other relevant sectors such as tourism and energy. The assessment of the cost per activity and budgetary impact should be provided. The potential risks and respective mitigating measures are broadly defined, but do not specify the potential risks in rural areas, where water supply utilities are managed by local authorities.

Service sector development

The Albanian economy is led by the service sector. In 2017, services again increased their share of gross value added to 53.4%¹. The ERP provides no diagnostic on the services sector. The measure under the 2017-2019 ERP aimed at the standardisation of the tourism industry was excluded from the current ERP without any reason being given despite its expected solid growth (as noted in the *Economic outlook and risks* section above) and high potential impact on competitiveness. No other measure on services is included in the 2018-2020 ERP.

Business environment and reduction of the informal economy

Insufficient clarity of land ownership, corruption, weak contract enforcement, limited access to finance, especially for SMEs and a large informal economy are the key weaknesses of Albania's business environment. The entrepreneurial skills and financial literacy of the population remain underdeveloped. The diagnostic section of the ERP identifies only some of the key obstacles to competitiveness and growth. The ERP diagnostic also highlights the necessity to establish an e-permit portal as a 'one-stop shop' service to facilitate the issuance of regulatory permits. The report on policy guidance implementation provides a comprehensive update on measures undertaken in 2017 to reduce the regulatory burden and the NPL ratio as well as to encourage entrepreneurship among women. More could have been said about the need for significant streamlining of business regulations, including better impact assessments of legislative proposals and better stakeholder consultations. Actions to reduce the informal economy are not specified as a reform measure, but they are described in the programme and should contribute to improving the business environment.

The measure to reduce the regulatory burden on businesses as well as the measure aiming to reduce the NPL ratio in the banking system address relevant obstacles to competitiveness and growth. They also aim at stimulating job creation and promoting female entrepreneurship. The reform measure on reducing the regulatory burden needs to be implemented in the broader context of tackling the other challenges identified in the sector. The same comment applies to the measure on improving access to finance by tackling the high number of NPLs. The activities of both measures planned for 2017 were partially implemented. The timeline for implementing the reform measure was prolonged until 2019 in both cases. The measures set out clearly the expected impact on competitiveness and social outcomes, which are main shortcomings in the business environment. The potential risks are correctly assessed.

Research, development and innovation and the digital economy

Albania's capability in both research, development and innovation (RDI) and the digital economy is at an early stage and has few if any positive effects on the economy yet. The lack of cooperation and coordination between academia, the private sector and the government constitutes the main obstacle to competitiveness and growth. Albania's RDI institutions are integrated into the global RDI programmes only to a very limited extent. This explains their low success rate in the EU R&D framework programme Horizon 2020. Public expenditure on RDI as a share of GDP is low. The current ERP diagnostic provides analysis of some of these shortcomings. The ERP correctly underlines the importance of well-developed broadband infrastructure for boosting the digital economy and establishing electronic platforms in the

¹ Provisional data

service sector. This is in line with the priorities of the 2020 Digital Agenda. However, the ERP does not address the low engagement of the private sector in RDI programmes. The implementation of the 'triple-helix' model is important and a 'smart specialisation' strategy should also be considered.

The measure aiming at improvement of the institutional capacity of the research and innovation system will address some constraints in the area. The activities planned for 2017 were only partially implemented. The National Agency for Funding in Higher Education was established. However, the activities for 2018-2020 are defined too broadly without clear objectives. They focus on developing institutional capacity rather than implementing specific measures in the field. The envisaged cost per activity and budget impact conflict with the ambitious level of the reform measure. This means the expected impact is more than questionable. Moreover, pure capacity-building cannot be seen as a structural reform. Some risks are identified and devising a strategic framework for the sector is considered as a mitigating measure. The measure aiming to support the development of innovation policies has been dropped from the programme without justification. This is unfortunate as the establishment of an innovation hub and the incubator for the ICT start-ups had a lot of potential.

The measure on implementation of the legal and regulatory framework for developing the broadband infrastructure is in line with Albania's 2020 Digital Agenda. It addresses some key obstacles to competitiveness and growth. However, the proposed activities are defined in very general terms and describe the preparations for reform implementation rather than the reform itself. They could be extended by listing the range of activities needed to establish the broadband infrastructure. The timeline runs only until 2019. The cost per activity and budgetary impact are well defined. The expected impact on competitiveness and social outcomes, as well as the potential risks, are correctly identified. However, no mitigating measures are proposed.

Trade-related reforms

Trade remains constrained by non-tariff barriers and complex and unsynchronised border procedures. At the same time, the regulatory regime for investment needs to be harmonised and strengthened. To increase productivity and economic competitiveness, conditions should be improved to foster much-needed investment. The ERP takes stock of the actions needed in this respect, such as improving the qualification of the workforce, combating the informal economy and protecting intellectual property rights effectively.

The trade facilitation reform measure is highly relevant and in line with national priorities and regional initiatives, such as the connectivity agenda agreed in the Berlin Process and the Central European Free Trade Agreement (CEFTA) Trade Facilitation protocol. The planned ratification by the authorities of Additional Protocol 5 under CEFTA is crucial to implementing a number of trade facilitation measures which are also part of the Regional Economic Area multi-annual action plan (REAMAP). The ERP includes the effective implementation of the Customs Code as well as references to the exchange of information with neighbours through the EU-financed system for the electronic exchange of data (SEED) maintenance project. It also contains references to the efforts to establish an authorised economic operator (AEO) programme in Albania that is aligned with the EU's *acquis* in this area and that will facilitate trade for Albanian AEO's within the CEFTA region. The expected impact on competitiveness and social outcomes as well as potential risks are correctly identified. In this respect, it is important to emphasise the need to strengthen the capacity of the National Committee for Trade Policy Coordination and Facilitation, which is critical for implementing the planned measures. Furthermore, to have a greater impact on competitiveness this measure needs to be combined with efforts to expand the country's industrial base (these are still underdeveloped in the ERP) in order to diversify tradable goods.

Education and skills

A key bottleneck to competitiveness and growth is the lack of a workforce with the right skills to be employable on the labour market. Albania does not perform well in Programme for International Student Assessment (PISA), although its results have improved steadily over the years. Major efforts are under way to improve the relevance and quality of vocational education and training (VET), mainly in donor-supported VET institutions. Nevertheless, VET provision is by no means up to the standards. Teachers lack practical skills for teaching and for preparing students for work. Notwithstanding recent improvements in the VET system, its quality, efficiency, attractiveness and relevance to learners are still lower than expected. Greater investment in skills at all levels of education is needed.

The strategic framework for improving skills is in place and implementation of most measures has started. The continuous implementation of the 2014-2020 National Strategy on Employment and Skills and the Pre-university Education Strategy represent positive steps, but more efforts are needed to integrate work-based learning schemes in VET provision. The qualification standards and curricula are being modernised, but schools still lack the capacity to implement them in practice. Entrepreneurial and soft skills that are essential to improving employability need to be strengthened through changes in the curricula, teacher training and new ways of learning. The impacts of the measures taken are yet to be seen.

The two measures aimed at modernising high-school curricula and improving VET to address skills mismatches are ongoing. They tackle key issues for the Albanian education system and include teacher training. However, cooperation between relevant stakeholders is still weak. The revised VET curricula should also target vulnerable groups, but no activities are envisaged for students from disadvantaged backgrounds. The lack of capacity continues to pose risks to implementation, which might be further impacted by the recent administrative restructuring.

Employment and labour markets

Despite improvements on the labour market, the employment rate and labour market participation remain low and the incidence of undeclared work is significant. Unemployment decreased overall, but it remains very high for young people. The high unemployment rate of high-skilled workers reflects the skills mismatch. Labour market participation of women also remains low as they face more barriers related to childcare and care for the elderly and social norms. There are limited links between passive and active employment schemes. The informal economy is being tackled to some extent by fighting tax evasion and promoting tax compliance, but undeclared work is not addressed in a comprehensive manner. Labour inspections suffer from low administrative, human and financial capacities. Stronger enforcement is needed along with the incentives schemes to encourage formal hiring.

Active labour market policies are small in scope and employment services are weak, making their impact on the labour market low. The budget for active labour market policies is stagnating and no new measures have been implemented. The share of active labour market policy beneficiaries increased to 5.5% in 2017. However, this was mainly a consequence of more stringent application of the legislation targeting non-active jobseekers. While instrumental for designing and implementing employment and social policies, tripartite relations remain weak and the extension of the mandate of the National Social Council is still pending.

The measure to modernise the employment offices and expand the scope of active labour market policies is relevant but has been progressing only slowly. The establishment of the National Agency for Employment and Skills would be an important step but this is dependent on the adoption of the Law on Employment Promotion, which has been delayed. Due to ongoing restructuring, the human resources are not yet in place to allow proper planning. There are no monitoring and evaluation mechanisms planned in the measure.

There are serious risks of reduced capacity to progress with the design and implementation of employment and labour market policies. The administrative restructuring has led to the dismantling of the Ministry of Social Affairs and Youth and reduced resources for the new service dealing with employment. This could significantly hamper implementation of the ERP measure, as well as employment and social policies overall. Sufficient staff and funding are crucial to providing effective employment activation and social protection to those in need.

Social inclusion, poverty reduction and equal opportunities

Poverty continues to pose a challenge and is linked to labour market vulnerability. Poor and vulnerable households have insufficient access to quality education. They suffer from limited job opportunities and access to social protection measures. Social and economic inclusion is a particular challenge for people living in rural or mountainous areas, single women, Roma and Egyptians and people with disabilities. Reforms of the social protection system have started. However, local authorities still lack the means to link social support more effectively with activation and active labour market measures.

Implementation of the Social Protection Strategy is under way. The reforms of the cash assistance and disability payments reforms are particularly critical to ensuring better targeting and more transparency and accountability. A system of social care at local level to address regional disparities in poverty and exclusion has not yet been established. Establishing the Social Fund is critical to ensuring the financing of the services at local level. Specific training and coaching for employment programmes have been piloted but the number of people involved in such schemes remains limited.

The measure on social inclusion proposes several fragmented activities, which makes follow-up difficult. They address the main bottlenecks but there is a need to strengthen evidence-based policy-making. Social inclusion measures, implementation of gender equality actions and decentralisation of social care reform require proper analysis, sound statistical data and budgeting. The proposed activities do focus on data collection and analysis, which is an important step forward. However, as in previous years, the measure includes several different activities and there is no indication of monitoring or evaluation mechanisms, nor is it clear which bodies are responsible for the implementation. Sufficient funding and coordination between the ministries and institutions responsible are still missing. The proposed measures could be more targeted and specific so that its impact could be monitored and evaluated.

1.5. IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2017

2017 policy guidance	Summary assessment
<p>PG 1: Continue pursuing fiscal adjustment with a view to meeting the indicated medium-term targets for reducing public debt as a share of GDP. Introduce further fiscal consolidation measures if debt reduction is at risk of falling short of target</p>	<p>There has been limited implementation of PG 1.</p> <ul style="list-style-type: none"> • The fiscal deficit has been stabilised at around 2 % of GDP which – under current economic conditions – is sufficient to meet the obligation of reducing the public debt-to-GDP ratio on an annual basis. It is, however, unlikely to be sufficient to honour the commitment to lower the debt ratio from currently around 70 % to below 60 % by 2021. No further fiscal consolidation measures have been introduced.
<p>PG 2: Persist with recent revenue mobilisation efforts, in particular by (i) strengthening tax administration further;</p> <p>ii) broadening the tax base based on a review of tax expenditures;</p> <p>(iii) introducing a valuation-based property tax.</p>	<p>PG 2 has been partially implemented.</p> <ul style="list-style-type: none"> • Partial implementation: Annual tax revenues increased by 7.8 % in 2017 and social security contributions increased by 9.7 % based on 50 000 new contributors. Particularly the latter development suggests the campaign against informality is achieving results. • Limited implementation: There has been some modest base-broadening, but there has been no review of tax expenditures other than by the IMF Article IV mission. There has been some backsliding on base-broadening by granting new tax exemptions to the tourist and IT sectors. • Partial implementation: The Local Tax Law was amended in December 2017 and will enter into force on 1 April 2018. The necessary bylaws for implementing a valuation-based property tax were adopted in March 2018. Full nationwide implementation is pending.
<p>PG 3: Implement the remaining measures of the NPL resolution strategy.</p> <p>Implement the measures foreseen in the Memorandum of Cooperation to increase the use of the national currency effectively, including differentiated reserve requirements for lek and foreign exchange deposits.</p> <p>Strengthen the supervision of the non-bank financial sector by increasing the capacity of the financial supervisory authority.</p>	<p>There has been substantial implementation of PG 3.</p> <ul style="list-style-type: none"> • Substantial implementation: Most measures have been implemented, while a few important elements of the strategy are still pending. • Limited implementation: The BoA has started to follow up with a list of planned measures to be implemented throughout 2018 (including differentiated reserve requirements), but the government has not come up with a list of follow-up measures yet. • Substantial implementation: The capacity of the financial supervisory authority was increased substantially through technical

<p>Return to a normalisation of monetary policy if inflation rates converge to the target in a sustained way.</p>	<p>assistance, changing the operational structure and management, and improving vocational training for staff.</p> <ul style="list-style-type: none"> • Full implementation.
<p>PG 4: Ensure the full unbundling of transmission and distribution activities in the electricity and gas sectors and establish a power exchange. Adopt the legal provisions necessary to promote and monitor energy efficiency improvement measures in compliance with the Energy Community Treaty.</p>	<p>PG 4 has been partially implemented.</p> <ul style="list-style-type: none"> • Partial implementation: The Transmission System Operator has been certified subject to certain conditions, which have not been met within the deadline. Regarding the unbundling of distribution from supply activities, an unbundling plan has been prepared and unbundling model has been approved. The legal and functional unbundling of the Distribution System Operator still needs to be finalised. The electricity market remains foreclosed. • Partial implementation: Finalised establishment of a new gas company 'Albgaz sha' as a result of removing gas transmission and distribution activities from 'Albeprol sh.a.' • Partial implementation: A draft law to amend the law on power sector has been prepared and awaits adoption. • Limited implementation: Adoption of the decision of Council of Ministers of 1.12.2017 "On the approval of the 2nd and 3rd National Energy Efficiency Action Plan of Albania, 2017 – 2020".
<p>PG 5: Continue the processes of clarifying the ownership of agricultural land and registering property, and put in place a functioning comprehensive cadastre and an e-cadastre by 2019.</p>	<p>PG 5 has been partially implemented.</p> <ul style="list-style-type: none"> • Partial implementation: there has been some facilitation of registration of assets to simplify the procedures included in the Council of Ministers Decision No 994, dated 9 December 2017 'On the registration of acquisitions of agricultural land owned'. • Limited implementation: The process continues but is slow. Further efforts are needed to continue with the completion of the reform.
<p>PG 6: Enhance the capacities of employment services and their provision of active labour market measures to the unemployed and inactive.</p>	<p>There has been limited implementation of PG 6.</p> <ul style="list-style-type: none"> • Limited implementation: Most of the implementation measures needed to enhance employment services and their provision of active labour market policies have been delayed or limited. This was mainly due to administrative restructuring of the government, which poses risks for future implementation as well. However, the measures announced do tackle relevant challenges.

<p>By end 2017, outline concrete plans to address undeclared work.</p> <p>Intensify teacher training to improve quality of teaching and support curricular reform.</p>	<ul style="list-style-type: none">• No implementation: No concrete plans to address undeclared work were taken or announced. The labour inspectorate suffers from low staffing and funding.• Limited implementation: Progress has continued, albeit slowly. Teacher training is an accompanying measure to modernisation of curricula, but no stronger or additional measures were taken or announced.
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1.6. THE 2018 POLICY GUIDANCE

JOINT CONCLUSIONS OF THE ECONOMIC AND FINANCIAL DIALOGUE BETWEEN THE EU AND THE WESTERN BALKANS AND TURKEY

The Economic and Financial Dialogue between the EU and the Western Balkans and Turkey

Brussels, 25 May 2018

[...]

In light of this assessment, Participants hereby invite Albania to:

1. Introduce further fiscal consolidation measures with a view to meeting the indicated medium-term target of reducing public debt to below 60% of GDP in 2021.
2. Support fiscal consolidation by (i) strengthening tax administration further; (ii) broadening the tax base and avoiding new tax exemptions; (iii) fully implementing the valuation-based property tax; and (iv) ensuring that new Public-Private Partnerships are only contracted on the basis of solid cost-benefit analyses and fiscal risk assessments.
3. Conduct monetary policy in line with reaching the inflation target. Increase the transparency of monetary policy communication by publishing time series on core inflation and inflation expectations. Implement the remaining measures of the NPL resolution strategy, also with a view to addressing factors hampering access to finance for corporates. Based on regular analysis of relevant indicators and impact assessment, explore other measures in line with the Memorandum of Cooperation to increase the use of the national currency at all levels.
4. Ensure effective liberalisation of the energy market and functioning of the power exchange. Adopt the legal provisions to effectively implement the national energy strategy and further broaden the energy supply mix, focussing on incentivising energy efficiency and renewable energy production beyond hydropower.
5. Further strengthen the process of cadastral, land and property registration, including clarification on land ownership, with a special emphasis on de-fragmentation and consolidation of agricultural land, and swift case handling in case of court procedures. Reinforce measures to finalise the property restitution and compensation process.
6. Ensure sufficient capacities for the implementation of employment policies, in particular for youth and women, and improve linkages between active and passive employment measures. Address undeclared work, including by strengthening the labour inspectorate. Support the development of basic education and increase the investment in initial teacher training.

ANNEX: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The 2018-2020 economic reform programme was adopted by the government on 25 January 2018 and submitted to the Commission on 31 January, as required. No components of the ERP are missing and its structure largely follows the guidance note provided by the Commission.

Inter-ministerial coordination

The programme was jointly coordinated by the (former) Ministry of Economic Development, Trade, Tourism and Entrepreneurship and the Ministry of Finance. All relevant line ministries were involved and contributed to the drafting exercise. However, the programme suffered significantly from institutional weaknesses around the parliamentary elections and subsequent changes in staffing and organisation regarding ERP coordination between the two lead institutions and line ministries.

Stakeholder consultation

The 2018-2020 ERP was disseminated for consultations to several international organisations, partners for development, diplomatic missions to Albania, etc. Annex II includes the comments provided by stakeholders.

Macroeconomic framework

The programme presents a concise and reasonably comprehensive picture of past developments. Almost all the relevant data are covered, but weaknesses remain, not least regarding labour market and wage statistics. The macroeconomic framework is coherent, consistent and sufficiently comprehensive and provides a good basis for policy evaluation and discussions. This part of the ERP is of the same quality as previous years' programmes. Some of the factors affecting financial intermediation could also have been covered in more detail.

Fiscal framework

The fiscal framework is detailed and well integrated with the policy objectives. It is also consistent with the macroeconomic framework. Data on the implementation of the 2017 budget cover the first 11 months of the year. The factors behind projected revenues are presented clearly, including the expected fiscal impact of economic growth, discretionary measures and better tax administration. However, there is scope for a better description of the planned expenditure measures and their anticipated budgetary impact. Fiscal data do not meet ESA2010 requirements as regards the delimitation of general government, the distinction between financial and non-financial transactions or the recording of accruals. Since November 2014, Albania has submitted regular excessive deficit procedure notifications to Eurostat on a best-effort basis and is expected to gradually align its fiscal statistics with EU requirements.

Structural reforms

The structural reforms sections (4, 5 and 6) broadly follow the guidance note. Section 4 and Table 12 in the Annex give an adequate but not complete overview of the implementation of the structural reform measures from the 2017-2019 ERP. The total number of reform measures is limited to 17 while the page limit (40 pages) for section 4 has been exceeded. The tables on budgetary impact and on implementation of 2017-2019 ERP measures have only partially been completed. Table 9 on employment and social indicators is missing.

2. THE FORMER YUGOSLAV REPUBLIC OF MACEDONIA

2.1. EXECUTIVE SUMMARY

The economy of the former Yugoslav Republic of Macedonia was stagnant in 2017, but the outlook is now positive. The country was affected by prolonged political uncertainty in the first half of the year, which caused private and public investment to drop sharply. Together with low public consumption, this offset increases in household spending and exports. Domestic uncertainty is now receding and the external economic environment is improving. As a result, the government's Economic Reform Programme (ERP) expects a moderate acceleration of growth from 3.2% in 2018 to 4.0% in 2020, mainly driven by exports, private consumption and investment. Risks are equally distributed on both sides. On the one hand, import growth might be stronger than expected, in particular in case of higher investment. On the other hand, given the recent solid performance of the country's export industry, export growth could also be higher than projected, which would translate into a stronger GDP growth profile. The possibility of a renewed rise in political tensions and delayed implementation of important policy measures poses a further risk on the downside.

Fiscal adjustment plans are not very ambitious, in particular considering the country's strengthening recovery. The ERP expects a moderate decline in the general government deficit, to 2.3% of GDP in 2020. This is not sufficient to stabilise the public debt ratio. The main contribution to the fiscal adjustment is projected to come from subdued public consumption, while revenues as a share of GDP are expected to drop, resulting from moderate revenue growth, which prevents a faster fiscal consolidation. The programme does not provide much quantitative detail on planned revenue and expenditure measures, nor on their fiscal impact. In particular, the relatively low levels of revenue deserved a more detailed presentation.

The main challenges in these respects include the following:

- **Improving fiscal sustainability, increasing employment, and developing the domestic private sector remain key challenges for the country.** Public debt has more than doubled since 2008, mainly as a result of sustained primary deficits. Structural problems in the labour market, such as low participation rates, and a mismatch between the skills available and the skills in demand, restrict the country's growth potential. The development of the domestic private sector is hindered by a lack of legal certainty for companies. A significant brain drain is one of the consequences of poor job prospects for young people. Sustained efforts are needed to address the following issues.
- **Stabilising and reducing the country's debt ratio would require more ambitious fiscal consolidation, based on concrete measures.** The quality and efficiency of public spending could be improved by tackling the low efficiency of public administration, the poor targeting of social transfers, and insufficient capital expenditure. This would also improve economic growth. The introduction of fiscal rules and a fiscal oversight body would help strengthen the budgetary framework.
- **The business environment has improved but doing business in the country remains costly.** Challenges include frequent legal changes to the regulatory framework, a lack of systematic, efficient and transparent law enforcement including in inspections and commercial dispute settlement, and many para-fiscal charges¹ at different administrative levels. These obstacles are also clearly put forward in the ERP diagnostic but they are not addressed in any measures.

¹ Taxes collected for a specific purpose by bodies that are not the official national tax agency.

- **The size of the informal sector continues to hamper private sector development.** The informal economy creates unfair competition from unregistered companies. Undeclared revenues and work also harm public revenue collection and workers' rights. The ERP does recognise the informal economy as an obstacle to growth, but does not include any measure to address this problem. Overall, the programme is weak in addressing the underlying obstacles to private sector development and competitiveness.
- **The low quality of the education system as a whole is a fundamental impediment to more inclusive economic growth in the country.** Educational reforms in the past led to improved access to education; however, the effect on the quality of education and the skills of the graduates was weak. The poor results of the country's first ever Programme for International Student Assessment (PISA) test participation outline the need for urgent quality reforms. The coverage of active labour market measures in particular for low-skilled unemployed needs to be stepped up. There is a need to ensure a better targeting of social benefits to persons at social risk of poverty.

There has been partial implementation of the policy guidance jointly adopted in the Economic and Financial Dialogue of 23 May 2017. The government adopted a medium-term fiscal framework envisaging a fiscal consolidation by 0.7% of GDP, which is not very ambitious in view of the country's expected favourable position in the business cycle. On a positive note, the new government improved fiscal transparency by swiftly publishing public sector data, such as revenue and spending performance, but also available records of public sector payment arrears. A significant step was taken with the adoption of a credible public finance management (PFM) reform programme. The use of the urgency procedure to pass legislation has been reduced and systematic stakeholder consultation through the use of the National Electronic Registry of Regulations (ENER) has improved. Activation measures for the unemployed have been strengthened, but measures targeting low-skilled or long-term unemployed are still scarce.

Overall, the ERP addresses many of the reform priorities identified by the European Commission. However, important points are missing and there is room for more focus and improved implementation. The ERP contains plans to improve the sustainability of public finances by reducing public sector deficit and debt levels. The adoption of a public finance management (PFM) strategy and plans to introduce fiscal rules are an important step in this drive for sustainable public finances. In addition, significant measures have been taken to improve the transparency of public finances. The planned structural reform measures do not all adequately address core needs for regulatory reform. The ERP contains a misplaced focus on subsidy disbursement to the private sector. Instead, the focus should be on more fundamental policy reforms that would alter market conditions. Major challenges such as the informal economy, business environment obstacles and basic education (pre-primary to secondary education) are not properly addressed.

2.2. ECONOMIC OUTLOOK AND RISKS

The programme's economic scenario expects a moderate acceleration of output growth, based on a continued benign international environment, a solid performance of real disposable income and an improving business confidence leading to a recovery in investment. As a result, output growth is expected to increase from 3.2% in 2018 to 4.0% in 2020, bringing average growth to 3.6% in this period. In particular in 2019 and 2020, expected output growth is above the country's annual growth potential of slightly more than 3%. Exports are forecast to increase by around 8% during 2018-20. This is in line with the country's recent export performance, as it benefits from an inflow of export-oriented investment. Private consumption is expected to be sustained by greater disposable income, resulting from low inflation and solid growth in wages and employment. Gross investments are projected to increase on average by 4.4 % annually, which appears to be a conservative estimate. Imports are also expected to increase, reflecting strengthening domestic demand. However, the overall effect of stronger trade flows on growth is forecast to remain largely neutral.

The programme presents two alternative macroeconomic scenarios for 2018-2020 based on what it views as the main risks to growth. The first scenario presumes lower-than-expected growth in the main trade partner economies. This would lead to weaker external demand, lower exports but also weaker industrial production and lower investment. In this scenario, output growth is projected to be lower by 0.8pp on average in each of the three programme years. The second alternative scenario assumes delays in investment in infrastructure and equipment. This would also translate into weaker import growth. As a result, annual output growth would be some 0.4 percentage points lower than in the baseline scenario. The programme also provides estimates of the impact of those alternative scenarios on the labour market, on inflation and on public finances.

Table 1:

Macroeconomic developments and forecasts

	2016		2017		2018		2019		2020	
	COM	ERP	COM	ERP	COM	ERP	COM	ERP	COM	ERP
Real GDP (% change)	2.9	2.9	1.7	1.6	2.7	3.2	3.2	3.5	n.a.	4.0
<i>Contributions:</i>										
- Final domestic demand	6.5	6.5	2.2	1.2	3.1	3.2	3.3	3.6	n.a.	3.8
- Change in inventories	1.0	n.a.	-1.2	n.a.	-0.3	n.a.	0.1	n.a.	n.a.	n.a.
- External balance of goods and services	-3.6	-3.6	0.8	0.5	0.0	0.0	-0.2	-0.1	n.a.	0.2
Employment (% change)	2.5	2.5	2.2	2.3	2.2	1.9	2.1	2.1	n.a.	2.2
Unemployment rate (%)	23.7	23.7	22.2	22.4	21.4	21.5	21.0	20.5	n.a.	19.5
GDP deflator (% change)	4.1	4.1	1.4	3.6	1.9	2.0	2.3	2.3	n.a.	2.3
CPI inflation (%)	-0.2	-0.2	1.2	1.4	2.0	2.0	2.4	2.0	n.a.	2.0
Current account balance (% of GDP)	-2.7	-2.7	-2.5	-2.0	-2.4	-1.8	-2.3	-1.8	n.a.	-1.9
General government balance (% of GDP)	-2.7	-2.7	-2.9	-2.9	-3.0	-2.7	-3.0	-2.5	n.a.	-2.3
Government gross debt (% of GDP)	39.5	39.5	39.7	39.2	40.4	42.4	40.9	44.6	n.a.	42.5

Sources: Economic Reform Programme (ERP) 2018, Commission 2017 Autumn Forecast (COM)

The ERP's growth projections and the risks it identifies are broadly plausible. The programme's assumptions on the international environment and on possible trajectories of key domestic demand components are in line with the economy's historic growth patterns. Yet, household spending may surprise by being greater than expected, as disposable incomes are likely to benefit from robust increases in employment and real wages. Furthermore, the macroeconomic framework outlined in the ERP has a rather conservative estimate for the expected increase in investment (it forecasts an annual increase of

4.4% on average). It would have been useful for the ERP to also prepare a higher growth scenario, simulating stronger investment growth and analysing the effect this would have on the country's external balances. Possible feedback loops of planned structural reforms on the country's economic performance could have been spelled out more explicitly in the ERP, as well as risks to the implementation of planned reforms stemming from the fragile political situation.

Inflation projections are plausible, although for 2019 and 2020 they are rather low. As a small open economy, the country's price level is mostly influenced by international price developments. In this context the expected inflation levels are therefore in line with the programme's assumptions on the international environment, which expect the oil price to be largely stable when denominated in the national currency. However, given that the programme expects output growth in 2019 and 2020 to be above potential, greater inflationary pressures might appear at the end of the programme period.

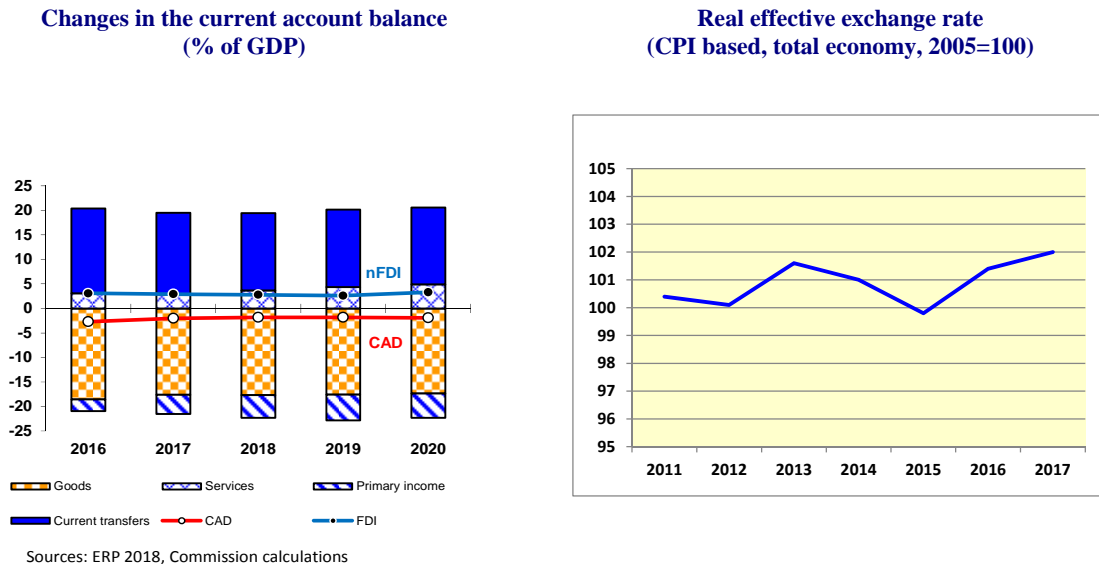
The country's external position appears sustainable. The current account deficit dropped from 3.1% of GDP in 2016 to 1.3% of estimated GDP in 2017. This was mainly due to a stronger surplus in the secondary account. This deficit was more than covered by foreign direct investment inflows, which, however, fell to 2.2% of GDP, compared to 3.1% in 2016. The government expects the current account deficit to remain at a relatively low level in 2018-2020, at 1.8%-1.9% of GDP. This is because the expected improvement in export performance is projected to counterbalance increased imports that result from stronger domestic demand. However, if investment increases more than expected, this relatively benign scenario could turn out to be too optimistic. Overall, the financing of the country's external position continues to rely on substantial remittances from people working outside the country. In the past, these remittances have proved to be very stable, in particular in times of crisis. During recent years, the country has also attracted 2%-3% of GDP in annual foreign direct investment (FDI).

Although foreign companies have become significant drivers for exports, spillovers to the domestic economy remain modest. Foreign companies established in the country accounted for more than 50% of total exports in 2017, up from 16% in 2011. They are the main drivers of export diversification and thus help increase the economy's resilience to external shocks. Since 2012, the share of higher-value added products in the country's export structure has increased gradually as foreign direct investment started to concentrate in the chemicals, machinery and transport equipment sectors. These sectors provided about half of total exports in 2017 or almost double their share of 2011. The weight of traditional sectors, such as iron, steel and clothing, declined accordingly. However, export activity remains heavily concentrated among the top 20 exporters, about three quarters of them foreign-owned, accounting for some 60 % of total exports of foreign companies. In spite of programmes supporting the building of backward linkages between local firms and foreign companies, these relationships are mainly restricted to low-skilled service supply, rather than to technical cooperation. FDI's value-added for exports amounts to some 10% only, as these companies import most of their raw materials. Therefore the economy is not making the most of the opportunity these companies offer for productivity-raising upgrading of domestic industrial production, which is required to help the economy achieve a self-sustaining structural change towards higher-value added production.

External debt is projected to slightly increase further in 2018-2019, but to drop in 2020. In 2017, gross external debt declined by about 0.6 pps, reaching 73.6 % of GDP at the end of December 2017. The decline in public external debt was larger than the increase in private debt, which consisted mainly in a rise in intercompany loans. Over the programme period, the authorities expect an increase in external debt by some 4.5 percentage points, mainly due to higher public borrowing, which, however, will drop in 2020, due to a significant repayment due during that year. The maturity structure of external debt deteriorated slightly during the last year, with the share of short-term debt increasing from 16.3% of total at the end of 2016 to 17.7% by end-2017. The ERP contains an annex with a sustainability analysis of external debt. This analysis is more elaborate than in past programmes and projects only a slight decline in the ratio of external debt to GDP in 2020. The share of more flexible kinds of debt (trade credits and

intercompany loans) is projected to rise over the programme horizon, making external debt less vulnerable to shocks to the primary current account and to GDP growth.

Graph 1: External competitiveness and the current account



The banking sector has remained stable, despite a marked slowdown in financial intermediation in 2016 and 2017. Although loan and deposit growth slowed down markedly during the period of high political uncertainty, the sector's solvency, liquidity and profitability indicators remained robust. Concentration remains high and unchanged compared to previous years, with some 58% of assets held by the three biggest banks. There are 15 banks in total, most of which are foreign-owned. Liquidity was abundant, partly reflecting banks' sluggish lending and their diminished appetite for government securities. The capital adequacy ratio increased in 2017 and stood at almost double the regulatory minimum of 8% by the end of the year. Banks' profitability continued to increase, yet more slowly than in preceding years. Basel III capital standards came into force in March 2017. The quality of banks' assets improved slightly in the year to December 2017: the share of non-performing loans (NPL) in total loans to the non-financial sector amounted to 6.3% (0.3pps lower than one year earlier). However, not including the mandatory write-offs since 2016, the NPL share remains at about 10%. The central bank took further measures in 2017 to resolve the NPL problem, preparing a draft strategy for NPL resolution. However, the high share of NPL on banks' balance sheets remains an obstacle to credit extension and to the transmission of monetary policy. Further measures are necessary to address this problem.

Table 2:

Financial sector indicators*

	2012	2013	2014	2015	2016	2017
Total assets of the banking system, mEUR	5,738	6,008	6,509	6,889	7,230	7,508
Credit growth to private sector, annual change in %	7.3	4.3	8.4	9.1	4.6	3.1
Deposit growth, annual change in %	7.2	4.8	8.2	7.9	4.3	6.0
Loan- to-deposit ratio	88.1	88.8	88.1	90.6	87.0	87.7
Financial soundness indicators						
- non-performing loans (in % of total loans to the non-financial sector)	10.5	11.5	11.3	10.8	6.6**	6.3**
- regulatory capital to risk weighted assets	17.1	16.8	15.7	15.5	15.2	15.7
- liquid to total assets	32.4	31.2	29.8	28.2	28.9	27.1
- return on equity	3.8	5.7	7.4	10.4	13.6	13.5
- foreign-currency denominated loans (in % of total loans)	56.6	54.0	50.7	47.7	44.9	42.5

Sources: National Central Bank, Macrobond

*at end-year

**including the impact of write-offs

2.3. PUBLIC FINANCE

Public spending remained within the deficit targets. In July 2017, the new government adopted a supplementary budget, taking into account lower than expected nominal GDP growth, while maintaining the initial deficit target of 2.9% of GDP. The supplementary budget projected a revenue shortfall of some 1.5% compared to the initial draft budget and reduced some "non-productive" discretionary spending, such as advertising and business trips, while transfers to the pension system and other social transfers were increased. The supplementary budget also introduced subsidies for wages and employment. The government used some funds to reduce payment arrears. At 2.7% of GDP, the 2017 general government deficit remained below the 2.9% target of the supplementary budget. Both, total revenues and total spending remained 3% below target, in particular capital spending was some 16% lower than planned, at some 3.3% of GDP.

The 2018 revenue and expenditure targets seem feasible, but they are not very ambitious. On 22 December 2017, Parliament adopted the budget for 2018, envisaging a deficit of 2.7% of GDP, while expecting GDP growth of 3.2% and an increase in inflation by 2%. This deficit target is at the same level as the realised preliminary budget deficit in 2017 of 2.7% of GDP, although the underlying growth assumption is significantly more favourable. On the revenue side, the government intends to increase excise taxes on diesel fuel, but otherwise does not envisage any major changes to the tax regime. On the expenditure side, the government announced additional spending for wage and employment subsidies, but also financial incentives for successful enterprises. However, the overall amount of those discretionary support schemes is limited and, according to government estimates, will affect the budget by about 0.3%-0.5% of GDP. On capital spending, an increase of almost 1.3pps, in terms of GDP, is planned in 2018, compared to the actual outcome in 2017 (3.2% of GDP). The ERP would have benefited from an explanation of how the government intends to meet these targets in the light of significantly revised growth assumptions.

Over the medium term, the programme envisages a very moderate improvement in the country's fiscal position. The budget deficit is expected to drop to 2.3% in 2020, and the debt ratio will decline slightly only in the last year of the programme period. In the absence of concrete revenue or expenditure

measures, these plans seem to rely primarily on economic growth. This approach exposes the fiscal framework to the risk of an underperforming economy, as experienced in previous years. Because of its high share of euro-denominated public debt, the country is also exposed to exchange rate risk. However, the country's exchange rate vis-a-vis the euro has remained remarkably stable so far. The programme also calculates cyclically-adjusted deficit ratios, based on potential growth of 3%. This implies for 2019 and 2020 a positive output gap, and actually leads to an increase in the structural deficit in those two years, reaching 3% of GDP in 2020, compared to 2.6% of GDP in 2018. Given the increasing ratio of debt to GDP, and rising debt-financing costs, the government should use the opportunity of above potential growth to proceed more forcefully towards lowering budget deficits faster than currently envisaged. This requires concrete consolidation measures, in the absence of which even the modest deficit reduction currently envisaged may be too optimistic.

The government's plans to raise the efficiency of revenue collection and of spending seem to be progressing slowly. Tax rates are low and the structure of expenditure is inflexible. Given this situation, the government has declared in the 2018 ERP its intention to underpin its fiscal consolidation plans by measures increasing the efficiency of social and capital spending and by improving tax collection and administration. Social assistance programmes remain fragmented and the measures announced by the government to streamline these payments are still in the initial phase. General government capital expenditure amounted to less than 4 % of GDP on average between 2012 and 2017, a relatively modest amount among peer countries.² To raise its efficiency, public capital spending needs better prioritisation from the outset, based on multi-year projections of all involved costs, including costs for maintenance of transport infrastructure projects, as well as ongoing monitoring and performance evaluation.

Table 3:

Composition of the budgetary adjustment (% of GDP, general government)

	2016	2017	2018	2019	2020	Change: 2017-20
Revenues	30.3	31.3	31.1	30.7	30.5	-0.8
- Taxes and social security contributions	26.4	26.7	26.9	26.8	26.6	-0.1
- Other (residual)	3.9	4.6	4.2	3.9	3.9	-0.7
Expenditure	33.0	34.2	33.8	33.3	32.8	-1.4
- Primary expenditure	31.8	32.9	32.5	31.8	31.0	-1.9
<i>of which:</i>						
Gross fixed capital formation	3.8	4.6	4.5	4.5	4.7	0.1
Consumption	10.6	10.6	10.3	9.7	9.1	-1.5
Transfers & subsidies	17.3	17.7	17.7	17.5	17.2	-0.5
Other (residual)	0.1	0.0	0.0	0.1	0.0	0.0
- Interest payments	1.2	1.3	1.3	1.5	1.8	0.5
Budget balance	-2.7	-2.9	-2.7	-2.5	-2.3	0.6
- Cyclically adjusted	-2.7	-2.6	-2.6	-2.7	-3.0	-0.4
Primary balance	-1.5	-1.6	-1.4	-1.0	-0.5	1.1
Gross debt level	39.5	39.2	42.4	44.6	42.5	3.3

Source: Economic Reform Programme (ERP) 2018.

Sizeable refinancing needs lie ahead. The government expects the level of public debt guarantees to decline after 2019, as the bulk of public construction projects will have been finished by then.

² This figure does, however, not include public capital spending by the Public Enterprise for State Roads (PESR), which was moved off-budget in 2013.

Repayments of sizeable external commercial loans are due to commence in 2020, followed by Eurobonds maturing in 2021 and 2023, respectively. These will require substantial refinancing, notwithstanding the government's abundant deposits at the central bank. Annual gross financing needs are estimated at about 14% of GDP on average between 2017 and 2020, rising to about 17 % in 2021 as the third Eurobond (500 million) matures. Over one fifth of total financing needs are accounted for by external debt repayments. The government plans to finance the budget deficit and maturing debt repayments by a combination of external sources (international financial institutions, commercial banks, Eurobonds) and domestic sources.

The structure of government debt has improved. To reduce risks inherent in a build-up of debt, the government has improved the debt structure in recent years, by lengthening maturities in the domestic bond portfolio and increasing the share of fixed interest rate debt, which accounts for about three quarters of total government debt. Borrowers do not hedge against foreign currency risks, mainly due to a lack of suitable instruments in the domestic financial markets. The government successfully lengthened the maturity structure of its domestic debt portfolio by issuing longer-term bonds. In the past year, there was a shift in the profile of bondholders away from commercial banks towards institutional investors, in particular pension funds and life insurance companies, reflecting the increasing weight of the mandatory second pension pillar, as well as towards foreign investors.

Box: Debt dynamics

Table 4:
Composition of changes in the debt ratio (% of GDP)

	2016	2017	2018	2019	2020
Gross debt ratio [1]	39.5	39.2	42.4	44.6	42.5
Change in the ratio	1.5	-0.4	3.3	2.1	-2.1
Contributions [2]:					
1. Primary balance	1.5	1.6	1.4	1.0	0.5
2. "Snow-ball" effect	-1.3	-0.7	-0.6	-0.8	-0.8
<i>Of which:</i>					
Interest expenditure	1.2	1.3	1.3	1.5	1.8
Growth effect	-1.0	-0.6	-1.2	-1.4	-1.7
Inflation effect	-1.4	-1.4	-0.8	-0.9	-1.0
3. Stock-flow	1.3	-1.3	2.5	1.9	-1.7

Notes:

[1] End of period.

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

Source: *Economic Reform Programme (ERP) 2018*, Commission calculations

General government debt is expected to increase significantly in 2018 and 2019, mainly as a result of planned infrastructure investment. In 2020, a major debt repayment will be the main driver of a renewed annual decline in the debt-to-GDP ratio (-2.1pps). Without this one-off effect, the debt ratio would drop by 0.4pps only, mainly due to nominal growth, which will reduce the debt ratio by 2.7 pps compared to the preceding year. The debt-increasing impact of the primary deficit would diminish over time by 1 percentage point. Real growth and inflation would, to an increasing extent, moderate the rise in debt. However, these effects are partially offset by the high and rising cost of debt financing. Interest expenditure is likely to add some 0.5pps of GDP to the debt ratio by 2020, compared to 2017.

The transparency of public finances has increased considerably, but the fiscal framework needs to be further developed. The government has enhanced the quality and availability of fiscal data in the past year. It has published a list of unpaid public sector liabilities, and is working on a clearance strategy. It has also put on its website a citizen's budget for 2017 and 2018. In order to support fiscal consolidation and discipline, budget planning and execution need to be improved, in particular by putting the recently developed medium-term expenditure framework in operation, and by swift adoption of fiscal rules.

2.4. STRUCTURAL REFORMS

Despite the success in improving certain legal and regulatory aspects of doing business, the business environment continues to be problematic. This constitutes one of the main structural bottlenecks to competitiveness and growth. The regulatory framework is not transparent and changes frequently. Inspections are a considerable burden to businesses as their purpose is often unknown and fines are applied inconsistently or unfairly. There is no systematic, efficient and transparent process for law enforcement or commercial dispute settlement. Companies complain that parafiscal charges are often levied without a clear rationale. The informal sector is sizeable, and estimated to account for around 17% of GDP. This poses a serious challenge to private sector competition, trust and worker's rights, and also deprives government of considerable revenues. Significant improvements were made in 2017 to the public financial management framework. It is now critical for this framework to be fully and effectively implemented. The measure to improve the VET sector is welcome but the whole education system should be modernised to match the needs of the labour market. The government improved the coverage and effectiveness of active labour market policies (ALMP) with the launch of the Youth Guarantee and the greater focus on young people not in education, employment or training (NEET). The global diagnostic is overall accurate and has been strengthened in this year's ERP, while the area diagnostics could be made more precise to discuss underlying causes.

Out of a total of 19 measures, 11 are new measures and 8 are rolled over, implying considerable adjustments. Most of the dropped measures were justifiably excluded following the Commission's assessment of their relevance for competitiveness and long-term growth in 2017. However, this is not the case for all the excluded measures. Moreover, in several instances there is no clear linkage between the diagnostics and the proposed measures, or to what extent measures have been selected on the basis of an evidence-based appraisal system. The agriculture and industry measures receive by far the highest budget allocations, along with the ALMPs and the Youth Guarantee. The new support measures for industry, included in the government's Plan for Economic Growth, consist of subsidy schemes for private companies and do not tackle underlying structural obstacles to industrial development. In addition, they raise concerns on equal treatment of companies; implementation monitoring; compliance with EU state aid rules; and fiscal sustainability. The measures focus insufficiently on improving the business environment and there is no policy initiative to directly address the informal economy. In addition to the reinforcement of the labour inspectorate, a set of facilitating measures could be set up to foster the transition towards an economy with lower labour informality.

Public finance management

Public finance management (PFM) has long been problematic, especially in medium-term budget planning, public procurement management, fiscal transparency, and assessing the budget impact of policy proposals. However, the PFM framework has now improved. The ERP diagnostic identifies or refers to these shortcomings, and also notes in particular the lack of public procurement harmonisation with the EU *acquis*. However, the government has made clear progress in this area in the past year, such as improving the coverage and quality of fiscal data, including on public sector arrears. A comprehensive PFM reform programme was adopted at the end of 2017. This programme now needs to be swiftly and fully implemented.

The two new measures envisage the harmonisation of the public procurement legal framework with the EU *acquis* and the improvement of internal financial control. The public procurement measure is likely to play an important role in better use of public funds and improve business conditions by increasing transparency, legal certainty and fair competition. However, there is no discussion of the specific impact on private sector competitiveness, such as a possible reduction in corruption and informality. The internal financial control measure is not directly linked to competitiveness, but rather to

public finances and this policy belongs more in section 3 of the ERP. There is little or no discussion of implementation risks, such as inter-institutional coordination and developing the capacity of the Public Procurement Bureau.

Energy and transport market reform

The economy is characterised by high energy intensity, inefficiency in the ageing energy production system, and in inefficiency of energy consumption. The transport market is heavily concentrated on road transport only. There has been a significant lack of progress in regulatory reform, market liberalisation and inadequate regional connectivity in both energy and transport markets. This poses a problem, as does the poor implementation of Energy Community commitments, notably on the Sustainability Charter. The ERP diagnostic acknowledges these shortcomings. The transport market diagnostic notes the dominant position of road transport although it is not explicitly described as a key constraint. The analysis would have benefitted from a discussion of the significant financial and environmental side-effects of this dominance. The economy requires alternative transport modes, notably rail transport. The programme refers to an upcoming national transport strategy plan which still has to be finalised and adopted. It also notes a project to liberalise rail transport, but makes no reference to the Trans-European Network for Transport (TEN-T) framework coordinated by the South East Europe Transport Observatory (SEETO).

The two new measures on energy correctly focus on regulatory reform of the energy market. Only one of the 2017-2019 ERP infrastructure-building measures was included in the 2018-2020 ERP in accordance with the Commission assessment recommendations and guidance note. The other measures were replaced by two measures on regulatory reform to increase the competitiveness of the electricity market. The measures are relevant as they at least partly tackle key constraints and could help increase security of energy supply by starting to address the country's problems with its ageing lignite power generation plants and unstable energy production, and dependence on imported Russian gas. Addressing these issues is part of the obligations under the Third Energy Package, the Renewable Energy Sources Directive and the Energy Efficiency Directive.

The adoption of a new energy law, which aims to set up a more liquid and organised electricity market, will allow for more competition on the energy market and will stimulate cross-border regional energy market integration and connectivity. As this region consists mostly of small unconnected markets, integration and connectivity is particularly important. One problem not discussed in the ERP is that the legal basis for the Energy Regulatory Commission has not been adapted to the Third Energy Package. It is also important to urgently transpose the EU *acquis* to ensure that the energy regulator can operate effectively. The ERP does not specifically discuss price deregulation, an important issue as prices are likely to increase to more correctly reflect costs. The increased burden on low-income households will require targeted support.

The new measure on renewable energy sources (RES) and energy efficiency will help diversify energy generation and contribute to energy supply security, with positive effects on the economy. This measure consists of both regulatory aspects (incl. adoption of the law on energy efficiency) and plant capacity building. It would be further strengthened if the country implemented additional regulatory reforms to reduce environmentally harmful subsidies or increase green taxes. It remains unclear whether the energy efficiency activities being implemented will only benefit public buildings. If so, their impact on competitiveness will be limited. At the same time, it must be underlined that energy efficiency and the use of renewable energy cannot be achieved without full compliance with the relevant EU *acquis*.

Implementation of the measure to construct a joint railway border station with Serbia is underway.

The description of the measure refers to joint border procedures on a 'one-stop-shop' principle. However, there is no discussion of specific plans to set up these procedures, which would certainly make the reform more effective. The measure is part of the railway Corridor X rehabilitation project and identified within the connectivity reform measures (CRM), although full implementation of the measures identified in the latter is not referred to in the ERP. The measure seems relevant to increase competitiveness in particular by facilitating cross-border freight traffic. The ERP also indicates that the new crossing will encourage more train operators to operate at the crossing, but does not explain how. In addition, the measure relies on external funding for construction but does not provide a budget for maintenance investment.

Sectoral development

Agricultural sector development

The relatively large agricultural sector consists of highly fragmented private-sector and state-owned land parcels, with low productivity and competitiveness and poor irrigation infrastructure.

Overall, the sector accounts for 10% of GDP and 18% of employment in 2015 but in some regions these shares are considerably higher. In the diagnostic, the ERP emphasises the excessive fragmentation in agricultural land. Private farms operate mostly on subsistence level and they are too small to take advantage of economies of scale or invest in new technologies. At the same time, within the large share of state-owned land most state farms do not function well, or at all. The ERP underlines how climate change could adversely impact the sector, especially through increasing water deficits. Economic cooperation between farmers and the development of agro value-chains are still in its early stages. Moreover, migration from rural areas continues and a significant part of the land is abandoned.

As stated already in last year's assessment, the three measures are appropriate and address main structural constraints facing the sector.

These include land fragmentation, increasing shortages of irrigation water and the lack of modern technology and tools. But further regulatory reform is needed. The three measures complement each other in that coordinated implementation would strengthen their effectiveness. However, there have been problems with implementation in all three measures, and this lessens their effectiveness in removing structural constraints to growth. Also, the relatively high levels of untargeted agricultural subsidies further reduce incentives for structural adjustment in the sector.

The measure to improve irrigation systems is based on a clear diagnostic and assessment of future requirements.

These requirements include those arising from climate change and the growing need for additional irrigation, water management and flood protection structures and the rehabilitation of existing infrastructure due to poor maintenance. The ERP sets out timelines and a general impact estimation but there is little by way of quantitative projections. It provides a considerable budget, although not all described projects seem to be covered (e.g. the Slupchanska dam). Given the size of construction works and the varied impacts they will have, it would be helpful to have an explicit description of how to directly involve affected in the measures.

The measure on consolidation and defragmentation of agricultural land is a highly relevant and complex reform. It could potentially have a significant positive impact.

However, the ERP does not explicitly discuss developing proper legislation to deal with abandoned land, efficient monitoring of the use of state-owned land (using up-to-date statistical data) or amending the law on land consolidation to incorporate state-owned land into the process. At the same time, the planned activities are more related to preparation for land consolidation than consolidation itself, and often could be further specified. It is difficult to appreciate the expected impact on competitiveness. The discussion is in general terms and does not contain quantitative objectives or estimates. For example there are no targets for x% of

agricultural land consolidated by a specific date. The ERP does clearly note possible risks and actions to prevent or counter-act such risks.

The measure to set up agricultural cooperatives has the potential to further promote rural development and investment, and improve competitiveness and employment in the agri-food processing industry. The ERP provides a detailed description and feasible timeframe. It is nevertheless unclear to what extent differently-sized cooperatives would receive similar support, and how cooperatives would operate and provide services to farmers. Overall, a more systematic approach to the implementation of measures would be helpful. The country should also link the measure to the EU alignment process on producer groups and common market organisations. As was the case with the measure on land consolidation, the expected impact on growth and competitiveness is not sufficiently considered and the impact of the measure is difficult to grasp.

Industry sector development

The main obstacles to competitiveness in industry include low investment and innovation, limited export diversification, underdeveloped enterprise clusters, inadequate entrepreneurial skills, and a poor match between education and labour market needs. There has been some shift towards higher value added production and exports in recent years. Nevertheless, traditional products such as iron, steel and textiles still make up a large share of exports. Linkages between domestic industry and international production chains -including in the technological industrial development zones- remain weak. The ERP diagnostic makes reference to these main bottlenecks to industrial competitiveness, and states that the existing industrial policy strategy for 2009-2020 is being revised to address these issues in the future.

Three new measures focus on stimulating industrial investment, promoting exports and developing new markets. However, these measures mainly rely on financial subsidies to the private sector. The measures are part of the government's Plan for Economic Growth. The planned activities mainly rely on a series of financial incentives, including subsidies for investment, salaries, training and product development. These support measures do not address any underlying structural constraints and they raise questions on equity and efficiency. One such question is why beneficiary companies would not themselves hire more staff, or why they would be unwilling to use their own funds to grow and innovate or attract alternative private financing sources. It also raises the question why the private sector e.g. in the form of chambers of commerce does not offer relevant support services to small and medium-sized enterprises (SMEs). In addition, the three measures seem to partly overlap.

The objective of attracting foreign and domestic investments and further integrating businesses in international value chains is relevant. However, the diagnostic does not suggest that the key obstacle constraining such integration is access to finance and a need for subsidies. Direct state subsidies to SMEs further raise concerns in terms of WTO- and EU *acquis* rules on state aid, and on the fiscal sustainability of such measures. It is of utmost importance to effectively monitor the outcome of these schemes, ensure coordination of the numerous financing activities and agencies to avoid overlap, and set up an exit plan for these subsidies.

Service sector development

The service sector accounts for over half of employment and over 60% of GDP and faces similar key constraints as industry. These constraints include weak entrepreneurial skills; gaps between skills and labour market needs, an often unpredictable regulatory environment, the absence of systematic law enforcement, and a large informal sector, particularly in construction. The ERP does not present a sector-wide diagnostic that discusses the structural obstacles to growth and competitiveness for services. Instead,

it focuses on tourism and identifies the following key constraints inadequate absorption capacity of investment, weak management, poor coordination and cooperation and lack of resources among the various stakeholders and agencies.

The measure to increase competitiveness in the tourism and hospitality sector could have a significant impact on the sector. However, the scale of the impact is unclear as outputs are unquantified. This measure is also subject to multiple risks. The reporting in the ERP on the implementation of the measure in 2017 is difficult to assess since the activities were not specified or quantified. At the same time, the measure seems to have been significantly scaled up compared to the previous year and now includes financing from the national budget; but the measure still lacks details. Although it could potentially have considerable impact on both employment and gender equality, this is not specified. The measure is still not embedded in a more strategic approach and this may explain why there have been long delays in programme implementation in the past. Further delays cannot be ruled out: completion of the tourism strategy could be complicated by the lack of proper stakeholder consultation so far, a risk also mentioned in the ERP.

Business environment and reduction of the informal economy

Development of the private sector is impeded by the large informal sector, an often unpredictable regulatory environment, the absence of systematic law enforcement, business inspections conducted for unclear reasons, non-transparent parafiscal fees. Entrepreneurial skills and financial literacy in SMEs are generally weak. The regulatory framework is insufficiently transparent and is frequently changed. However, the government now obliges all ministries to use the National Electronic Registry of Regulations (ENER) for stakeholder consultation of draft legislation, and it has increased the length of the stakeholder consultation period. Inspections are a considerable burden to businesses as their purpose is often unclear, and rules and fines are inconsistently applied. The many parafiscal charges are also levied in a non-transparent way. The considerable size of the informal economy in output and employment distorts private-sector competition, undermines societal trust and deprives the government of significant revenues. The weak links between FDI and local businesses should have been addressed in the programme.

The measure aimed at developing a national web portal for the electronic delivery of state services could help businesses. However, the measure is limited in its potential to address the key challenges facing companies. In spite of the many obstacles to competitiveness, the ERP contains only one measure in this area. This measure seeks to develop a national portal for e-services to simplify doing business and strengthen transparency. This would support SMEs and others by decreasing administrative burdens. Although this would indeed help enterprises, the activities planned for 2017 have only been partially implemented. This measure has now been under implementation for five years and it is difficult to establish what progress it has achieved. The measure is complex and covers several enterprise policy areas, and involves combining and streamlining many procedures and institutions. Its implementation therefore requires improved inter-agency cooperation, interoperability of standards and regulations and information exchange. It also requires appropriate hardware, software and training. The main risk is therefore a lack of institutional willingness and skills to use this portal. Furthermore, given recent experience of this and other IT projects, the budgeted costs seem too low. The expected impact on competitiveness could be substantial but in the ERP this impact is described in general terms with no quantitative targets.

Research, development and innovation and the digital economy

Key obstacles to growth in the research, development and innovation area include a lack of innovation infrastructure and weak cooperation and coordination between academia, the private

sector and the government. The ERP diagnostic shows that, despite progress in innovation policy and implementation in recent years, there is a lot of room for improvement. The country still ranks as only a 'moderate innovator'. This is in turn linked to very low total R&D expenditure (0.44% of GDP in 2015), consisting mainly of public expenditure with marginal private-sector input. The diagnostic rightly underlines the strong correlation between investment in R&D and competitiveness and economic growth. It further points out two other issues: the weak research base and low absorption capacity of SMEs. However, it does not specify reasons for the weak cooperation between universities and the private sector. There is also no discussion of the digital economy and a lack of strategies on key digital policy areas such as digital skills and telecommunications and broadband development. All of these are necessary to ensure transformation towards a digital economy and to significantly improve competitiveness.

The measure on improved infrastructure and access to finance for research aims to provide funding for several stages of the innovation cycle. This partially addresses a key constraint. Although this measure continues to be relevant, its implementation so far has been problematic due to long delays. For this reason, activities planned for 2017 were only partially implemented. The measure is especially targeted at SMEs to support innovation and competitiveness. However, the low funding absorption capacity of SMEs is a serious constraint, as is the poor coordination capability of the agencies in charge. The expected impact on competitiveness is considered only briefly and the discussion is in broad terms and does not contain further quantified targets. In last year's assessment the Commission positively evaluated the measure on creation of a 'Triple Helix Partnership' between academia, private sector and government. Despite this, this measure was dropped from the ERP because of implementation delays, even though it had a clear link to a key constraint faced by the economy.

Trade-related reforms

Key constraints in this area are the trade impediments faced by SMEs. These impediments are linked to non-tariff barriers, including technical standards and administrative obstacles. Barriers also include relatively high logistical and customs costs and a lack of managerial, financial and technical skills. The ERP highlights several of these constraints but does not discuss the weak linkages between FDI and domestic companies.

The measure on trade facilitation to simplify inspections and clearance procedures has the potential to improve competitiveness. This new measure focuses on speeding up all trade that requires veterinary and phytosanitary certificates issued through the EU Trade Control and Expert System (TRACES). The resulting improved data exchange between customs authorities would lead to faster and cheaper trade flows. Swift and rigorous implementation of all trade facilitation commitments under AP5 would indeed be significant steps to address key constraints and strengthen governance. This would in turn stimulate trade and attract investment. The ERP provides a quantitative assessment of the expected impact on growth and competitiveness. The budgeted costing needs further clarification as it is quite small and it is unclear to what extent all activities required by the measure have been costed.

Education and skills

Key indicators in education and skills area remain below the EU average despite a general improvement in the main education outcomes over the years. Although the share of early school leavers is above the EU average, the main challenge for the country is the low quality of the primary and secondary education system. Indeed, the PISA survey³ highlighted worrying results. Higher education is also not without shortcomings as almost one third of recent graduates have a job not matching their field

³ PISA is a triennial international survey which aims to evaluate education systems worldwide by testing the skills and knowledge of 15-year-old students.

of study. In addition, the VET system is insufficiently connected to the labour market needs and is not in a position to ensure a smooth transition from school-to-work. There is a generally poor image of the VET sector, although VET students account for almost 60% of all students at upper secondary education. The labour market has difficulties finding the appropriate skills. The ERP diagnostic mentions some of these challenges but does not properly analyse the pre-primary, primary or secondary education. This is a major weakness.

The measure to further develop the qualification system in VET may help contribute to the targets set in the Employment Strategy 2016-2020. However, improving the match between education and labour demand will require continuous commitment of all stakeholders. There is a need to modernise the education system as a whole, not just in VET, and this will require substantial resources. Only an improvement of overall quality of education will provide the relevant quality basis for creating a sustainable and inclusive economy. The capacity of the Ministry of Education and Science should be increased substantially to meet the targets, and a better coordination with the Ministry of Labour and Social Policy should also be ensured.

Employment and labour markets

The employment rate has been increasing steadily from 45.8% in 2011 to 53.7% in 2017. However the rate of young people not in employment, education or training (NEET) remains high at 24.3% in 2016 compared to the EU average at 11.5%. It does not show any clear trend in the period 2012-2016. It should also be noted that women experienced the largest decline in the unemployment rate in 2017 which was at 21.4% and thus 1.2% lower than the male unemployment rate. The unemployment rate of low educated people is the highest although it marked the largest decline. Despite a decreasing trend over the years, about 18.5% of employed persons are working informally, in particular in the agricultural sector.

The two measures on upgrading active labour market policies (ALMP) and the introduction of the "Youth Guarantee" are ambitious in scope. The National Authorities follow up their ALMPs with impact evaluations and use the findings when designing the ones for the following year. The ALMPs clearly address the bottlenecks identified in the ERP. Last year's recommendations were taken on board in this year's measure: the coverage increased from 6,000 to 16,000 and will include the profiling of unemployed as well as preparation of individual employment plans. Further development of the "Occupational Outlook" is envisaged to fine-tune next year's ALMPs. Meanwhile, the political will of national authorities to tackle youth unemployment is clear. The country-wide introduction of the "Youth Guarantee" by 2019 is the first initiative of this kind in the Western Balkans. However, the final impact of these initiatives might be lower than expected considering the administrative capacity of the Employment Service Agency. While its capacity to carry out profiling and personalised counselling of job seekers has been strengthened, the continuity and sustainability of reform efforts still need to be consolidated. Outsourcing the activities is not a long-term or sustainable solution; the Employment Service Agency should be able to commit and implement the required activities with its own resources.

Social inclusion, poverty reduction and equal opportunities

AROP (At Risk Of Poverty) before social transfers and pensions affects 41.6% of the population in 2016 despite some improvements since 2013. Pensions and social transfers play a very important role in reducing the poverty rate by almost half (21.9%) in 2016. Unemployed and other inactive persons are especially affected. It is particularly worrying that poverty impacts children more (28.6%) than adults (21.3%). Unemployed persons are also facing a very large material and social deprivation rate (65.5% of unemployed in 2015 compared to the employed persons 35.9%) The ERP recognises the need for significant reforms to reduce the poverty level below 16% by 2020. The social system is facing

performance challenges and its spending is inequitable and directed towards categorical programmes. The system requires a profound reform both in terms of the financial entitlements and the assistance and support service to the most vulnerable.

The measure mainly aims at better targeting of those at risk of poverty and social exclusion. It includes the adoption of a new law on Social Protection, which is under preparation with the different stakeholders and should be adopted in 2019. This law aims to better target those at risk of social exclusion, to allow an adequate level of social benefits and to improve the services to them. It should represent a substantial improvement of the social safety net and help the government to achieve its objective of reducing the level of poverty.

2.5. IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2017

2017 policy guidance	Summary assessment
<p>PG 1:</p> <p>Develop a proper fiscal consolidation strategy by defining and costing concrete revenue and expenditure measures on a multi-annual basis, whilst protecting growth-enhancing spending.</p> <p>Improve the efficiency and effectiveness of public spending by streamlining and better targeting transfer payments.</p>	<p>There has been limited implementation of PG 1:</p> <ul style="list-style-type: none"> • No implementation: The ERP and the Fiscal Strategy 2018-2020 aim at fiscal sustainability and gradual fiscal consolidation, maintaining macroeconomic stability, boosting competitiveness of the economy and increasing employment. A gradual reduction of the budget deficit is foreseen from 2.7% of GDP in 2018, to 2.5 in 2019 and 2.3% in 2020. However, a durable multi-annual fiscal consolidation plan relying on both revenue- and expenditure-based measures has not been developed. The plan is all the more urgent given the increased fiscal risk deriving from the subsidy-based new economic growth plan. Consolidation in the past has focused on one-off measures such as under execution of capital expenditure or accumulation of arrears that the government is resolute to repay. To conclude, merely announcing an ambitious deficit target over the medium term with no accompanying active policies (such as operating measures, programme measures or other permanent savings) to improve the fiscal position is not regarded as a consolidation plan. • Limited implementation: The country has announced some measures to streamline and better target transfer payments. However, there is no reference to the implementation in 2017. For social assistance, better targeting and reallocation within the current envelope would improve social inclusion. The ERP includes a new measure (N 19) to streamline the payment of social financial transfers. In addition, it includes labour activation components (N17). Sizable efficiency and effectiveness gains can also be achieved through the rationalisation of untargeted budgetary subsidies, particularly to the agricultural sector, but there is no reference to this in the ERP.
<p>PG 2:</p> <p>Improve budget planning capacity, in particular through the introduction of a medium-term expenditure framework.</p>	<p>PG 2 has been partially implemented:</p> <ul style="list-style-type: none"> • Partial implementation: The country has adopted measures to introduce a medium-term expenditure framework. An EU twinning project has supported the process of strengthening the capacities for medium term

<p>Enhance fiscal transparency by including information in the budget documentation on the composition of deficit financing; the budgetary impact of new policy initiatives; payment arrears; and spending and borrowing by state-owned enterprises.</p> <p>Adopt fiscal rules, as an ordinary budget law if their constitutional embedding proves difficult.</p>	<p>planning. The Minister of Finance has announced that the MTEF will be operational from 2019. The preparation of a new organic law is under way.</p> <ul style="list-style-type: none"> • Substantial implementation: The country has adopted measures to address this recommendation. The government has taken concrete steps to enhance fiscal transparency, such as publishing on the MOF website the list of public sector arrears, and drafting citizens' budgets for 2017 and 2018. Fiscal data is available in tabular format on the website. However, implementation of the other points contained in this recommendation is still pending. • Limited implementation: The country has announced that fiscal rules will be included in the new organic budget law that is under development.
<p>PG 3:</p> <p>Continue efforts to further strengthen the use of the local currency</p> <p>and to further foster NPL resolution by developing a comprehensive strategy to these ends, with the participation of all relevant stakeholders.</p> <p>The monetary policy stance should remain consistent with the exchange rate peg, using available scope within this framework in line with safeguarding price stability.</p>	<p>PG 3 has been substantially implemented:</p> <ul style="list-style-type: none"> • Partial implementation: The NBRM has prepared draft strategies both for NPL resolution and for strengthening the use of the local currency, which include a comprehensive set of policy measures. However, the draft strategies still need to be consulted with other ministries and agencies (they have been already consulted with the Ministry of Finance) and adopted. • Partial implementation: See previous paragraph. • Full implementation: The central bank maintained a monetary policy stance consistent with the exchange rate peg and in line with safeguarding price stability.
<p>PG 4:</p> <p>Adopt a comprehensive and credible public finance management reform programme.</p> <p>Prioritise public investments against clear policy objectives. Increase the transparency on the selection criteria for investments and on their impact on economic growth and on the fiscal path.</p>	<p>PG 4 has been substantially implemented:</p> <ul style="list-style-type: none"> • Full implementation: The country adopted a comprehensive and credible PFM programme in December 2017. • Limited implementation: The adopted PFM programme encompasses conducting a Public Investment Management Assessment (PIMA) with IMF support. The PIMA will include an assessment how to improve the capacity to prioritise public

	<p>investment against policy objectives. The PIMA will also aim to improve transparency of selection criteria for public investment and their impact on growth and the fiscal path.</p>
<p>PG 5:</p> <p>Reduce the use of the urgency procedure for legislation</p> <p>Make full use of the National Electronic Registry of Regulations (ENER) to ensure proper and systematic consultation of the stakeholders</p> <p>Reinforce the independence and the capacities of commercial courts.</p>	<p>PG 5 has been substantially implemented:</p> <ul style="list-style-type: none"> • Full implementation: In September 2017 the government decided to limit the use of urgent and shortened procedures and to more systematically consult stakeholders for draft legislation. • Substantial implementation: In July 2017 the government obliged all ministries to publish all draft legislation on ENER. In August 2017 the government adopted new Rules of Procedure doubling the number of consultation days to 20. • Partial implementation: In 2017 the country adopted a strategy and action plan for reform of the judiciary for 2017-2022. The strategy aims to ensure an independent, impartial, transparent and efficient judiciary. The institutional capacity of the courts to uphold contracts and resolve commercial disputes <i>for now</i> remains inadequate, with time-consuming and costly procedures and not necessarily free of political interests. However, the strategy and action plan are promising.
<p>PG 6:</p> <p>Strengthen the outreach and coverage of active labour market policies towards the long-term unemployed, youth, and the low-skilled.</p> <p>Improve the qualifications of teachers</p>	<p>PG 6 has been partially implemented:</p> <ul style="list-style-type: none"> • Partial implementation: In August 2017 the country adopted the Employment and Social Reform Programme 2018-2020. it aims at reaching out to the most vulnerable categories of unemployed persons such as the youth and the long-term unemployed. The target for 2018 is coverage of 16,000 people (compared to 6,551 in 2016). • Partial implementation: The Ministry of Education and Science has adopted the Strategy for Education that includes Teacher Training Programmes. The ERP reports that more than 350 teachers in 3-year and 2-year vocational education and training have been trained on new modularised

<p>and increase enrolment in pre-school education.</p> <p>Stimulate work-based learning in both initial and continuous vocational education and training.</p>	<p>curricula. 421 mentors in companies where the students perform practical classes have been trained, out of which 400 are certified mentors; 161 teachers in practical training are trained in companies, and a programme for vocational and didactic training of the trainers has been prepared by employers where practical training is realised.</p> <ul style="list-style-type: none"> • Limited implementation: The Ministry of Education and Science has adopted the Strategy for Education that includes measures to increase the enrolment in pre-school education. • Substantial implementation: A three-year dual vocation education project based on the German model started to prepare secondary vocational schools' students for work in selected companies. The legislation was amended to facilitate practical trainings by companies. The VET strategy and draft bylaws were prepared. Mentors in companies were trained, a register for the recording of training created as well as a register for the concluded agreements between schools and companies. A national body for the systematic implementation of work-based learning has been established.
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2.6. THE 2018 POLICY GUIDANCE

JOINT CONCLUSIONS OF THE ECONOMIC AND FINANCIAL DIALOGUE BETWEEN THE EU AND THE WESTERN BALKANS AND TURKEY

The Economic and Financial Dialogue between the EU and the Western Balkans and Turkey

Brussels, 25 May 2018

[...]

In light of this assessment, Participants hereby invite the former Yugoslav Republic of Macedonia to:

1. Develop a proper medium-term fiscal consolidation strategy. Stabilise the public debt ratio by pursuing a sufficiently tight fiscal stance while protecting capital spending.
2. Streamline and better target social spending and agricultural subsidies. Reduce public sector payment arrears and develop an arrears prevention strategy. Take the necessary organisational steps in view of improving tax collection. Adopt the organic budget law with a set of fiscal rules and establish an independent fiscal council to assist in their enforcement.
3. Conduct monetary policy consistent with the exchange rate peg, using available scope within this framework in line with safeguarding price stability. Adopt and implement a comprehensive NPL resolution strategy, addressing all underlying obstacles also outside the remit of the central bank, with the involvement of all relevant stakeholders. Adopt and implement a comprehensive strategy for fostering the use of the local currency, with the participation of all relevant stakeholders.
4. Prepare risk assessments focusing on sectors and branches most vulnerable to informalities and identify and apply appropriate corrective measures.
5. Clarify the mandate of each inspectorate to avoid overlap and put in place and apply transparent and consistent procedures. Create a register of para-fiscal charges on central and local levels that clearly states the purpose of each charge and make it publically available. Strengthen the institutional capacity of civil courts to uphold contracts and handle commercial disputes within a reasonable time and at reasonable costs.
6. Modernise the education system at all levels by further improving the infrastructure, curricula and teacher qualification. Pursue the reform of the VET system to facilitate school- to-work transition. Facilitate women's access to the labour market and ensure sufficient capacity of the Employment Service Agency for implementing the Youth Guarantee. Adopt the law on social protection to better target those at risk of social exclusion. Increase enrolment in pre-school education.

ANNEX: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The Economic Reform Programme (ERP) 2018-2020 was submitted by the government on 30 January 2018. It is broadly in line with the medium-term fiscal strategy and the 2017 Budget Law. No components of the ERP are missing.

Inter-ministerial coordination

The preparation of the ERP was centrally coordinated by the Ministry of Finance. The programme was formally endorsed by the government. An inter-ministerial ERP working group involving seven ministries, several agencies and other offices worked on its preparation.

Stakeholder consultation

As part of the consultation process, the draft ERP was posted on the website of the Ministry of Finance for the period 27/11/2017 to 10/12/2017, when it was open to comments/recommendations by external stakeholders, including social partners and invitations were sent to interested parties for written contributions. The government also held a public consultation in Skopje on 05/12/2017. For the first time, the draft ERP was discussed at a session of the Economic and Social Council. The contributions are included as an annex to the ERP.

Macroeconomic framework

The macroeconomic projections are more realistic than in previous years. The programme presents two alternative scenarios compared to the baseline, assuming lower growth in trade partner countries, and lower investment. An analysis of external debt sustainability is provided as an annex.

Fiscal framework

For 2017, the programme is based on the most recent budget projections following the second budget revision and on fiscal data available at the end of the third quarter. In spite of the revised economic growth assumptions, the programme adheres to the fiscal targets of previous years, but it does not present concrete measures underpinning the planned consolidation. Compared to the 2017 fiscal outcome, the revenue projections, and the envisaged increase in capital expenditure for 2018-2020 seem plausible. The programme would have benefitted from information on the expected budget impact of policy changes. The programme includes an analysis of the budget deficit's sensitivity to lower GDP, lower revenue, and higher expenditure growth, and of the sensitivity of public debt to changes in interest rates and exchange rates.

Structural reforms

The structural reforms sections (4, 5 and 6) follow the guidance note. The measure descriptions usually provide annual activity timelines, budget estimations (except measure 19), expected impact on competitiveness, and expected impact on employment but in general terms only. However, only two elaborate on the impact on gender. Most measures briefly discuss implementation risks, and most (11 out of 19) include mitigating actions. The reporting of the implementation of the policy guidance and the structural reform measures from the 2017-2019 ERP (table 12 in annex) is sufficient, but not always up-to-date. The ERP respects both the measure and page limits. Tables 9-11 of the annex are filled in appropriately.

3. MONTENEGRO

3.1. EXECUTIVE SUMMARY

The medium-term macroeconomic scenario projects a deceleration of growth. This would be the result of the impact of fiscal consolidation on both private and public consumption in addition to a fading contribution of investment after some large construction works are completed. Net exports are expected to continue strengthening, supported by tourism and the decline of investment-related imports. However, the still large trade deficits and external debt will remain an important risk for the country's external position. The banking system is regaining strength, improving its solvency and liquidity position, but the burden from non-performing loans continues to challenge the profitability of banks.

The government introduced a rather ambitious fiscal adjustment plan. Since December 2016, a series of measures are being adopted to increase budget revenue, contain spending and rebalance the public debt structure in more favourable terms. The 2018 budget relies on strong growth, the increase of VAT and excise rates, savings resulting from the reform of a costly benefits scheme for mothers as well as a public sector wage freeze to reduce the deficit. The fiscal strategy relies on achieving strong primary surpluses as of 2020 (following completion of the first section of the Bar-Boljare highway), to set public debt on a clear downward path. However, recurrent contingent liabilities and the overestimated performance of local government budgets risk derailing the medium-term fiscal targets.

The main challenges in these respects include the following:

- **Stabilising and reducing a high debt level require sustained fiscal efforts.** So far, the fiscal consolidation measures have helped strengthen tax collection and contain current spending to some extent. Additional measures to contain consumption-related spending and increase overall spending efficiency could further strengthen the credibility and sustainability of public finances. Moreover, budget allocations seem at present insufficient to cope with contingent liabilities from previous periods related to unfavourable court judgments. Overall, there is room for strengthening fiscal oversight and compliance with budget targets and fiscal rules.
- **The position of financial institutions is improving but smaller banks still lag behind.** The Central Bank of Montenegro is revamping the financial sector's legal framework for both banking and non-banking operations. Meanwhile, the resolution of non-performing loans (NPLs), in particular those related to the corporate sector, remains essential if banks are to expand credit to the economy.
- **A healthy entrepreneurial sector is necessary to improve Montenegro's competitiveness and help reduce external imbalances.** Too many inactive and indebted companies represent a burden for the economy, distorting the real situation of banks' exposure while impacting on public finances with irrecoverable tax arrears. A swift removal of inactive companies from the business registry would help establish a sounder and more trustworthy business environment.
- **Regulatory reform in rail transport and public-private partnerships/concessions should contribute to practical rail market opening and mobilisation of private sector expertise and investments.** Setting up an efficient and independent rail regulatory and safety authority will increase competition and improve quality of service. At the same time, Montenegro lacks an effective regulatory and institutional framework for public private partnerships and concessions in line with EU rules.
- **Boosting investment in research and innovation (R&I) and rolling out the deployment of fixed high-speed broadband networks can become drivers of future growth.** In order to achieve its

ambitious target of 100% high-speed broadband coverage by 2020, Montenegro needs to prepare an implementation plan. Montenegro should also increase the gathering of R&D (research and development) and Innovation statistics and advance plans to introduce fiscal incentives for R&I in line with EU state aid rules.

- **The skills mismatch and the lack of job creation remain a key obstacle to growth and competitiveness; nonetheless, both employment and activity have been improving.** The skills mismatch manifests itself at secondary and higher education levels; it stems from high transitions from vocational education and training (VET) to higher education and to programmes less relevant for labour market needs. Provision of employment services and active labour market policies continues to be weak, affecting their outreach and effectiveness. Further efforts are needed to strengthen linkages between the labour market and social protection and reduce disincentives to work. Some important actions with the potential to improve social inclusion were started, but progress has been slow.

The policy guidance jointly adopted at the Economic and Financial Dialogue of 23 May 2017 has been partially implemented.

Substantial improvement was recorded with the adoption and prompt implementation of the new consolidation package and of fiscal and public debt strategies. Moreover, expenditure slippages were contained as no new legislative measures were adopted in 2017 without a fiscal impact assessment. However, there was no progress to provide with a detailed overview of the erosion of budget revenue due to tax exemptions. The Economic Reform Programme (ERP) announces an analysis to consider setting up a Fiscal Council but does not propose any clearly specified measure.

Good progress was made in opening the energy market. More needs to be done to ensure that the rail regulatory authorities have the capacity and independence to achieve this. Some efforts have been made to improve the financial and non-financial support for businesses and further steps are planned in the programme. The modernisation of school programmes is ongoing, but further efforts are needed. After a stall in discussions, the preparation of the new labour law has resumed. Active labour market policies were not strengthened, and they continue with low financing, coverage and targeting. Relevant actions have been initiated to establish cooperation between employment offices and social work centres and enhance the social protection information system. Overall, the structural reform measures planned in last year's ERP were only partially implemented.

The medium-term macroeconomic scenario is well articulated with the ERP's fiscal framework being sufficiently comprehensive and integrated with the overall fiscal policy objectives, the state budget and fiscal strategy. On structural reforms the focus of structural reforms is on the one hand on regulatory reform in the energy and transport markets and on the other, private sector development with as many as 11 measures on industry, services, business environment and R&I. Education, employment and social policy measures are not sufficiently developed and prioritised in the programme given the many challenges. Both reforms in the field of education focus on vocational education and training and there is no reform in the social inclusion and poverty area.

3.2. ECONOMIC OUTLOOK AND RISKS

The economic reform programme (ERP) presents a prudent macroeconomic scenario. Real growth was expected to gradually slow from 4 % in 2017 to 2.6 % in 2020. Private and government consumption is set to decelerate (by 2 and 3 percentage points respectively in 2018 compared to their growth rate in 2017) due to the negative impact of fiscal consolidation measures. Fixed capital formation is not expected to contribute to growth beyond 2019 after the completion of the works on the first section of the Bar-Boljare highway and the power interconnection cable with Italy. The contribution of net exports is expected to continue strengthening, in particular in the two outer years, supported by robust tourism activity and the decline of investment-related imports.

The ERP's baseline is plausible but might overstate the negative impact of fiscal consolidation and the completion of some investment projects. The ERP projects average real growth at 2.8 % over the period 2018-2020, slightly lower than the Commission forecast and the IMF and consensus projections. The ERP assumes a larger negative impact of the fiscal policy on private and government consumption beyond 2018, even though no major fiscal consolidation measures are planned thereafter. Also, the ERP seems to underestimate the contribution of investment to growth once the main section of the highway is completed, which does not appear consistent with the large number of investments presented in the programme (Annex 3). The ERP also projects lacklustre labour market performance, which does not appear fully justified considering employment's elasticity to GDP growth.

Table 1:
Comparison of macroeconomic developments and forecasts

	2016		2017		2018		2019		2020	
	COM	ERP	COM	ERP	COM	ERP	COM	ERP	COM	ERP
Real GDP (% change)	2.9	2.9	3.9	4.0	3.0	3.0	3.3	2.7	n.a.	2.6
<i>Contributions:</i>										
- Final domestic demand	10.0	9.5	5.9	5.4	3.2	3.6	3.0	1.7	n.a.	1.0
- Change in inventories	0.8	-0.5	-0.5	-0.6	-0.5	0.0	0.0	0.0	n.a.	0.0
- External balance of goods and services	-7.9	-6.5	-1.5	-1.3	0.4	-0.6	0.4	1.1	n.a.	1.6
Employment (% change)	1.1	1.1	2.6	1.5	2.3	0.7	2.0	0.4	n.a.	0.3
Unemployment rate (%)	18.0	18.0	17.2	17.0	16.7	16.7	16.0	16.6	n.a.	16.6
GDP deflator (% change)	n.a.	5.1	n.a.	2.1	n.a.	1.6	n.a.	1.1	n.a.	0.9
CPI inflation (%)	0.1	0.4	2.5	2.5	2.2	2.6	2.0	1.9	n.a.	1.5
Current account balance (% of GDP)	-17.9	-18.1	-18.0	-18.0	-16.7	-18.0	-16.0	-16.5	n.a.	-14.5
General government balance (% of GDP)	-3.7	-3.6	-6.2	-3.1	-5.6	-1.6	-2.7	0.1	n.a.	5.4
Government gross debt (% of GDP)	67.2	63.4	69.5	65.5	73.2	66.5	74.9	66.1	n.a.	59.7

Sources: Economic Reform Programme (ERP) 2018, Commission Autumn 2017 forecast (COM)

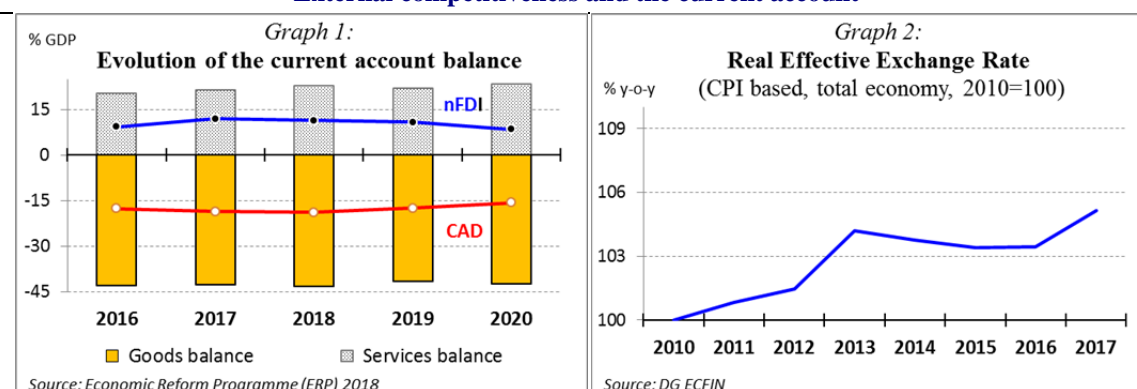
The baseline scenario faces downside risks stemming from external shocks on tourism or investment. Like in previous years, these risks are assessed in an alternative low-growth scenario which assumes a mild decline in tourism compared to the baseline and further stagnation of investments. The consideration of a modest negative shock on these two key drivers of growth helps to illustrate linkages within the economy. Along these lines, a negative impact on tourism would result in a fall in employment and private consumption, and consequently, in fiscal revenues. This would broaden the budget deficit and therefore public debt. An investment shock would further reinforce these negative consequences, but also reduce the trade deficit given the country's high reliance on imports.

Montenegro is a price taker on global markets given its relative size and trade openness. This condition is further reinforced by Montenegro's import of the euro area monetary stance through its

unilateral adoption of the euro as sole legal tender. Overall, the inflation scenario remains largely driven by international commodity prices, in particular of petroleum products and food, while domestic price pressures remain modest as average nominal wage growth is set to remain below the inflation rate in the medium-term due to labour market slack. Increases to the value added tax rate and excise duties would generate temporary inflationary pressures in 2018, estimated between 0.5 and up to one percentage point. Inflation would decline from 2019 as the impact of previous year's tax hike fades out, to reach an average rate of 1.5 % in 2020. However, the ERP's expected inflation rate in 2020 might be slightly underestimated considering the effects on Montenegro of imported inflation from a stronger global economy increasing external demand pressure on commodity import prices.

A high and persistent current account deficit remains driven by a structurally large trade imbalance. Robust tourism growth, remittances from a large diaspora, and pension transfers from abroad result in continuing surpluses in the balances of services, primary and secondary income. However, the merchandise trade balance displays chronic high deficits, exacerbated by large infrastructure investments and a narrow production base. There is scope to relieve imports by further developing domestic resources, like agriculture, food processing, construction materials, or electricity production. External competition remains very challenging for domestic companies. However, the real effective exchange rate has been appreciating again after 2016 while productivity growth remains weak (estimated in the ERP at some 1.5 % to 1.8 % per year). Therefore, the outlook is for some weak cyclical reduction of the external deficit, reflecting the investment trend and the demand for construction materials generated by ongoing major investments.

External competitiveness and the current account



Investment and consumption needs result in a high reliance on foreign financing. Foreign direct investment inflows and external debt remain key elements to finance Montenegro's growth model. The baseline scenario foresees net FDI to cover some 60 % of the external gap; the rest of the deficit being financed by private loans and sovereign debt. External debt totalled 158 % of GDP in 2016, increasing by EUR 432 million compared to 2015, and it is estimated to have further increased in 2017. This increase was largely driven by government borrowing (accounting for 32 % of total external debt) as a result of Eurobonds emissions and foreign loans to finance the budget deficit. The ERP does not provide data on the net international investment position (NIIP). Overall, the strong dependence on foreign financing implies risks to the country's external position and also to public finances if financing conditions tighten or investors' confidence weakens.

Table 2:

Financial sector indicators

	2013	2014	2015	2016	2017
Total assets of the banking system, mEUR	2,959	3,136	3,472	3,791	4182
Foreign ownership of banking system	83.5	82.7	80.4	79.4	80.4
Credit growth	3.1	-1.9	0.8	1.3	11.8
Bank loans to the private sector %	91.4	93.2	93.8	93.6	91.8
Deposit growth	5.9	10.0	13.7	9.4	13.8
Loan to deposit ratio	1.2	1.0	0.9	0.8	0.8
Financial soundness indicators					
- non-performing loans	17.5	15.9	12.6	10.3	7.3
- net capital to risk weighted assets	14.4	16.2	15.5	16.0	16.4
- liquid to total assets	20.0	22.2	24.8	24.5	25.3
- return on equity	0.5	5.4	-0.9	1.2	7.0
- forex loans to total loans %	1.6	1.6	1.6	1.1	0.7

Sources: National Central Bank, Macrobond

Although the financial sector's contribution to the economy is recovering, lending to the corporate sector remains subdued. The banking system is regaining strength, improving its solvency and liquidity position. Credit risk has been reduced, and lending to private owned companies started recovering, growing by 4.8 % year-on-year at the end of 2017, albeit still in clear contrast with the much faster two-digit expansion of households and general government credit. One key reason is the high level of indebtedness of local companies. Although the ratio of NPLs has been declining since 2013, reaching 7.3 % of total loans at the end of 2017, these impaired loans are largely concentrated in the corporate sector and challenges the profitability of banks.

3.3. PUBLIC FINANCE

In 2017, the new government started implementing a relatively ambitious fiscal adjustment programme. A plan was adopted for redressing public finances in parallel with the 2017 budget law. This plan was complemented by a rather ambitious medium-term fiscal strategy adopted in July, which frontloaded additional increases of excise duties, contained further cuts in public sector wages and revision of the mothers' benefit scheme. However, despite the consolidation measures already implemented, the general government deficit increased to 5.4 % of GDP in 2017, or 1.2 % of GDP higher than the revised plan, and 2.3 % of GDP higher than the ERP projection. This overrun was largely driven by capital spending, while unexpected payment obligations (i.e. repayment of liabilities from past years related to unfavourable court judgments, not projected in the ERP) added 1.7 % of GDP to the deficit. The wage bill ratio to GDP was contained due to restrictive wage policies, while the revision of a costly benefits scheme for mothers led to savings in social transfers by one percentage point of GDP as some beneficiaries of these mothers' benefits returned to the pension system. Strong economic growth and some further increases in excise rates helped boost tax collection, which surged by 9 % year-on-year in line with the budget plan. Social security contributions also grew strongly, supported by the new recovery programme of tax arrears.

The increase in indirect taxes is expected to lead to some reduction of fiscal imbalances in 2018. On 26 December 2017, the parliament adopted the central government budget for 2018, envisaging a 1.5 percentage points reduction of the fiscal deficit over the year to 2.6 % of GDP. Budget consolidation would be mainly revenue driven. Tax revenues are planned to increase by 1.6 % of GDP in 2018, driven by higher VAT and excises rates from the beginning of the year. Current expenditure is projected to fall

by 1.5 percentage points of GDP in 2018, contributing to the adjustment effort. The main drivers of spending reflect the priorities of the government: further capital investment and transfers to public institutions (in particular to health and education), all increasing strongly by some 16 % over the year. The public debt profile will enable a 10 % year-on-year reduction in interest payments in 2018. Some savings are also planned on social security transfers. However, part of the reduction on these transfers would be offset by a rise in pensions as most of the former benefits to mothers of three children or more, which previously benefited from pension rights, are converted again into pension rights.

The net consolidation effect of the original budget is estimated at 1.5 % of GDP in 2018 in the ERP. However, while this revenue target seems attainable thanks to the increase in total budget revenue (expected to raise by 2.6 percentage points of GDP), the impact of the consolidation measures on the expenditure side appear less certain, like the optimistic projection of 1 % of GDP surplus expected from municipal budgets. Moreover, the budget remains exposed to contingent liabilities from previous years (which averaged 2.6 % over the last three years), while budget reserves are planned to be further reduced to 0.4 % of GDP in 2018. Overall, while the current primary deficit is projected to improve by 4 percentage points of GDP, in the absence of additional consolidation measures the revised budget risks missing its deficit target.

Box: The budget for 2018

- * The draft state budget for 2018 was approved by the government¹ on 14 November 2017 and adopted by the parliament on 26 December 2017. However, by the end of February, 9 municipalities out of 23 had not yet adopted their budgets for 2018.
- * On 7 March 2018, the government presented a bill to increase expenditure by EUR 82 million and revenue by 57 million, with the EUR 25 million gap being covered by additional borrowing. As a result, the central government deficit would climb to 3.2 % of GDP, up from the original target of 2.6 %. On the expenditure side, EUR 70 million are earmarked for the buyback of shares² from the electric power company EPCG, while EUR 6.5 million set to cover public companies' debt, and EUR 4 million for the implementation of public administration reform. The revenue increase would be largely driven by the collection of EPCG's dividends worth EUR 43 million, while VAT revenue was revised upwards by additional EUR 10 million.
- * The consolidation measures of the 2018 budget are a sequel to the 2017 Fiscal Strategy. On the revenue side these concern an increase of the standard VAT and excises rates, and some positive fallout on municipalities' budget from the legalisation of informal construction. In the same way, the expenditure side will continue with further implementation of 2017's reforms, like the reduction of wage coefficients and salaries for several categories of public sector workers, the completion of the revision of the benefits scheme for mothers' and a marginal reduction in discretionary spending. Some new liabilities (already committed), or some new tax incentives for tourism facilities would add some marginal drag to the budget.
- * The budget is drawn up on a cash basis and not on an accrual principle. Therefore, some items like payments of commitments from previous years might derail the deficit target.

¹ Every year the government prepares the State budget while each of the 23 local self-government assemblies adopts its own budget after approval of their draft budget by the Ministry of Finance.

² This is a financing transaction which does not affect the deficit because involves the purchase of financial assets.

Table: Main measures in the budget for 2018

Revenue measures*	Expenditure measures**
<ul style="list-style-type: none"> • Increase of the standard VAT rate from 19 % to 21% (0.97 % of GDP) • Increase of excise duties on tobacco, alcohol and carbonated drinks (0.7 % of GDP) • New utilities connection fee after regularisation of informal constructions (0.10 % of GDP) • Recovery and restructuring of tax arrears (0.55 % of GDP) • Reduced VAT rates (from 21 % to 7 %) for high-category hotels (- 0.08 % of GDP) 	<ul style="list-style-type: none"> • Public sector wage reduction (-0.12 % of GDP) • Revision of the former benefit for mothers of three or more children (-0.31 % of GDP) • Reduction in discretionary spending (-0.09 % of GDP)
<p>* Estimated impact on general government revenues. ** Estimated impact on general government expenditure.</p> <p>Source: ERP</p>	

The ERP envisions further spending reduction in the outer years. As most of the measures included in the 2017 strategy have been already implemented, except for a new (albeit still symbolic) excise on coal along with some further increases in other excise duties to be introduced in 2019, the budget consolidation impact would be half a point of GDP that year, and zero in 2020. At the same time, the finalisation of the first section of the Bar-Boljare highway would enable the budget to swing into a very strong surplus of more than 5 % of GDP in 2020. This would contribute significantly (together with moderate inflation and growth rates) to bring the public debt below the fiscal rules' threshold of 60 % of GDP (unless further contingent liabilities derail the deficit targets).

Table 3:
Composition of the budgetary adjustment (% of GDP)

	2016	2017	2018	2019	2020	Change: 2017-20
Revenues	42.6	42.6	44.2	44.2	43.9	1.4
- Taxes and social security contributions	35.1	38.4	39.6	39.7	39.6	1.2
- Other (residual)	7.5	4.1	4.6	4.5	4.3	0.2
Expenditure	46.2	45.7	45.8	44.1	38.6	-7.1
- Primary expenditure	44.0	43.3	43.7	42.0	36.6	-6.7
<i>of which:</i>						
Gross fixed capital formation	2.7	7.1	8.0	7.8	3.3	-3.8
Consumption	16.3	15.6	15.8	15.2	14.8	-0.8
Transfers & subsidies	14.8	14.1	13.2	12.7	12.4	-1.7
Other (residual)	10.2	6.5	6.8	6.3	6.1	-0.4
- Interest payments	2.2	2.4	2.0	2.1	2.0	-0.4
Budget balance	-3.6	-3.1	-1.6	0.1	5.3	8.4
- Cyclically adjusted	-2.5	-2.7	-2.6	-0.2	6.1	8.8
Primary balance	-1.4	-0.8	0.4	2.2	7.3	8.1
Gross debt level	63.3	65.5	66.5	66.1	59.7	-5.8

Sources: Economic Reform Programme (ERP) 2018

Structural reforms to strengthen the sustainability of public finances are not well detailed and their fiscal impact remains unclear. The ERP briefly presents a series of reforms which are under way, including tightening the conditions for early retirement, reshaping the social protection system by amending the Social and Child Protection Law, a review of the cost of medicines, and optimising the number of employees in the public administration. However, the programme does not present any fiscal estimates for these.

Contingent liabilities appear to be the main risk for attaining fiscal adjustment targets. These liabilities have been a regular occurrence in the past, but have not been included in the ERP's medium term budget projections as they are part of the financing side of the budget (i.e. 'below the line'). The ERP assumes strong budget surpluses after 2020 due to the completion of the first section of the Bar-Boljare highway. This assumption could be at risk in case new debt-financed sections of the highway are launched before Montenegro adopts a law on public private partnerships and concessions to help mobilise private capital to support public sector investment (*see also Chapter 4, Public finance management*). Finally, one more risk would be an economic downturn triggered by external shocks on commodity prices or tourism, the latter pondered in the ERP's alternative scenario³.

The basis for improving the quality of public finances is being gradually set up. The regular occurrence of contingent liabilities, spending overruns, and budget rebalances indicate budgeting planning weaknesses. Several activities are under way to strengthen the budget regulatory framework. In October 2017, amendments to the Law on budget and fiscal responsibility formally introduced three-year budgeting (to be put into effect starting from the 2019 budget). The ERP provides for the establishment in 2019 of a new payroll management system to centrally pay out wages for public servants. In November 2017, the government adopted a decision to introduce programme budgeting by the end of 2020. Meanwhile, work on implementing ESA2010 accounting standards for government finance statistics is making slow progress.

Box: Debt dynamics

Table 4:
Composition of changes in the debt ratio (% of GDP)

	2016	2017	2018	2019	2020
Gross debt ratio [1]	63.4	65.5	66.5	66.1	59.7
Change in the ratio	-1.8	2.1	1.0	-0.4	-6.4
<i>Contributions [2]:</i>					
1. Primary balance	0.7	0.4	-0.4	-2.2	-7.4
2. "Snow-ball" effect	-2.7	-1.2	-0.8	-0.3	-0.2
<i>Of which:</i>					
Interest expenditure	2.2	2.4	2.0	2.1	2.0
Growth effect	-1.7	-2.4	-1.9	-1.7	-1.7
Inflation effect	-3.2	-1.2	-1.0	-0.7	-0.6
3. Stock-flow adjustment	0.3	2.9	2.3	2.1	1.2
<i>Memorandum item</i>					
Gross financing needs	16.8	9.3	7.1	12.7	11.8
Highway loan [3]	0.2	4.1	4.8	5.6	0.0

Notes:
 [1] End of period.
 [2] The snow-ball effect captures the impact of interest expenditure on
 [3] Includes loan and government own contribution.
 Source: Economic Reform Programme (ERP) 2018, ECFIN calculations

Sustained GDP growth and deflators are helping to contain public debt stock. The combined effect of GDP growth, and a moderate but positive inflation are set to override debt interest costs, resulting in a negative contribution from the 'snow-ball effect', eroding the nominal increase in debt. This, coupled with the end of the work on the highway in 2019, would set the public debt into a clear downward trajectory as of 2020. The debt analysis presents some stock-flow adjustment, which could be explained by the way the authorities account for the US dollar based highway loan, which it is recorded in euros using the exchange rate applied at the time of subscribing the contract, whereas each year's debt stock is recorded at the current exchange rate.

The resumption of the highway works in 2017 brought new debt, increasing the debt stock by 2 percentage points to 65.1 % of GDP by the end of the year. The structure of the debt is largely dominated by external liabilities, which make up 81.2 % of the total. Debt volatility is limited as 80 % of it presents fixed interest rates, with an average rate of 3.1 % and an average time to maturity of 4.7 years. Overall, currency risk is also limited, as some 87 % of the debt is denominated in euros. To reduce interest and exchange rate risks, the government adopted in March 2018 a decision enabling the possibility of purchasing derivatives to hedge against such risks. State guarantees accounts for 7.4 % of GDP at the end of 2017, below the fiscal rules threshold of 15 %.

³ See sensitivity analysis box below.

Authorities adopted a new Public Debt Management Strategy in March 2018. Overall, given the high level of public debt, its repayment profile (surging from 5.5 % of GDP in 2018 to 17.1 % in 2020) and the tightening of global financial conditions, it is essential to rebalance the debt structure and to minimise borrowing costs by developing a sound market strategy. Some measures of the new medium-term debt strategy have started to be implemented to facilitate the re-financing of debt, including long-term debt arrangements with financial institutions to pre-finance outstanding Eurobonds and to extend their average maturities and reduce rollover risks. The challenge represented by the sizeable budget financing needs is expected to be contained by the financing proposal for a loan received from a consortium of international banks, by the Chinese loan to finance the highway, and by an EUR 500 million Eurobond emission in April 2018. Altogether, these would cover financing needs until 2020.

Box: Sensitivity analysis and comparison with previous ERP

The ERP's low-growth scenario's assumes stagnating investment combined with a 2 % contraction in tourism revenue, weakening the fiscal position as a result. Budget revenue would contract while expenditure remains at the same level as in the baseline due to the high level of non-discretionary spending of the budget, resulting in some 0.5 % of GDP annual deterioration of budget balances each year until 2020. This higher deficit would also feed into the public debt stock, which is expected to peak at 69.5 % of GDP in 2019, instead of 66.1 % as projected in the baseline, before dropping back to 63.8 % of GDP in 2020.

The ERP 2017 baseline fiscal projections were much worse than the ERP 2018 because the fiscal strategy had not been implemented yet, projecting substantially higher budget deficits and debt (see below). In addition, the revision of nominal GDP numbers in 2017 also improved the debt-to-GDP ratios, contributing to improve the current ERP fiscal projections.

<i>(in % of GDP)</i>		2017	2018	2019	2020
ERP 2017	General Government balance	-6.1	-5.5	-3.8	--
	General Government debt	71.6	74.9	77.5	--
ERP 2018	General Government balance	-3.1	-1.6	0.1	5.4
	General Government debt	65.5	66.5	66.1	59.7

3.4. STRUCTURAL REFORMS

Structural reform needs remain concentrated on the labour market, and human and physical capital. Labour market performance is poor, characterised by high youth unemployment, low participation of women and high long-term unemployment. Active labour market policies are ineffective. More progress is needed to align education and skills with the labour market needs. There are significant transport bottlenecks, but they need to be addressed in a fiscally sustainable and transparent manner, with due attention given to network maintenance and regulatory reform. The high price and low availability of high-speed broadband is not supportive of economic growth and innovation. Local companies have poor export performance or are only focused on the local market and non-tradable sector, as well as being insufficiently integrated in international production processes. Despite ongoing work, challenges to the rule of law remain. Corruption continues to be a serious problem and the informal sector is large, creating unfair market conditions. The ERP's analysis of the bottlenecks to growth and competitiveness is broadly consistent with this.

The majority of the reform measures are appropriate to foster growth and competitiveness. Out of a total of 20 measures, 8 are new measures and 12 are rolled over. The measures that were dropped were justifiably excluded following the Commission's assessment of their relevance for competitiveness and long-term growth in 2017 or, as regards infrastructure, as a consequence of the revised ERP guidelines. The ERP 2018-2020 prioritises several regulatory and administrative measures in the area of the labour

market, transport, energy, and financial services, in place of large infrastructure measures that were dropped this year. This new focus responds to a general need to develop the country's institutional and economic framework. Similarly, the focus on private sector development and innovation, including strengthening industry and services and improving the business environment, is good as it targets key binding constraints to competitiveness and long-term growth. The two proposed measures on education and skills, while relevant, are limited to VET, and basic and higher education are not considered. The labour market and employment measures are relevant, but their implementation –according to the ERP timeline– bears risks. The area of social inclusion, poverty reduction and equal opportunities does not contain any measure, despite clear challenges. Several 2017 reforms are delayed, underlining the need for more realistic planning, risk mitigation, and close monitoring of the implementation of the structural reform agenda.

Public finance management

Weaknesses in public finance management (PFM) continue, including the lack of an effective regulatory framework for public private partnerships and concessions in line with EU rules. Several reforms foreseen in the 2016-2020 PFM reform programme are progressing on schedule, but there are considerable delays in areas requiring technical assistance. There is ongoing work on improving strategic planning, internal control, and reforming the debt management division. Significant efforts are still needed to ensure the alignment of macroeconomic and business statistics. In the area of the priority reform - public procurement – major work remains to be done, such as establishing an effective regulatory framework for public private partnerships and concessions in line with EU rules. This is delayed for several years, even though it is considered a means to potentially help finance future investments. Moreover, the June 2017 amendments to the Law on public procurement represent backsliding in terms of alignment with the EU *acquis* and hinder the smooth functioning of the system. The ERP correctly identifies the PFM challenges, which are primarily discussed in Chapter 3.

The measure to introduce e-procurement will have a positive impact on the level of competition and transparency in the use of public funds, but implementation has been delayed for the second year. The Montenegrin administration faced capacity constraints when preparing the tender documents for e-procurement. The envisaged switch to e-procurement - mandatory under EU rules - represents a major change. This needs to be well planned, efficiently implemented, and accompanied by adequate training and communication activities.

Energy and transport market reform

Montenegro has small electricity and transport markets, characterised by a significant infrastructure gap and high investment costs. They can be important drivers for economic growth to the extent that they can be fully integrated into a regional context. For this reason, the need to complete the practical opening of the markets is rightly identified as a key priority for both sectors. The priority reforms in this area are well-aligned with the connectivity reform agenda promoted by the EU. Montenegro has made considerable progress, especially in the energy sector, by implementing connectivity reforms. However, investments in renewable energy and energy efficiency are not sufficiently targeted through the ERP. Likewise, in the transport sector, inter-modality projects and improving border-crossings procedures (on the basis of the good practice established with Albania at the Hani i Hotit/Tuzi border) remain of paramount importance.

The measure to improve the regulatory and institutional framework for Montenegro's integration with the regional electricity market is directly linked to the connectivity reform agenda agreed at the 2015 Vienna Summit (under the Berlin process). It should be noted that the activities foreseen for 2018 are focused on aligning national legislation with the relevant EU *acquis*. Implementation activities are planned for 2019 and 2020, but detailed information is missing. The focus should be on the implementing legislation under the third energy package, including the auction rules for granting support

to producers of renewable energy. However, it seems realistic that this measure can be achieved given both the timeline and the allocated budget.

The measure setting up a single window for maritime transport will lead to a safer and more efficient management of port activities, making the ports more competitive. The expected impact is conditional on the successful implementation of the required IT project; this is planned to be achieved by 2023. The relevant EU Directive 2010/65, which is currently under revision with the aim to establish a European Maritime Single Window Environment, also needs to be taken into account.

The measure establishing an efficient and independent regulatory and safety authority for rail transport is a necessary pre-condition for the practical opening of the market. This reform measure consists of amendments to the Law on the Railways, which are compliant with the relevant provisions of Directive 2012/34 (recast) on a single European rail area. Responding to the May 2017 joint policy guidance, the measure will support the full opening of the rail market. The expected impact is to create a level playing field for new entrants, which in turn should increase competition, improve quality of service and sector productivity. While the measure does not have a significant budgetary incidence, the functional reorganisation, the necessary trainings and the overall strengthening of the administrative capacities are major undertakings.

Sectoral development

Montenegro's economy is dominated by services, which account for 71.9% of gross value added, while industry and agriculture make up 12.3% and 8.8% respectively in 2016. This is a consequence of the country's fast growing tourism sector and de-industrialisation.

Agricultural sector development

Agricultural development continues to be constrained by a number of challenges. These include fragmented and small parcels with high production costs, limited export opportunities, weak sector organisation, limited access to credit, and a lack of qualified labour, adequate equipment, and infrastructure. Montenegro managed to secure support of about EUR 120 million to the sector, including for food production and processing. The effectiveness of this support will need to be closely monitored and any overlap of funding programmes avoided.

The measure to invest in the food production sector to help companies achieve EU standards is essential for the agricultural sector to become more competitive. The level of public support in this area is steadily increasing, and Montenegro has prepared measures to provide more farmers with access to credit, which will help the support scheme to be effective. Montenegro is also encouraged to make faster progress in obtaining EU export accreditation for exports of animals, products of animal origin and food products. While it is important to reduce import dependency and increase exports, Montenegro identified tourism as an important market for its agricultural products.

Industry sector development

Key bottlenecks for further industrial development are low product diversification and labour productivity, underinvestment in modernisation and weak linkages between private companies and science. The production of competitive higher value added products remains limited and local industry is characterised by marginal participation in global supply chains, and low digitisation. As a first step in order to support an increased diversification and industrial modernisation, Montenegro adopted a comprehensive industrial policy. The ERP is broadly aligned to the above-mentioned obstacles to industrial development. Given the current steel and aluminium production overcapacity on world markets, the objective for base metals should be to shift towards higher quality, niche markets, and material efficiency, including metal recycling. Non-energy resource efficiency and circular economy policy planning should be considered as part of Montenegro's efforts to support industrial modernisation.

The two measures to boost industrial modernisation address a key constraint through the promotion of investments linked with job creation and the installation of new equipment. Since the introduction of the scheme in 2016, industrial investments amounting to EUR 7.2 million were supported by about EUR 1 million in subsidies. Another EUR 1.25 million financial support is included in the 2018 budget. The pilot scheme to support the purchase and installation of new industrial equipment is still receiving little interest, with only one grant provided in 2016 and four grants in 2017. Its impact on competitiveness is therefore so far limited.

Service sector development

The service sector contributes over 70 % of Montenegro's gross value added (GVA) and employs nearly three-quarters of the workforce. Of this, tourism alone provides a fifth of GVA and employs over 15 % of the workforce. One of the most important challenges is the diversification of the service sector and the dependency on tourism. The ERP does not contain an analysis of the service sector as a whole but is limited to the identification of obstacles in the tourism and banking sectors. In the tourism sector, Montenegro's effort to become a high-end tourism destination is hampered by infrastructure and accommodation issues, limited accessibility of destinations, high seasonality, and regional disparities. A number of high-end hotel facilities were put into operation in the last few years. A reduced 7 % VAT rate was introduced in January 2018 for high-end hotels' food and beverage preparation services - such reduced VAT rates are more often granted for basic consumption products, for the purpose of inclusive economic growth.

The banking sector improved its solvency and liquidity position, but corporate sector borrowing remains below pre-crisis levels. The level of non-performing loans in the banking sector has gradually declined to 7.3 % of total loans at the end of 2017, down from its peak of close to 26% in 2011. A credit registry was set up in 2008, but its scope and usage remain limited. Lending interest rates fell and private sector credit grew moderately.

The measure that seeks to diversify the tourism offer is formulated as an objective rather than as a reform with targeted activities. There is no correlation with the expected impact, which depicts tourism employment trends as a whole. However, the responsible ministry clarified its plans during a Commission fact-finding mission: it is seeking to implement a regular grant scheme to mobilise local level initiatives to make tourism in the north of the country more attractive.

The measure on strengthening the regulatory framework for prudential control and bank resolution is an accession priority that requires careful planning. The strengthened framework could foster the further resolution of NPLs by reducing systemic risks and enhancing the intermediate role of financial institutions in the economy. It should be prepared in close cooperation with relevant stakeholders.

Business environment and reduction of the informal economy

Recent progress in improving the business environment has been more incremental than qualitative, as shown by different international rankings, partly due to implementation delays. Businesses complain about the poor implementation of laws and delays in obtaining information and services. Challenges remain in SMEs access to finance and in construction, notably high permit costs, and lengthy procedures for paying taxes and property registration. Enhancing the efficiency and effectiveness of public administration and the further roll-out of e-government are important to ensure business-oriented public services. Moreover, further efforts are needed to strengthen the rule of law, including by reducing the informal sector and fighting corruption. Investors also complain about the inconsistency of case law, non-enforcement of court decisions and interferences with property rights. The ERP diagnostic recognises most of these obstacles. However, it does not identify a broader set of measures on reducing the informal economy.

The measure that introduces e-services to the land registration system seeks to speed up the issuing of land and property registration documents. The need to improve the land registry is frequently stressed by business representatives. This is also reflected in the World Bank Doing Business report, where Montenegro is ranked in 76th place on this indicator.

The measure that introduces e-fiscal invoices remains relevant for reducing the informal economy. This reform, which has been postponed for the second time, has the potential to create a better level-playing field for registered businesses and improve revenue collection. Montenegro expects a significant revenue increase of some EUR 30 million annually, but it is now expected to materialise only as of 2020 due to delays.

The two SME measures foreseen represent ongoing efforts to expand the available financial and non-financial support. In 2018, the Montenegrin Investment and Development Fund (IDF) plans to set up a guarantee and micro-credit scheme, which will help facilitate SMEs' access to finance. Montenegro also plans to build up the capacity of the seven existing SME clusters and continues to provide small grants to support them. The IDF's activities are scaled up, reaching EUR 176 million in loans and factoring arrangements in 2017 (approx. 4 % of GDP), but they continue to depend largely on external funding. The IDF's activities should be externally reviewed for their effectiveness, and impact. At the same time, only limited budgetary resources are dedicated to non-financial support. Increasing the rate of SMEs' use of regional funding instruments, such as COSME and Enterprise Development and Innovation Facility (EDIF), remains a significant challenge.

The upgrade of ICT systems for issuing construction permits has the potential to significantly shorten the time needed to issue such permits. The measure seeks to improve the functioning of one-stop shops introduced in 2012 by establishing e-services as part of the wider e-government agenda. This addresses another of the World Bank Doing Business indicators, on which Montenegro is underperforming. The measure was first presented 2 years ago, but was not implemented pending a reform of the Law on spatial planning, which was eventually adopted in October 2017. Implementing legislation for this law, which should also provide for procedural safeguards, is pending.

Research, development and innovation and the digital economy

Montenegro's low number of researchers per capita - only 20% of the EU average – is a key contributing factor to the country's lack of competitiveness in research and innovation (R&I). With a current rate of only 0.38 % of GDP invested in R&I, serious efforts are needed to reach the 2020 target of 0.6 %. Investment in higher education and university science education is particularly needed to develop a higher skilled workforce. Further key constraints that continue to hamper the country's progress in this area are: insufficient integration of the private sector, a low number of domestic innovative enterprises, and limited commercial and legal expertise in research institutions, such as on IP rights. Furthermore, the lack of part of the R&D and Innovation statistics impedes access to reliable data.

Montenegro is already taking steps to address these shortfalls, and has initiated plans to participate in the EU Innovation Scoreboard. Along with the envisaged introduction of fiscal incentives to support R&I, the development of a smart specialisation strategy will be an essential tool for identifying key measures to support competitiveness and growth. The ERP diagnostic correctly identifies some of the bottlenecks.

Montenegro needs to speed up broadband access so that its citizens can benefit from a digitalisation of the economy. Montenegro's information society strategy sets an ambitious goal of 100 % household coverage with speeds above 30 Mbit/s by 2020, whereas the current coverage is 26.5 %. It remains challenging to set conditions for meeting this goal and delivering an action plan that is implementable. Broadband alone will not provide for the economic benefits of digitalisation. It needs to be accompanied by skills development, cyber security and a conducive regulatory environment. On the latter, Montenegro is advised to take a pro-active approach on issues such as cross-border data transfers and data protection,

and to closely follow the EU digital agenda. The ERP diagnostic correctly identifies some of the bottlenecks, but falls short of identifying regulatory reforms.

The measure establishing a science and technology park in Podgorica focuses on infrastructure. Design and tendering have been delayed, as was the case with the Technopolis (a former ERP measure). This is now operational (although its labs are still to be equipped). Along with its infrastructure plans, Montenegro has an action plan, which is already budgeted, to: i) set up a centre of excellence; ii) develop a policy programme to support start-ups; and iii) boost the activity of researchers and link it to private sector needs. The action plan covers the period 2018-2020. Funding for expert support in developing a sound management structure for the science and technology park has been secured, while funds for training and equipment are taking longer to ensure.

The measure to apply a cost reduction framework for electronic communication networks will not be sufficient to achieve the targets of Montenegro's strategy in this area. In line with last year's policy guidance, Montenegro advanced its preparations for legislative alignment with Directive 2014/61/EU to reduce the cost of high-speed broadband deployment. However, a discrepancy remains between the planned entry into force of the respective national law in January 2021 and Montenegro's 2020 goal of 100% broadband availability, even if partial implementation could be envisaged earlier. An analysis of the broadband market and the existing regulatory framework to identify funding needs and tools is planned for 2019 only. The ERP does not detail any further activities in order to translate the findings of the analysis into an action plan.

Trade-related reforms

While the export of services is steadily increasing, the export of goods remains hampered by a narrow export base, a low level of diversification, and a predominance of low value-added products. There are significant gains expected from greater intra-regional economic integration. Efforts on this should include streamlining customs procedures and greater use of trade facilitation tools, such as the authorised economic operators programme. The ERP acknowledges these weaknesses, but it does not include a detailed discussion of customs procedures and trade facilitation.

The implementation of the Central European Free Trade Area (CEFTA) protocol 5 on trade facilitation will reduce transaction costs. Montenegro ranks below the EU average in trading across borders indicators. The measure addresses this through further streamlining and harmonisation of customs procedures with neighbouring countries. Finalising the negotiations on CEFTA protocol 6 on service sector liberalisation has the potential to play an important role in Montenegro's economic development. The ERP does not mention any plans to develop a national trade facilitation strategy.

Education and skills

The key obstacle to growth and competitiveness remains the skills mismatch and weak inter-institutional cooperation between education and labour market. The skills mismatch is manifested at secondary and higher education levels and stems from high transitions from vocational education and training (VET) to higher education, and to programmes that are less relevant for labour market needs. Weak performance in basic education and low investments in teacher training and transversal skills affect performance in the later stages of education. This link with basic education is not acknowledged in the ERP. Despite some initiatives – in particular at the higher education level - there are no systematic forecasting or student tracer mechanisms in place.

Most progress has been achieved in improving the VET system. Efforts were taken to integrate entrepreneurial learning as a key competence in the curricula from primary school and secondary education, including VET. New and revised curricula were introduced, accompanied by teachers training. In July 2017, the Law on VET introduced a dual education system, while promotional activities were

carried out to attract and inform students. Higher education saw the introduction of 25 % practical training and the establishment of an agency for control and quality assurance. Limited progress has been made on enrolment policies to address the root causes of the skills mismatch. Improving pre-school enrolment and the quality of basic education received less focus.

The two reform measures in the ERP in this area are relevant for improving VET and school-to-work transitions, but more efforts are needed to address the skills mismatch. Modernisation of VET programmes with the support of sectoral committees will continue, and importantly, monitoring and evaluation should be established. The implementation of the newly introduced dual education system, especially to ensure the cooperation with employers and quality apprenticeships, will be crucial. Better inter-institutional cooperation is needed, as well as stronger focus on career guidance. Poor use and application of forecasting tools for future skills and employers' needs act as an additional obstacle to matching skills with labour market needs.

Employment and labour markets

Labour market dynamics remain volatile, partly because of legislative changes in social policy in recent years. Nonetheless, both employment and activity have been improving, albeit at a slow pace. Young people, women and the long-term unemployed remain the most vulnerable to obstacles entering and remaining on the labour market. The ERP diagnostic insufficiently addresses the structural challenges, with no focus on labour demand (i.e. the lack of job creation) and deep-rooted inactivity and links with the informal economy. Further efforts are needed to strengthen linkages between the labour market and the social protection system.

After the legislative repeal of lifelong benefits for mothers with three or more children, new activation and employment support measures are yet to be outlined, in particular for young people and women. More decisive action is needed to activate the beneficiaries of social protection benefits who are able to work. This will involve in particular, investing in upskilling and reskilling, and better cooperation between employment services and social work centres to activate people.

The reform measure foresees previously planned legislative amendments, but the timing of this implementation remains uncertain. The measure consists of pursuing previously announced amendments to the Labour Law and the Law on employment intermediation and benefits during unemployment, but their full roll-out cannot be expected until 2019. The focus should also remain on reducing undeclared work and on further strengthening of labour inspection and on an incentive-based approach to formalising employment. The follow-up on previous measures is also weak. The traineeship programme for graduates seems to be having positive results. However, the implementation of other active labour market policies is not being followed up properly and there has still been no evaluation of their effectiveness. Effective counselling and employment intermediation are negatively affected by the presence of passive measures and lack of sufficient human and financial resources in employment services.

Social inclusion, poverty reduction and equal opportunities

Poor labour market outcomes are coupled with weaknesses in the social protection system, which suffers from weak services and targeting. Poverty is significantly higher in the north, compared to other parts of the country. Poverty rates are also higher for Roma, pensioners, the long-term unemployed and people with disabilities. Young people and the low skilled are also among those who face more difficulties in accessing the labour market, putting them more at risk of social exclusion. The ERP analysis is not comprehensive, reflecting the need for stronger evidence-based policy planning and stronger social statistics.

There is no specific measure on social inclusion in the 2018-2010 ERP. Nevertheless, some important actions with the potential to improve social inclusion have begun. Among these is the project to improve the cooperation between the employment agency and social welfare centres. This project's aims are to provide support for people that are hard to employ and to support their integration into the labour market. Furthermore, the Integrated Information System of Social Protection (the 'Social Card') aims to improve the efficiency and effectiveness of the administration, and the provision of social services. There are some plans to further pursue pension system reform focused on indexation and limiting early retirement, while there is less consideration on the adequacy of pensions along with prolonging working lives.

3.5. IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2017

2017 policy guidance	Summary assessment
<p>PG 1:</p> <p>Fully implement the 2017 consolidation package, and take additional fiscal measures if necessary to achieve the envisaged budget savings of around 3% of GDP.</p> <p>Adopt a comprehensive medium-term fiscal strategy with concrete revenue and expenditure measures with sustainable effects in order to stabilise public debt and reduce debt-related vulnerabilities.</p> <p>Consider establishing an independent fiscal council.</p>	<p>PG 1 has been partially implemented:</p> <ul style="list-style-type: none"> • Partial implementation: The plan for redressing public finances was adopted and implemented. The 2017 consolidation package was implemented and produced in the current budget sizeable savings over the year worth 3.1 % of GDP, but the general government deficit significantly overshot the rebalanced budget target, mostly due to one-off payment obligations. • Full implementation: A fiscal strategy with concrete revenue and expenditure measures was adopted and is being implemented according to plan. The strategy aims to stabilise the public debt ratio in 2019 and achieve a sizeable budget surplus in 2020. • No implementation: Analysis on the establishment of a fiscal council was launched but no clearly specified measure proposed.
<p>PG 2:</p> <p>Gradually reduce public spending on wages and pensions as a share of GDP.</p> <p>Ensure the availability of adequate financial resources for the implementation of new legislative measures.</p> <p>Strengthen tax revenues and review tax exemptions with a view to a further reduction of tax exemptions.</p>	<p>PG 2 has been partially implemented:</p> <ul style="list-style-type: none"> • Partial implementation: The 2017 budget execution and the 2018 budget medium term fiscal framework present each year an annual reduction of pension expenditure as a share of GDP. However, budget execution data for 2017 confirm wage expenditure (in percent of GDP) increased marginally above the plan. • Full implementation: No new legislative measures were adopted in 2017 without a fiscal impact assessment. • Limited implementation: Tax revenue has been strengthened by means of the measures contained in the plan for redressing public finances, the fiscal strategy, and the restructuring of tax arrears. However, the ERP provides a very succinct qualitative assessment of tax exemptions, and fails to present an analysis of the erosion of the tax base (in particular VAT) from foregone revenue compared to the benefits to the economy attributable to the subsidies.

<p>Adopt measures in order to facilitate debt servicing by tapping the local debt markets, extending maturities, and advancing the privatisation agenda.</p>	<ul style="list-style-type: none"> • Substantial implementation: Recourse to domestic borrowing for budget financing surged by 160 % in 2017 compared to the plan. Authorities subscribed a loan with the World Bank to cover the 2018 budget deficit, to repay maturing bonds in 2019, and a new Medium Term Debt Management Strategy was adopted and implemented in order to extend debt maturities and lowering interest rates. However, there was no further advancement with the privatisation agenda.
<p>PG 3:</p> <p>Continue efforts to foster NPL resolution by developing a comprehensive strategy to that end, including participation by all relevant stakeholders, with the aim of reducing credit risks in the banking sector and removing impediments to credit extension in the economy.</p> <p>Consider to include corporate debt restructuring and tackle other underlying structural obstacles of resolution as part of the strategy.</p> <p>Enhance prudential and banking resolution frameworks to the end of buttressing financial stability.</p>	<p>PG 3 has been partially implemented:</p> <ul style="list-style-type: none"> • Partial implementation: The central bank continued with determined actions aimed at NPL disposal and restructuring in the banking sector, which contributed to the decline of the NPL ratio. However, the impediments for NPL resolution outside the remit of the central bank as well as the high stock of NPLs held outside the banking sector have been largely unaddressed so far. • Limited implementation: Underlying obstacles to NPL resolution that remain outside the remit of the central bank (in the area of e.g. judiciary system, contract enforcement and bankruptcy procedures or obstacles to selling collaterals), have remained untouched. However, the factoring companies currently holding a large part of NPLs were incorporated into the scope of central bank supervision in late 2017, which will allow the central bank to undertake further actions aimed at the resolution of NPLs that are held outside the banking sector. • Substantial implementation: In 2017 the authorities strengthened the central bank's supervisory powers (through, inter alia, including factoring companies into the scope of the central bank's supervision) and advanced work on the framework for the recovery and resolution of credit institutions. The central bank intends to publish a macroprudential policy strategy document still in the first half of 2018.
<p>PG 4:</p> <p>Harmonise national rules with Directive 2014/61 on cost reduction measures for the development of</p>	<p>There was limited implementation of PG 4:</p> <ul style="list-style-type: none"> • Limited implementation: The drafting of a Law on measures to reduce the cost of setting up high speed electronic communications

<p>high-speed electronic communication networks.</p> <p>Ensure effective, efficient and independent rail regulatory and safety authorities to implement the full opening of the rail market.</p>	<p>networks is at an advanced stage. The law remains to be adopted and the ERP foresees a delayed implementation by 2021 only.</p> <ul style="list-style-type: none"> • Limited implementation: The Ministry established a working group in July 2017 to prepare amendments to the existing law on railways. The amendments relate to an independent regulatory and safety body. The adoption of the amended law is planned for 2018.
<p>PG 5:</p> <p>Continue to strengthen financial and non-financial support services for SMEs.</p> <p>Adopt legislation to ensure the operational independence of the state aid authority.</p>	<p>There was substantial implementation of PG 5:</p> <ul style="list-style-type: none"> • Substantial implementation: SME financial and non-financial support was expanded. Financial support channelled via IDF almost tripled since 2013, reaching EUR 176 million or approx. 4 % GDP in 2017. Non-financial support is being strengthened as a priority reform, but budgetary resources and activities should be further reinforced. • Full implementation: In February 2018, Parliament adopted amendments to the Law on protection of competition) along with amendments to the Law on state aid control. These changes provide a legal framework for the operational independence of the State Aid Authority.
<p>PG 6:</p> <p>Reform the law on social protection to ensure cost-effectiveness, better targeting of assistance and the reduction of disincentives for women to work.</p> <p>Carry out a review of active labour market policies with a view to improving their coverage and targeting the long-term unemployed, women and youth.</p> <p>Improve school-to-work transitions through work-based learning and promoting the appeal of</p>	<p>PG 6 has been partially implemented:</p> <ul style="list-style-type: none"> • Partial implementation: Montenegro repealed benefits for mothers of three and more children (providing transitory solutions for women who left the labour market). The plan is (i) to redirect social funds to those mostly in need (i.e. an increase in child benefit and one-off benefits for new-borns, the merging of personal disability allowance and the allowance for providing care and assistance to other persons) and (ii) for active labour market policies. However, the plans are unclear and have not been properly designed yet. • No implementation: The Employment Agency has yet to demonstrate that a rigorous monitoring system is in place to trace users and anticipate needs and to ensure quality of the agency's action to help its users. • Partial implementation: Legislative amendments expanded the dual model of apprenticeship with the aim of ensuring a

vocational professions.	positive impact on the quality of training and of school-to-work transitions. Results of the implementation of the dual model are yet to materialise. It will crucial to ensure and carry out continuous and proper monitoring of this.
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3.6. THE 2018 POLICY GUIDANCE

JOINT CONCLUSIONS OF THE ECONOMIC AND FINANCIAL DIALOGUE BETWEEN THE EU AND THE WESTERN BALKANS AND TURKEY

The Economic and Financial Dialogue between the EU and the Western Balkans and Turkey

Brussels, 25 May 2018

[...]

In light of this assessment, Participants hereby invite Montenegro to:

1. Fully implement the July 2017 fiscal strategy. Take additional fiscal measures if necessary to achieve the debt and deficit targets as outlined in the 2018 ERP. Establish adequate budget allocation to accommodate contingent liabilities related to unfavourable court cases. Prepare an options paper on the establishment of an independent body for fiscal oversight for further consultation with stakeholders, including the EU.
2. Gradually reduce public spending on wages and pensions as a share of GDP. To this end, implement the new optimisation plan of the public administration reform, including local self-government and public institutions, and prepare pension reforms that would change the valorisation and indexation of pensions and tighten eligibility for early retirements.
3. Continue efforts aimed at NPL resolution and corporate debt restructuring, focusing also on loans held outside the banking sector and underlying obstacles outside the remit of the central bank. Establish a framework for the recovery and resolution of credit institutions. Consider conducting asset quality reviews in the banking sector and options for enhancing the emergency liquidity assistance framework. Enhance the accountability and transparency of macroprudential policy by publishing a document outlining the central bank competences, objectives and instruments in this area.
4. Based on a mapping of infrastructure and analysis of market interests, develop a comprehensive action plan on broadband roll out and coverage, and implement the broadband cost reduction measure in line with EU Directive 2014/61. Ensure the collection and delivery of statistical data on research and development, and innovation. Develop a model for the introduction of fiscal incentives for the research and innovation sector in line with EU state aid rules.
5. Adopt legislation on concessions and public private partnerships in line with EU rules and best practices accompanied by an action plan for institutional capacity building in this area. Ensure effective, efficient and independent rail regulatory and safety authorities to implement the full opening of the rail market.
6. Review active labour market policies in order to improve their coverage and effectiveness, in particular for youth, women and the long-term unemployed. Ensure better coordination between employment activation measures and social benefit schemes. Increase enrolment in vocational and higher education corresponding to labour market needs.

ANNEX: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The Economic Reform Programme for the period 2018-2020 was adopted by the Government of Montenegro on 25 January 2018 and was submitted to the Commission on 31 January 2018. The programme is in line with the Medium-Term Budgetary Framework and the Budget Law.

Inter-ministerial coordination

The preparation of the 2018 ERP was centrally coordinated by the Office of the Prime Minister and the Ministry of Finance. An inter-ministerial working group involving all relevant Ministries contributed to Chapter 4. Montenegro established a high-level competitiveness council, chaired by the Prime Minister, to monitor the implementation of the ERP priority reforms and of the joint policy guidance.

Stakeholder consultation

The draft ERP was subject to an online public consultation between 15 December 2017 and 5 January 2018. A roundtable discussion with the stakeholders took place on 27 December 2017. The comments are included in the ERP, including how these were taken on board. The draft ERP was presented to the parliamentary committee for economy, finance and budget, attended however only by the deputies from the ruling coalition.

Macroeconomic framework

The programme presents a clear and concise picture of past developments. Data coverage has improved and includes more detailed analysis on potential growth, external debt and productivity. However, data on the net international investment position is not yet available. The macroeconomic framework is sufficiently comprehensive and coherent. The baseline macroeconomic scenario is plausible, albeit slightly below the forecasts of international institutions. Major uncertainties and risks are not always clearly outlined and recognised or even absent as in the case of the possible continuation (announced by the government but not in the ERP) of the Bar-Boljare highway works beyond 2019. The programme also presents an alternative macro-fiscal scenario with a lower growth path.

Fiscal framework

The fiscal framework is based on the presented medium-term macroeconomic scenario and is sufficiently comprehensive and integrated with the overall fiscal policy objectives, the state budget and fiscal strategy. Revenue and expenditure measures are explained clearly. However, important measures like the 40% buyback of the electric power company, or increasing the budget borrowing threshold were not included in the ERP. The programme does not present long-term projections of population trends and of the implications on health and pension systems. Further efforts would be needed to ensure ESA 2010 compatibility of fiscal data. Some discrepancies still remain between figures in the text and in some tables.

Structural reforms

The structural reforms sections (4, 5 and 6) follow the guidance note. The reporting of the implementation of the policy guidance and the structural reform measures from the 2017-2019 ERP is both sufficient and up-to-date. The number of reform measures is limited to 20 and the page limit for section 4 is respected. The structure of the reform measures is good, in terms of scope and clarity of timeline and to some extent in terms of budget for activities planned in the three years of the programme. However, several measures have long implementation periods (e.g. measures 15, 16) spread over 5 to 6 years. Table 9 is lacking data, while tables 10-11 of the annex are filled in appropriately.

4. SERBIA

4.1. EXECUTIVE SUMMARY

Economic growth is forecast to pick up markedly. Weather-related supply shocks trimmed growth to just below 2 % in 2017, well under initial expectations. However, economic expansion gathered pace in the second half of the year, supported by stronger investment. Economic expansion is expected to continue in the following years, mainly on the back of recovering private and public consumption. Although growing aggregate demand would drive prices up, inflation is forecast to stay close to the central bank target. Foreign direct investment is expected to remain large and to fully cover the current account deficit. Financial sector indicators improved but there are still pockets of vulnerability, in particular in some state-owned banks.

Fiscal policy is projected to turn expansionary. In the 4 years from 2014 to 2017, the general government budget moved from a very high deficit to a surplus. The 2018 budget is conservative and contains significant buffers but could have been more ambitious in addressing some legacy issues from the crisis. The medium-term budget deficit target of 0.5 % of GDP is sufficient to ensure fiscal sustainability and further reduction of government debt, which is still relatively high at above 60 % of GDP. Total expenditure is set to decline further but its composition is expected to become more supportive of growth. The success of budget consolidation, however, masks an unfinished reform agenda for the public sector.

The main challenges in these respects include the following.

- **Maintaining a proper macroeconomic policy mix and continuing difficult structural reforms remain demanding.** The baseline macro-fiscal scenario is premised on continuing economic reforms that should reduce fiscal risks and further support both public and private investment. Striking the right policy mix may be more difficult now that the programme with the International Monetary Fund (IMF) has expired.
- **Weak fiscal rules and incomplete reforms do not sufficiently support debt sustainability.** Government debt is still high and fiscal risks are elevated as key public sector reforms remain unfinished. Fiscal rules are weak, not binding and remain largely irrelevant for policy making. As gains in revenue collection have been instrumental in stabilising public finance, safeguarding them would necessitate further improvements to the tax administration on the basis of its recently updated transformation programme.
- **There is significant scope to improve the composition of government expenditure.** The economic programme expects lower payments on activated guarantees, on some transfers, and on interest expenditure over the medium term, channelling part of the savings towards increasing capital expenditure. Making budgetary spending more growth friendly would also require keeping a lid on wage and pension expenditures and strengthening the capital expenditure execution process.
- **Incomplete restructuring and privatisation of state-owned enterprises still poses a risk.** Non-performing loans and other performance indicators remain worse in state-owned banks. The privatisation and restructuring of state-owned enterprises continued to face delays, which are most critical in the energy sector.
- **Stepping up capital expenditure with a better system of planning and execution.** Serbia should develop a single mechanism for prioritising and monitoring all investments regardless of the source of financing, as provided for in the public finance management (PFM) reform programme. Public support to companies should seek a better balance between the current

limited support to domestic small and medium-sized enterprises (SMEs) and generous state aid to incoming foreign direct investment.

- **The business environment has improved but remains costly with unfair competition coming from the public and the informal sector.** There was no progress on regulating parafiscal charges. Own resources remain the principle funding for SMEs. Trade integration with the EU is growing, but remains hindered by many non-tariff barriers, especially in the phytosanitary area.
- **Youth and women did not sufficiently benefit from the positive labour market trends in 2017.** More substantive labour market reforms and increased investments in active labour market policies are needed to support access to employment for the large pool of unemployed, also with regard to the longer-term shrinking of the workforce. Education reforms need to be pursued vigorously and in concertation with all stakeholders.

The policy guidance jointly adopted at the Economic and Financial Dialogue of 23 May 2017 has been partially implemented. The 2017 budget was in surplus, significantly above the initially planned deficit. While most of the available additional fiscal space was used to further reduce the deficit in 2017, the execution of capital expenditure underperformed. There were no administrative or legal measures taken to address the recommendation to strengthen fiscal rules and the economic reform programme (ERP or ‘the programme’) does not include any plans or a timeline for it. The reform of state-owned enterprises advanced, albeit unevenly, while transformation of the tax administration proceeded with the introduction of risk management, but there were delays in other areas. While the monetary policy stance was in line with achieving the inflation target, limited steps were taken to restructure and privatise state-owned banks. The management of public projects has improved, but public investment remains relatively low and below the needs of both public and private operators. The single project pipeline for infrastructure investment is not yet in place. Regulatory dialogue with businesses should be further improved, especially on taxation. Parafiscal charges remain unregulated despite years of dialogue on the issue. Introduction of new financial instruments does not follow the needs of SMEs. The reduction of non-wage labour cost has been marginal and was not specifically targeted at the lower sections of the wage distribution.

The ERP partially matches the reform priorities identified by the Commission. The macroeconomic and fiscal frameworks are sufficiently comprehensive and coherent, providing a good basis for policy discussions. The structural reform part of the ERP remains largely unchanged from last year. The ERP proposes a set of measures to boost fiscal performance. It continues with the restructuring of publicly-owned operators in the energy and transport markets. The programme is strongly focused on the business environment, especially on the reduction of red tape. Reforms in education, employment and social policies are mostly prolonged up to 2020, thus beyond the three-year timeframe aimed for.

4.2. ECONOMIC OUTLOOK AND RISKS

Economic growth is forecast to pick up markedly. In 2017, weather-related supply shocks trimmed growth to just below 2 %, well under initial expectations. However, economic expansion gathered pace in the second half of the year, supported by stronger investment. Economic expansion is expected to continue in the following years, mainly on the back of recovering private and public consumption, reaching 4 % in 2020. Domestic demand is set to increase steadily, while growth contributions from net exports remain marginal and negative throughout most of the period covered by the programme. Decelerating from double-digit levels, export growth is nonetheless forecast to continue to be a major driver of economic activity. On the supply side, the industry (including construction) and service sectors are expected to be the main drivers of growth.

The macroeconomic scenario is premised on the continuation of economic reforms. It also assumes a benign external environment and the attraction of further significant foreign direct investments in tradable sectors. The baseline scenario is plausible, although it is slightly more optimistic than the latest European Commission forecast from autumn 2017. Contrary to previous years, economic growth is likely to be supported by an expansionary fiscal policy. The ERP expects the negative output gap to close and even turn slightly positive by 2020 as the economy grows above its potential.

Table 1:

Macroeconomic developments and forecasts

	2016		2017		2018		2019		2020	
	COM	ERP	COM	ERP	COM	ERP	COM	ERP	COM	ERP
Real GDP (% change)	2.8	2.8	2.0	2.0	3.3	3.5	3.5	3.5	n.a.	4.0
<i>Contributions:</i>										
- Final domestic demand	2.0	2.1	2.6	2.4	3.3	3.4	3.6	3.7	n.a.	4.4
- Change in inventories	0.3	0.5	0.0	0.0	0.0	0.0	0.0	0.0	n.a.	0.0
- External balance of goods and services	0.5	0.2	-0.6	-0.4	0.0	0.1	-0.1	-0.2	n.a.	-0.4
Employment (% change)	5.6	4.4	3.2	2.9	2.0	1.4	2.1	1.4	n.a.	1.6
Unemployment rate (%)	15.3	15.9	13.5	13.6	11.6	11.6	9.5	10.0	n.a.	8.1
GDP deflator (% change)	2.5	2.5	2.8	2.8	3.0	2.8	3.0	2.8	n.a.	3.0
CPI inflation, annual average (%)	1.1	1.1	3.2	3.1	3.3	2.7	3.0	2.8	n.a.	3.0
Current account balance (% of GDP)	-4.0	-3.1	-5.4	-4.6	-5.7	-4.2	-5.8	-4.1	n.a.	-3.9
Budget deficit (% of GDP)	-1.3	-1.3	0.8	0.7	0.0	-0.7	0.0	-0.5	n.a.	-0.5
Government debt (% of GDP)	72.5	73.0	64.9	63.7	63.9	62.8	61.5	59.8	n.a.	56.3

Sources: Economic Reform Programme (ERP) 2018; Commission autumn 2017 forecast

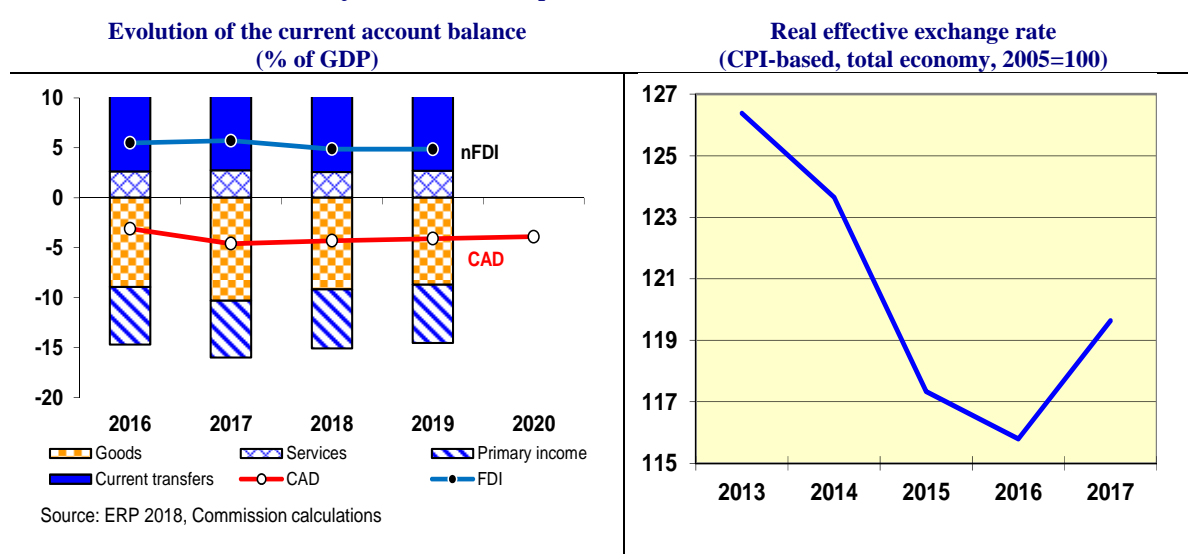
Risks remain elevated. The main challenges to the growth scenario are clearly outlined in the programme. Domestically, they are linked to the pace of implementation of structural reforms, in particular further improving the performance of state-owned enterprises and reforming the public administration. These reforms have also an important signalling effect about the authorities' commitment to the process of modernising the economy. As a result, they affect the country risk premium. In addition, maintaining a proper macroeconomic policy mix and continuing difficult structural reforms will represent a challenge, as the three-year Stand-By Arrangement with the IMF was successfully concluded in February and fiscal rules remain weak and largely irrelevant. Externally, developments in the EU, which

is the main export market and source of most of Serbia's foreign investment, exert a major influence on the country's economy. As economic growth largely depends on capital flows, risks also stem from the impact on them of monetary policy adjustments by the European Central Bank and the Federal Reserve.

In view of these risks and uncertainties, the ERP presents an alternative, pessimistic scenario. It envisages lower economic growth by 1.5 pps on average in comparison to the baseline scenario. There are very few details, however, on the precise assumptions underlying the alternative scenario and their impact on the various demand components.

Inflation is forecast to stay close to the central bank target of 3 %. As expected, in 2017 inflation slightly increased and entered the new tolerance band¹, averaging 3.2 % for the year as whole. The relatively stable price dynamics for a fourth year in a row and persistently strong fiscal performance created room for additional monetary policy relaxation. Cuts in the key policy rate resumed in the autumn when it was lowered in two steps of 25 basis points each, to 3.5 %, followed by another 25 points cut in March. Short-term price pressures remain contained, also in view of the fall in imported inflation due to a strong appreciation of the dinar. The high pass-through effect from the exchange rate remains a key price-setting factor and in order to prevent excessive daily exchange rate oscillations the central bank intervened regularly on the foreign exchange market. Over the medium term, rising aggregate demand is expected to push inflation up, while forecast uncertainty is mainly related to movements in primary commodity prices and policy decisions by major central banks.

Graph 1: External competitiveness and the current account



Views diverge on the direction of the current account deficit. The ERP envisages that the current account deficit will start shrinking again after going up in 2017, falling to 3.9 % of GDP by 2020. The main driver behind its reduction is expected to be a robust export performance on the back of continued foreign direct investment inflows in manufacturing and other tradable sectors. In parallel, a pick-up in investment activity and consumption should sustain import growth, and primary income outflows would increase further, along with rises in non-resident investment. While both these trends are recognised in the programme, it has a rather benign evaluation of their magnitude, which together with expectations of more favourable terms of trade, leads to a lower current account deficit than forecast by the Commission. Due to the envisaged deterioration of the public savings-investment gap, the forecast reduction of the

¹ In view of low inflation and inflation expectations, the central bank reduced its inflation target by 1 pp. to 3% ± 1.5 pps as of 2017.

current account deficit would require a narrowing private-sector gap, which does not seem plausible in an economic scenario based on higher investment and consumption growth.

Attracting foreign direct investment in tradable sectors is crucial for external sustainability and improving competitiveness. Although price and cost competitiveness indicators worsened in 2017, export performance remained solid. Past reforms and foreign direct investment in export-oriented sectors have sustained further improvements in structural competitiveness. This was attested by Serbia's progress in various international rankings, albeit at a slower pace than in previous years. In the last 3 years, foreign direct investment not only contributed to expanding the production base but also fully covered the current account deficit. This is expected to persist over the programme period. The net international investment position is forecast to remain negative at above 100 % of GDP. However, external buffers are set to remain sound as foreign exchange reserves cover around 6 months' worth of imports and close to three times the short-term external debt at residual maturity.

Financial-sector indicators improved but there are still pockets of vulnerability. Commercial banks remained highly liquid and well-capitalised, and their profitability increased. Lending activity accelerated last year, supported by lower borrowing costs and easing credit standards. Credit to households, in particular cash loans, grew faster than other segments. Progress with the strategy for non-performing loans and the mandatory write-off of fully provisioned impaired loans helped lower the gross non-performing loan ratio to 9.8 % by the end of 2017. The results, however, were uneven and less pronounced in state-owned banks where there is still a large overhang of bad loans. Privatisation plans for state-owned financial institutions have been delayed amid persistent governance issues in the sector, which the ERP fails to address. In the last 2 years, overall deposit and loan dinarisation increased, albeit from very low levels. Financial stability was supported by the introduction of Basel III standards in 2017.

Table 2:

Financial sector indicators

	2013	2014	2015	2016	2017
Total assets of the banking system, EUR million	34 378	34 618	35 655	36 992	37 714
Credit growth	-4.4	3.1	2.9	2.5	1.9
Deposit growth	3.3	7.6	6.5	11.4	3.3
Loan to deposit ratio	1.2	1.1	1.1	1.0	1.0
Financial soundness indicators					
- non-performing loans	21.4	21.5	21.6	17.0	9.8
- total provisions to gross NPLs	113.8	114.5	114.2	118.9	133.3
- regulatory capital to risk weighted assets	20.9	20.0	20.9	21.8	22.6
- liquid to total assets	38.5	35.6	34.3	36.9	36.7
- return on equity	-0.4	0.6	1.6	3.4	10.6
- forex loans to total loans*	70.9	70.0	71.9	69.3	67.5

Sources: ERP 2018, National Central Bank, DataInsight

* Includes both denominated and indexed positions.

4.3. PUBLIC FINANCE

For the first time in more than a decade the budget was in surplus. In the 4 years from 2014 to 2017, the general government budget turned from a deficit of 6.6 % of GDP to a surplus of 1.2 % of GDP². Last year's outcome outperformed by far the initial budget deficit target. As in the previous 2 years the better than expected result was mainly driven by strong revenue performance. Although a drought in the summer of 2017 undermined economic activity, it mainly affected agriculture, which is comparatively less taxed. On the other hand, positive developments in the labour market boosted consumption and labour tax bases and, aided by some one-offs, revenue collection improved across the board. This created space for the payment of bonuses for some public-sector employees and one-off payments to pensioners at the end of the year.

Table 3:

Composition of the budgetary adjustment (% of GDP)

	2016	2017	2018	2019	2020	Change: 2017-20
Revenues	43.2	43.9	42.4	41.8	41.2	-2.7
- Taxes and social security contributions	37.1	38.3	37.2	36.9	36.5	-1.8
- Other (residual)	6.1	5.6	5.2	4.9	4.7	-0.9
Expenditure	44.5	43.2	43.1	42.3	41.7	-1.5
- Primary expenditure	41.4	40.5	40.6	40.0	39.6	-0.9
<i>of which:</i>						
Gross fixed capital formation	3.3	3.0	3.6	3.7	3.7	0.7
Consumption	16.5	16.6	16.8	16.8	16.7	0.1
Transfers & subsidies	19.4	18.5	18.1	17.8	17.5	-1.0
Other (residual)	2.2	2.4	2.1	1.7	1.7	-0.7
- Interest payments	3.1	2.7	2.5	2.3	2.1	-0.6
Budget balance	-1.3	0.7	-0.7	-0.5	-0.5	-1.2
- Cyclically adjusted	-1.2	1.0	-0.5	-0.4	-0.6	-1.6
Primary balance	1.8	3.4	1.8	1.8	1.6	-1.8
Gross debt level	73.0	63.7	62.8	59.8	56.3	-7.4

Sources: ERP 2018, Commission calculations.

The budget consolidation success masks an unfinished reform agenda. While the good fiscal results are undoubtedly a significant achievement, sustaining them would require completing key public-sector reforms. Among them, restructuring and privatising state-owned enterprises, in particular in the petrochemical, transport, mining and energy sectors, remain of utmost importance in order to decrease contingent liabilities and remove a major source of fiscal risk. Delays in public administration reform need to be addressed in order to improve the quality and sustainability of public services. As gains in revenue collection have been instrumental in stabilising public finance, safeguarding them would necessitate further improvements in the tax administration on the basis of its recently updated transformation programme. Furthermore, the existing significant public infrastructure gaps and deficiencies in the preparation and execution of public capital projects would have to be tackled, so as to ensure that the available fiscal space is used in a productive and efficient manner.

² The text comments on the actual execution data for 2016, which differ from those in the ERP.

Fiscal policy is projected to turn expansionary. The medium-term budget deficit target of 0.5 % of GDP is sufficient to ensure fiscal sustainability and further reduction of government debt. However, this target, in combination with the expected closure of the output gap, would mean shifting the fiscal stance from pro-cyclical and restrictive to pro-cyclical and expansive. The fiscal expansion is expected to be predominantly driven by a steady decline in the revenue share in GDP, in particular non-tax, excise duties, and corporate tax revenue. Most of this decline is due to expiration of the one-offs that have boosted results in 2017, as well as to noticeably conservative revenue estimates, which points to the existence of potentially sizeable implicit buffers within the indicated deficit targets. Following a marginal reduction in the personal income tax burden in 2018, there are no other tax policy changes envisaged over the period covered by the programme.

Total expenditure is set to decline further but to become more supportive of growth. The level of government spending is high and the share of productive expenditure remains low. The ERP foresees remedying this by decreasing payments on activated guarantees, on some transfers, and on interest expenditure over the medium term, channelling part of the savings towards increasing capital expenditure. In addition, although this was not explicitly identified as in the previous programme, the authorities have signalled their intention to use any potentially available fiscal space to further boost investment spending. Expenditure on employees and on pensions is expected to stabilise at 9.5 % of GDP and 11.0 % of GDP, close to their respective levels in 2017.

Box: The 2018 budget

Parliament adopted the 2018 republican budget on 15 December 2017.

The general government deficit target is RSD 32.0 billion (0.7 % of GDP). Besides an increase in the non-taxable threshold for the personal income tax, there are no other major tax policy changes. On the expenditure side, despite falling interest payments, wage and pension hikes and a sizeable increase of capital expenditure are planned to keep the overall spending share in GDP broadly unchanged.

Table: Main measures in the 2018 budget*

Revenue measures		Expenditure measures	
<ul style="list-style-type: none"> Increase in personal income tax non-taxable threshold from RSD 11 790 to RSD 15 000 (-0.2 % of GDP) 		<ul style="list-style-type: none"> Targeted wage increase (0.7 % of GDP) 5 % pension hike (0.5 % of GDP) Increase in capital expenditure (0.8 % of GDP) 	
Total revenue effect	(-0.2 % of GDP)	Total expenditure effect	(2.0 % of GDP)

* Estimated impact on general government revenue and expenditure.

Source: ERP 2018

The 2018 budget is conservative. It is built on the basis of prudent revenue estimates, reflecting forecast dynamics of respective tax bases but without fully taking into account better outcomes in 2017. As in previous years, any possible gains due to improved tax collection and reduction of the informal economy are also not included. The budget contains some buffers on the expenditure side, although not explicitly. For example, investment expenditure has been increased by close to 30 % over the previous year, which given its poor implementation record and deficiencies in the capital budgeting process is likely to result in budget savings due to under-execution. Therefore, under the baseline macroeconomic scenario, the planned deficit of 0.7 % of GDP could be again easily outperformed.

The budget could have been more ambitious in addressing legacy issues. Most of the available fiscal space was used for targeted increases of public-sector wages and a 5 % rise in pensions. However, delaying the public administration reform has triggered another extension of the cumbersome partial employment freeze in the public sector. In addition, the budget did not remove the progressive cuts to

pensions and public sector employees' salaries that were introduced in 2014 on a temporary basis in response to the fiscal crisis. Maintaining the reductions might create potentially significant implicit liabilities.

There is a clear understanding of major fiscal risks and their potential budgetary and economic implications. The section on fiscal risks is one of the most extensive and detailed in the programme. A cluster of risks is associated with the functioning of public enterprises. Some of them, like those related to already issued guarantees or to foregone budget revenue and potential assumption of liabilities, have declined as a result of previous policy measures and the improved financial performance of state-owned enterprises. Nevertheless, these risks remain significant and, coupled with other sources of risk stemming from court decisions and deposit insurance, require close attention and prudent management. The programme is also upfront in acknowledging risks from natural hazards and disasters. However, given the gravity of this risk, the devastating impact of the 2014 floods and the unstable performance of a key sector like agriculture due to its sensitivity to weather conditions, the analysis and mitigating policies could be strengthened further. As in previous years, the programme fails to mention possible restitution-related obligations of up to EUR 2 billion or some 5 % of GDP that the government is legally required to issue already in 2018.

The alternative fiscal scenario does not sufficiently reflect all risks. The ERP presents a sensitivity analysis, estimating that 1 pp. lower economic growth would lead to 0.36 % of GDP higher budget deficit. In view of the high foreign currency-denominated government debt and debt service costs, the programme also traces the channels through which inflation impacts the budget and flags the relevance of exogenous factors like the exchange rate and interest rates. On the basis of the alternative macroeconomic scenario, the programme also outlines a fiscal path with a bigger deficit and slower pace of government debt reduction. However, the alternative fiscal scenario is still too benign and does not sufficiently take into account the numerous risks facing the budget and the high revenue volatility.

Low budget deficits should keep government debt and interest payments on a downward path over the medium term. After it reversed its growing trend in 2016, government debt fell markedly last year, helped by a high primary surplus and a strong appreciation of the dinar, especially against the US dollar. Although primary surpluses are planned to decline significantly over the programme horizon, they would remain a key debt-reducing factor, overtaken in importance only in 2020 by the so called 'snow-ball' effect capturing the impact of the differential between interest rates and nominal growth. As a consequence of lower primary surpluses, the pace of government debt reduction is forecast to slow down, especially in 2018 when the stock-flow adjustment is expected to contribute positively to debt. The envisaged fiscal stance would, nevertheless, support further reduction of government debt and interest payments.

There are downside risks to the debt trajectory. Despite declining under the baseline scenario, government debt and interest costs are forecast to remain high, reaching 56.3 % of GDP and 2.1 % of GDP in 2020 respectively. Gross financing needs (defined as the sum of new deficits and maturing debt) as a share in GDP, although falling as well, would stay in the double digits. Due to the high share of foreign currency-denominated debt, nearly four fifths of the total, government debt dynamics is highly sensitive to fluctuations of the dinar exchange rate. The government debt-to-GDP ratio could even potentially increase temporarily in 2018 if restitution-related bonds are issued or some of the other underlying budget assumptions turn out marginally worse. This possible setback, along with other risks related to the unfinished reform agenda, call for using excess revenue and possible under-execution of some budget expenditure to support a more prudent fiscal stance of close to a balance or in surplus, especially in 2018. This is also warranted given the better budgetary outcome in 2017 and the planned strong pro-cyclical fiscal expansion. Looking forward, existing fiscal rules should be strengthened by making them more binding and relevant for policy making, given also the loss of an important external fiscal anchor following the expiry of the IMF programme.

Box: Debt dynamics

Table 4:
Composition of changes in the debt ratio (% of GDP)

	2016	2017	2018	2019	2020
Gross debt ratio [1]	73.0	63.7	62.8	59.8	56.3
Change in the ratio	-3.0	-9.3	-0.9	-3.0	-3.5
<i>Contributions [2]:</i>					
1. Primary balance	-1.8	-3.4	-1.9	-1.8	-1.6
2. 'Snow-ball' effect	-0.7	-0.6	-1.2	-1.4	-1.8
<i>Of which:</i>					
Interest expenditure	3.1	2.7	2.5	2.3	2.1
Growth effect	-2.0	-1.4	-2.1	-2.1	-2.2
Inflation effect	-1.8	-1.9	-1.7	-1.7	-1.7
3. Stock-flow adjustment	-0.4	-5.3	2.2	0.3	-0.1

[1] End of period. In accordance with the Budget System Law, this includes all government-guaranteed debt and non-guaranteed local government debt. It differs from government debt according to the national methodology (Public Debt Law), which does not include non-guaranteed local government debt.

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

Source: ERP 2018, Ministry of Finance; Commission calculations.

The government debt-to-GDP ratio fell by close to 10 % of GDP in 2017. More than half of this decline was due to the appreciation of the dinar against the euro and the US dollar. The continuing strong fiscal performance, which brought the primary surplus to nearly 4 % of GDP, was the second important factor behind the steep debt reduction last year. Debt-reducing effects from real GDP growth and inflation also helped, more than offsetting the impact of the still high interest payments. Together with maintaining primary surpluses, they are forecast to contribute to a further decline of government debt over the period covered by the programme. Restitution-related debt and potential privatisation (concession) receipts, not included in this scenario, could significantly impact debt dynamics as well.

4.4. STRUCTURAL REFORMS

The low level of public and private investment is a main bottleneck to competitiveness in the Serbian economy. While the fiscal consolidation was successful, there were delays in the implementation of much-needed structural reforms due to a lack of sufficient determination in this area. There is mismanagement of public enterprises, in particular in the energy sector. Government support to foreign direct investment has gone up, while support to domestic companies remains low. The business environment remains unpredictable with only a limited amount of services and financial instruments available to companies. State aid continues to escape proper control, which impacts negatively the budget and erodes fair competition. In addition, the education system does not fully address the large skills mismatch. Overall, Serbia needs to show more determination to implement reforms to better support the private sector and ensure public finance sustainability. The ERP contains a realistic analysis of the key obstacles to competitiveness, growth, employment and social development.

The structural part of the ERP remained stable with 14 out of 18 measures rolled over from the previous programme. The measures proposed respond to the obstacles, but they are often modest given the real structural challenges. Contributions from the budget are provided for in all measures. However,

the methodology for establishing these contributions varies from measure to measure and is not a reliable indicator of commitment. The Commission assessment of the ERP has been progressively taken into account over the years. In particular, in transport and energy there is a slow shift from a focus in investment to structural reforms. The programme would have benefited from more market economy oriented reforms, which may not have significant funding needs but would improve the overall economic framework and socioeconomic outcomes. Looking forward, the next generations of the ERP should take into account that the situation in Serbia has changed since the first programme was adopted. Future measures should be more ambitious in order to better support private investment and job creation.

Public finance management

Increasing public investment and supporting growth strongly depends on continued reform of the budget process and increased efficiency of the tax administration. The tax collection improved as the tax administration, which has been mismanaged over the years, reorganised and became less tolerant towards the grey economy. The level of revenues has been going up faster than economic growth. Despite these changes, the tax administration remains a vulnerable part of the civil service with severe human resource problems. The unpredictable taxation system and the level of taxation of lower end salaries are repeatedly cited by the business community as one of the weakest aspects of the business environment. In addition, economic growth has been undermined by persistent under-execution of government investment spending, as some projects are not well prepared and cannot be implemented in time. Both at state and municipal level, the investment rates are the lowest in the region.

There has been limited progress on the implementation of the measure to transform the tax administration. An assessment on the strengths and weaknesses of the tax administration was carried out by the IMF in 2016 under its Tax Administration Diagnosis Assessment Tool (TADAT) and provides valuable guidance on the way forward. A system of risk analysis directed towards sectors and tax payers with higher probability of tax evasion has been prepared and needs to be effectively put in place. The key goal of the first ERP measure is to continue increasing tax revenues; therefore it proposes only revenues as a monitoring indicator. However, the indicators should address also other issues, which the diagnostics recognises as long term challenges, such as the need to train and retain the most valuable human resources, to channel resources to core tasks and to stop deploying them to non-core administrative activities. The latter is a pending recommendation of the EU Serbia economic policy dialogue from previous years.

The measure to improve public capital expenditure management and execution remains hampered by weaknesses in budgeting, planning and contract oversight. In 2017, public investment underperformed again, staying below the budgeted level of 3.3% of GDP. At 3% of GDP, government investment spending was significantly below the economy's needs and the lowest in the region. To improve this situation, a new decree regulating how ministries propose and execute projects was adopted. As the next step, the ERP proposes a very unambitious measure to establish an inter-ministerial database, which would include all projects. Serbia should step up the ambition, also by developing a single mechanism for prioritising all investments regardless of the source of financing, as provided for in the public finance management reform programme adopted by the government. The ERP diagnostic correctly detects that a significant share of public investment is financed from municipal budgets. However, the current measure does not address issues at local level, which are often even more problematic than those at state level.

Energy and transport market reform

The state of energy and transport infrastructure continues to be an obstacle to economic development and regional trade integration. Underdeveloped transport infrastructure coupled with a non-harmonised regulatory framework result in high transport costs and low levels of trade integration within the Western Balkans and with the EU. An underdeveloped electricity and gas transmission

network and not sufficient level of interconnectivity render the energy market inefficient and its contribution to economic development limited.

The ERP identifies many of the weaknesses and challenges in both sectors. It rightly points to the need to increase investments in infrastructure and strengthen capacities in order to implement energy and transport market reforms effectively. Regarding transport, more emphasis is put on regulatory reforms which continue to be implemented steadily. On energy, the ERP analysis is weak. Serbia needs to transform its energy sector and make it more environmentally sustainable on its path towards full EU membership. The magnitude of the necessary changes is not sufficiently reflected in the ERP's diagnostic. Moreover, the presentation of the regulatory framework is not entirely correct. The unbundling of state-owned enterprises has not been finalised. The current monopolistic situation blocks market development, in particular in the gas sector.

On energy, the measure rightly highlights the Trans-Balkan Corridor and the Niš-Dimitrovgrad gas pipeline as Serbia's priority energy infrastructure projects. Increased regional integration and connectivity with the EU will positively impact on Serbia's economic development. However, more importantly, the programme should introduce concrete measures to advance restructuring of public energy enterprises and reform tariffs to make Serbia's energy sector more efficient. EU accession requires large investments to upgrade Serbia's energy sector and meet environmental standards. Tariffs which reflect these costs will stimulate much-needed investment in energy efficiency. Both will help modernise Serbia's economy, create new jobs and business opportunities and support the achievement of its climate objectives.

The two measures on improving the transport market are welcome. The planned improvement in the capacity and quality of transport infrastructure and services rightly focuses on activities to enhance road infrastructure safety as required in TEN-T network standards. On rail, Serbia's plans to continue prioritising railway sector reforms are adequate, allocated with sufficient resources and, in line with the objective of progressive integration in the European rail transport market. However, adoption of the 2016-2025 transport strategy including a framework for introducing intelligent transport systems (ITS) for road and railway transport is overdue. Concrete measures supporting ITS and the multimodal dimension of transport are also needed.

Sectoral development

Agricultural sector development

The challenges facing the agriculture sector are land fragmentation, low productivity due to outdated technologies, small economic size and low utilisation of agricultural land per farm. While diagnosis in the ERP recognises the main agricultural challenges, it does not address further alignment of food safety, veterinary and phytosanitary regulations with EU standards, necessary strengthening of competent authorities in those areas, and a need for improved risk analysis and risk-based performance of border inspections. In addition, the performance indicators proposed in the ERP refer only to one of the IPARD measures namely 'processing and marketing', while support for the agricultural production measures is not reflected. It is recommended that indicators for the measure "Investments in physical assets of agricultural holdings" be added. Moreover, the real estate market for agricultural land is hindered by the weak state of cadastre/property registration, implementation of the restitution legislation, as well as the lengthy procedures for case settlements in courts. This kind of challenges could be in future addressed by the ERP reform measure on improving the geospatial sector.

The measure aiming to improve the competitiveness of agricultural holdings should focus on putting in place the conditions necessary to make use of the entire IPARD programme and efficient mechanisms to address problems arising from adverse weather conditions. From the point of view of increasing sector competitiveness, Serbia needs to proceed with the accreditation of more IPARD

measures than the current two. Investors should also be encouraged by increasing the attractiveness of the sector through a predictable legal framework, full liberalisation of the market for agricultural land and development of modern infrastructure (irrigation systems, agricultural real estate management, rural planning, access roads, storage facilities, etc.).

Industry sector development

Foreign direct investment (FDI) continued flowing into Serbia and has now reached pre-crisis levels; FDI is much more diversified than in the past. The ERP diagnostic, however, does not consider the price to attract FDI through various tax breaks and other incentives offered to foreign investors. Any analysis of price and impact of measures to attract FDI is hampered by the fact that there is no comprehensive and efficient state aid control. Moreover, it is estimated that foreign companies receive several times more subsidies than those available for domestic SMEs, which is only partially justified by higher productivity of FDI.

Plans to increase the competitiveness of the processing industry consist of administrative steps to prepare a new industrial strategy. It is a positive development that Serbia started working on a new industrial strategy which appears to be focused on industries with growth potential and not defending companies with a high number of employees, as has been the case with the previous strategy and policy. The Ministry of Economy should not be the only responsible ministry, as many measures would concern such areas as agriculture, telecommunications, environment, energy etc. In parallel, new instruments of industrial support need to be introduced to benefit smaller and domestic investors. The current ERP omits development of new instruments and only deals with the process of the new strategy, which reveals low ambitions of the policy in this area. The ongoing smart specialisation exercise offers an opportunity to engage with stakeholders from industry and academia and should provide guidance for development of new instruments.

Service sector development

Services constitute the greatest part of Serbia's economy and are most exposed to the lack of work skills. The ERP includes a diagnosis of the challenges faced by the service sector; however, there is no service-focused response, although it could be argued that most of the cross-cutting measures in the ERP will improve the environment for services. In particular, SMEs would benefit from a better registry and a modern regulation of e-commerce. Creative industries and the tourism sector have been growing strongly, in particular in Belgrade. The ERP could focus on the provision of additional tourist services or increased attractiveness of less-visited rural Serbia.

Business environment and reduction of the informal economy

The business environment has benefitted from a number of reforms, but it still presents a lot of uncertainty and costs. Serbia has climbed up the World Bank's Doing Business ranking, but the reforms have slowed down since the substantial simplification of the process of issuing construction permits. Private investment remains hampered by factors including a costly, unpredictable and non-transparent system of para-fiscal charges, difficult access to capital for smaller firms and red tape. Competition remains distorted by state-owned enterprises and the informal economy. The ERP diagnostic discusses challenges in land registry, financial markets and governance of public utilities. However, the below proposed measures lack ambition and could, solve only partial problems in these listed areas.

The measure to improve access to finance for SMEs should focus on the delayed regulatory plans for introduction of new financial instruments. As part of the macroeconomic stabilisation efforts, the government and the central bank addressed some of the main weaknesses in the banking sector and helped reduce the number of non-performing loans. The cost of access to finance has been reduced, but most SMEs remain locked out of loans and continue to use own resources as the primary source to

finance expansion. Some of these SMEs would benefit from improved regulation of financial markets to provide additional financing instruments, beyond loans. Several challenges remain in place, such as: (i) high cost and collateral requirements for innovative, young and potential growth companies, (ii) underinvestment in areas such as innovation financing, infrastructure financing, and environmental projects, and (iii) inadequate support for long-term finance, guarantee instruments and equity financing. The introduction of new financial regulations is announced for a third year and has accumulated delays, which are not explained in the ERP. The financial market would also benefit from full liberalisation of capital flows, as agreed between the EU and Serbia in the Stabilisation and Association Agreement.

The measure aimed at improved corporate governance of public utilities and state-owned companies is of key importance for competitiveness. The public corporate sector remains the biggest employer and investor in the country. In particular, the energy sector has a key impact on growth. The reform in governance of public companies has been identified as a core part of the ERP since the first programme. It has achieved some good results and these companies now pose less tax risk. However, public companies remain largely inefficient and are influenced by political deals, which go beyond managerial appointments. The proposed reform recognises these challenges, but proposes to deal just with procedural rules for appointments. More ambitious steps should be taken to lock politics out of daily management of these companies.

The measure aiming to unify the system of public registries of administrative procedures lacks a clear commitment and scope. Administrative burdens for businesses, in particular parafiscal charges, constitute a significant cost for businesses and tend to be unpredictable. The ERP indicates that the government has continued working on a law on fees which could reign in parafiscal charges. However, the ERP does not provide a concrete commitment as to the empowerment of the registry or the law to reduce the charges and ensure their proper control by the central government. The private sector has been appropriately involved in the process and its input should lead the government towards more specific announcements which go beyond the current procedural steps forward. Moreover, a significant part of the charges is set and collected by municipalities, but their contribution to the reform remains unclear.

The measure establishing a common information platform for all inspections (e-inspection) is only one of many possible initiatives to combat the informal economy. The informal economy remains large, although the government significantly increased revenues received from inspections and tax collection. The years 2017 and 2018 were formally proclaimed as years for combating the informal economy. The tax authority started an information campaign on the negative effects of informality. Beyond the measure, there are weaknesses in the fiscal and social regimes which do not incentivise the formalisation of employment or company operations. The planned but delayed platform should be completed by a proper risk assessment system ensuring that inspections are better targeted. Its main indicator should not be the number of inspections coordinated via the e-platform, but perception of businesses that inspections are carried out with fairness and expedience.

The new measure on a geospatial database can improve the clarity of ownership, which slows down investment decisions. If properly implemented, the reform measure has potential to contribute to the efficiency of the taxation system, leading to fairer distribution. The measure should be upgraded into a country-wide fully digitised and up-to-date cadastre. For this, ministries and the judiciary need to be involved in the measure, which is at the moment under the sole responsibility of the Geodetic Authority. Moreover, the acquis-prescribed establishment of the land parcel identification system (LPIS) in Serbia as part of the integrated administration and control system (IACS) may be sped up due to better access to the geospatial data infrastructure.

Research, development and innovation and the digital economy

Pockets of the Serbian economy are innovative and excel globally. Although the country has a relatively good scientific base, the level of investment in research is just 0.9% of GDP. At the same time,

cooperation between the public and private sectors is weak and not systematically supported. Most public funds for research end up in public research institutes while companies receive a very small share. With regard to this, the efforts linking academia with industry carried out by the ANTARES (Centre of Excellence for Advanced Technologies in Sustainable Agriculture and Food Security) project constitute an important example for other domains. The Prime Minister announced that digital services will be one of the priorities of her government, but this ambition is not reflected in the ERP. The mapping of broadband is still on-going. In the coming years, a subsidy for developing digital infrastructure in low population density areas needs to be budgeted for.

The measure supporting innovations and technological development includes support to private companies through the Innovation Fund and is an example of a targeted and well implemented support activity for SMEs. However, the fund continues to function in isolation from other possible measures that could make up a more comprehensive reform. More could be done to systematically push for public and private research cooperation, such as technology transfer offices and new science parks, both with the aim to support high tech start-ups. Therefore, the long overdue multiannual action plan to implement the national strategy for research should include explicit support to various initiatives that bring public and private actors together. The finalisation of the EU-guided smart specialisation exercise will provide further guidance on possible measures for innovation that merit increased public support.

The measure aimed at the development and improvement of the national broadband communications infrastructure will address a limited number of bottlenecks. The measure stops short of describing specific services that the benefiting public institutions will provide on the improved network. The ERP does not envisage rules providing for e-government and e-services over the internet and it still remains to be developed. The sector needs investments but the weak market regulation hinders expansion, while there are still some protectionist measures in place. For instance, the import of telecom equipment is cumbersome due to non-recognition of EU conformity certificates and unnecessary inspections. The access of telecom operators to ducts and antennas - although regulated based on prior assessment by the regulator - remains very difficult in practice. In view of this, the financial and political independence of the electronic communications regulator needs to be ensured.

Trade-related reforms

Trade integration with the EU further increased and occurs across a high number of industrial sectors. FDI has climbed back to pre-crisis levels. However, FDI and exports are too often in low value products. Determined political and administrative action is needed to work better with incoming investors so that they can fully use Serbia's potential and establish links with domestic suppliers, integrating them in their value chains. To this aim, some companies created clusters but their activities are not supported by a systemic public action. Similarly, the ongoing programmes for the internationalisation of SMEs need to be stepped up to reach a higher number of beneficiaries. These actions need to include services, such as IT, which have a strong potential for export. The Central European Free Trade Agreement (CEFTA) and regional economic area (REA) commitments need to be pursued with more determination, including finding workable solutions to political obstacles.

The measure to improve conditions for product safety and remove barriers to trade targets specific products; its scope should be extended to other products and areas. Serbia still needs to complete a thorough review of all legislation, technical regulations and standards, and remove distortive non-tariff barriers to trade that do not derive from the use of certificates of conformity, standards or other technical requirements. Non-tariff barriers are often disguised under the pretext of preserving public health. Sanitary inspections at the border continue to be performed largely without any risk analysis and in a way which adds unnecessary costs for the importers.

Education and skills

Quality and output of the education system are important factors for Serbia's growth and prosperity given the population decrease. Enrolment rates in compulsory schooling are high (pre-school programme and primary education 95.1 % in school year 2015-16), but overall preschool education coverage increased only slightly to 58.8 %, far below EU benchmarks. Children from Roma communities continue to be underrepresented at all education levels from early on. Studies on the competencies acquired in formal education and the school-to-work transition point to skills mismatches. High youth unemployment and the share of those who are not in education, employment, or training (NEET) which stood at 17.6 % in 2017, illustrate these findings. Low skills level of adult unemployed is a key obstacle for their access to employment.

The ERP continues to prioritise the introduction of workplace-based learning in vocational education and the establishment of a National Qualifications Framework (NQF). The corresponding ERP measure is rolled over from the ERP 2017-2019, and partly from the ERP 2016-2018. Following the adoption of the law on dual education (work-based learning), the main challenge is now to translate the legal framework into practice on the basis of a clear roadmap that is yet to be set up. The steps presented in the ERP are limitedly linked to the core objectives of the reform. Establishing closer and smooth cooperation among state bodies, social partners – as highlighted in the 2017 policy guidance - and economic actors both a central level and on the ground remains essential for an effective introduction of dual learning across the country.

The establishment of Serbia's National Qualification Framework is behind the schedule presented in the two previous ERPs. Following the recent adoption of the Law on NQF, efforts should now focus on establishing the relevant institutional setup and the implementation of the NQF system, in cooperation with relevant stakeholders.

Employment and labour markets

Some positive labour market trends continued in 2017. Labour force participation (15-64 years) reached 66.7 % in 2017, up 1.1 pps compared to 2016, and the employment rate increased by 2.2 pps to 57.4 %. Over the same period, the unemployment rate went down by 1.8 pps to 14.1 %. Long-term unemployment also dropped significantly. A strong gender gap above 10pps persists in women's labour force participation and employment. Youth has benefited as well from labour market improvements but their unemployment is still nearly 2.5 times higher than overall unemployment. Employment increase in 2017 was largely due to growth in manufacturing and services and strengthened formal employment. Despite improvements, job quality is a concern. Informal employment continues to hover near 20 %, partly due to its pervasiveness in agriculture. One fifth of all workers have very low work intensity, increasing the in-work poverty risk, compared to the EU average of one in ten (SILC 2017).

The ERP highlights the need for reforms conducive to employment, but does not include substantive labour market reforms. The ERP measure aimed at increasing active labour market policies has been further prolonged until 2020 with a moderate budget increase and accompanied by initiatives for improving quality and efficiency of services and active labour market measures. However, active labour market policies continue to have a very low coverage; less than 20 000 beneficiaries (around 3 % of registered unemployed) were included in measures such as training, employment or self-employment subsidies and public works in 2017. Most services delivered by Serbia's public employment service to around 110 000 beneficiaries (15 % of registered unemployed) consist of one-day support such as job search training and employment fairs. The ERP measure thus needs to be complemented by a significant budget increase for active labour market policies in order to support access to employment for the large pool of unemployed, also with regard to future demographic constraints on the size of the workforce.

A small step has been taken towards lowering the high non-wage labour costs in relation to last year's policy guidance. The 27 % increase of the tax-exempt part of the gross wage, taking into account the increase of the minimum wage from EUR 1.1 (RSD 130) net per hour to EUR 1.2 (RSD 143) as of January 2018, represents a total monthly saving from this change per employee of slightly less than EUR 3. Although the direction of this step is good, its impact is marginal and not particularly targeted at low-income earners. Advancing reforms of labour market institutions in Serbia could contribute to broadening employment opportunities and strengthening formal employment. The envisaged establishment of legal frameworks for the operation of private employment agencies and for seasonal work should be pursued without further delay.

Social inclusion, poverty reduction and equal opportunities

Despite positive labour market developments, inequality and poverty remain at elevated levels. The Gini coefficient in 2016 based on the most recent SILC survey was 38.6 %, up from 38.2 % in 2015, and is higher than in any EU Member State. The quintile ratio (ratio of income of 20 % richest to 20 % poorest) in Serbia increased from 9.0 in 2015 to 9.7 in 2016, which is 17% higher than in the EU Member State with the highest ratio (Romania 8.3). The share of persons at-risk of poverty or social exclusion is the highest among all countries conducting SILC, standing at 38.7 %; similarly, the at-risk of poverty rate stood at 25.5 % in 2016, impacting around 1.8 million people in Serbia. Most at risk are young people aged 18-24 (32.7 %) and children and youth below 18 (30.2 %), while the population over 65 years has the lowest at-risk of poverty rate of 19.1 %. Half of all households composed of two adults and three or more dependent children and 40 % of working-age single member households are at risk of poverty.

Few elements of the measure for improving the adequacy, quality and targeting of social protection introduced in the ERP since 2016 have been completed so far. The new Law on financial support to families with children adopted in December 2017 increases the lump sum grant for the first child from EUR 325 to EUR 850, gives access to paid maternity leave for mothers working on service and temporary contracts as well as insured farmers, and extends eligibility to child allowance in justified cases from 19 to 21 years. Preparations for the introduction of an electronic information system for managing all social benefits through 'social cards' are under way, including a better targeting assistance to those in need and improved coordination between employment and social services. The reform is still at an early stage not yet allowing an assessment of its impact with regard to tackling poverty.

4.5. IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2017

2017 policy guidance	Summary assessment
<p>PG 1: Ensure a continuous reduction of the budget deficit in 2017 and over the medium term.</p> <p>Use any additional fiscal space to lower the deficit beyond the targets that are currently envisaged, while continuing to increase capital expenditure.</p> <p>Adopt a credible and binding system of fiscal rules, capable of anchoring consolidation efforts.</p>	<p>PG 1 has been partially implemented.</p> <ul style="list-style-type: none"> • Full implementation: The 2017 budget was in a surplus of 1.2 % of GDP, significantly above the initially targeted deficit of 1.7 % of GDP. The current ERP also targets lower budget deficits in the 2018-2020 period. The updated medium-term budgetary objective is a deficit of 0.5 % of GDP, instead of the previously targeted deficit of 1.0 % of GDP. • Partial implementation: While most of the available additional fiscal space was used to further reduce the deficit in 2017, the execution of capital expenditure underperformed and was even below the 2016 level. • No implementation: Despite last year's commitment, there were only discussions on a possible design for a new set of fiscal rules and no administrative or legal measures were taken to address this policy guidance. Moreover, the updated ERP 2018 does not include any plans or a timeline for strengthening fiscal rules.
<p>PG 2: Support the fiscal scenario by reinvigorating reforms of the state-owned enterprises</p> <p>and of the tax administration.</p> <p>Improve the composition of budget expenditure by further reducing public spending on wages and pensions as a share of GDP.</p>	<p>PG 2 has been substantially implemented.</p> <ul style="list-style-type: none"> • Partial implementation: Reform of state-owned enterprises advanced unevenly. Further measures were taken by the railways company and the power utility EPS, more than 275 companies went into bankruptcy proceedings, more than 45 have been privatised since the end of 2014, and 10 strategic companies were resolved. However, a solution is still due for around 150 companies, employing some 50 000 people, including a number of big strategic companies in the mining and energy sectors. • Partial implementation: The action plan on implementing the tax administration transformation programme was adopted with some delays in December. Core activities are to be consolidated in 36 offices by June 2019. • Full implementation: Government expenditure on wages declined from 9.8 % of GDP in 2016 to 9.5 % of GDP in 2017, while public spending on pensions fell from 11.6 % of GDP to 11.1 % of GDP in the same period (excluding the 2017 payment of bonuses amounting to 0.2 % of GDP).

<p>PG 3: Implement the remaining measures of the NPL resolution strategy.</p> <p>Continue efforts to promote the use of the dinar, inter alia by maintaining a spread between reserve requirements in foreign currency and local currency also going forward.</p> <p>Finalise the reform and privatisation of the two large state-owned banks and find a solution for the remaining small state-owned banks.</p> <p>The monetary policy stance should be in line with achieving the new inflation target.</p>	<p>PG 3 has been substantially implemented.</p> <ul style="list-style-type: none"> • Substantial implementation: The authorities have substantially implemented the measures of the NPL resolution strategy. All measures included in the NBS action plan were completed, and while some measures pertaining to the government action plan are still pending, preparation has started with a view to complete them by 2018. • Full implementation: The authorities maintained a spread between reserve requirements in foreign and local currency. More generally, the efforts to promote the use of the local currency have yielded some positive results. • Limited implementation: The restructuring of Banka Poštanska štedionica is proceeding with some delays relative to original plans, while the privatisation of Komercijalna Banka has been delayed, and a solution is yet to be found for the remaining three small state-owned banks. • Full implementation: The monetary policy stance has been conducted in a way to achieve the new inflation target, supported by the evidence that through the year headline inflation remained anchored within the new target tolerance band.
<p>PG 4: Gradually adjust electricity tariffs to reflect actual costs.</p> <p>Further improve payment collection</p> <p>and avoid future accumulation of arrears in the energy sector.</p> <p>Advance the announced restructuring of Srbijagas debt and the implementation of EPS's optimisation plan.</p> <p>Expand the scope of the Single Project Pipeline to cover all large investment projects regardless of their source of funding and establish clear links to the budgetary process.</p>	<p>There was partial implementation of PG 4.</p> <ul style="list-style-type: none"> • Limited implementation: Regulated electricity tariffs increased by 2 % in October 2017, i.e. less than average inflation in 2017, and do not fully reflect actual costs. • Partial implementation: Collection rate for electricity bills has gone up to the very high level. Collection of gas bills has also improved. • Substantial implementation: The financing of weak public entities through arrears to Srbijagas and electricity company EPS has been significantly reduced. • Limited implementation: Srbijagas and EPS continued with restructuring, but with limited results. • Limited implementation: a decree was adopted but it is unclear if it introduces parallel structures and processes instead of the objective of establishing a single platform and single methodology for capital investment analysis and planning. Finally, there is no evidence that the

	provisions of the decree intended, to put the single project pipeline into operation are being conducted on time or at all.
<p>PG 5: Regulate the amount and number of para-fiscal charges at state level.</p> <p>Develop the regulatory framework for new financial instruments, and improve the access to finance.</p> <p>Put in place risk management systems in order to improve the functioning of the Tax Administration and to ensure better targeting and efficiency of inspections.</p>	<p>PG 5 has been partially implemented.</p> <ul style="list-style-type: none"> • Limited implementation: Law on republican taxes adopted, progress made on a registry of procedures. A draft law on fees under preparation. • Partial implementation: Regulatory framework still pending. Access to finance improved via other channels (increased range of loans). • Substantial implementation: New risk management system put in place, but full implementation is still pending.
<p>PG 6:</p> <p>Increase labour market participation</p> <p>and reduce the high non-wage labour cost of jobs at the lower sections of the wage distribution in a fiscally neutral way.</p> <p>Target active labour market measures to vulnerable groups, including social assistance beneficiaries.</p> <p>Develop dual learning in vocational education and training in close cooperation with social partners.</p>	<p>PG 6 has been partially implemented.</p> <ul style="list-style-type: none"> • Substantial implementation: Labour market participation rate increase by 1.1 pps in 2017; however not of critical groups (women, youth). • Limited implementation: 27 % increase of the untaxed part of the gross wage; this represents a monthly saving of around EUR 3 for any worker but is not specific for lower wages. • Limited implementation: the share of vulnerable groups (women and young) among the beneficiaries of active labour market measures increased, however their scope is so small in terms of numbers of beneficiaries that this does not qualify as a targeted approach. No progress was made regarding activation of social assistance beneficiaries. • Partial implementation: In 2017 the Law on Dual Education was prepared and adopted. Involvement of the social partners in the design of the law was insufficient. Only in December 2017 a first workshop for involving them into next steps of the measure took place.

4.6. THE 2018 POLICY GUIDANCE

JOINT CONCLUSIONS OF THE ECONOMIC AND FINANCIAL DIALOGUE BETWEEN THE EU AND THE WESTERN BALKANS AND TURKEY

The Economic and Financial Dialogue between the EU and the Western Balkans and Turkey

Brussels, 25 May 2018

[...]

In light of this assessment, Participants hereby invite Serbia to:

1. Use any revenue over performance in 2018 for debt reduction. Target a balanced budget over the medium term, in order to lock in recent fiscal consolidation gains and create sufficient buffers against fiscal risks. Adopt a credible and binding system of fiscal rules, capable of anchoring fiscal policy.
2. Further improve the composition of government spending by reducing non-interest current expenditure and increasing capital spending as a share of GDP over the medium term. In order to better plan and execute public investments, develop a single mechanism for prioritising and monitoring all investment regardless of the source of financing.
3. Conduct monetary policy in line with achieving the inflation target. Consider to gradually allow for more exchange rate flexibility as macroeconomic stability is cemented. Implement the remaining action points from the NPL resolution strategy and finalise the privatisation process of the remaining state-owned banks. Continue to promote the use of the local currency inter alia by maintaining a favourable treatment of dinar reserve requirements compared to those in foreign currency and by fostering the development of interbank markets and secondary markets for government securities.
4. Gradually adapt electricity tariffs so they reflect real costs including necessary investments to upgrade the energy network and to meet environmental standards. In parallel, increase investments in energy efficiency. Finalise the unbundling of state-owned enterprises alongside accelerating their restructuring, in particular Srbijagas and EPS.
5. Use findings of the smart specialisation exercise to finalise a new industrial strategy and ensure that all instruments of support to companies are in line with state aid rules. Implement the law on fees so that parafiscal charges will be predictable and based on a fee- for-service principle. Ensure predictability and risk based control of phytosanitary checks at the border.
6. Reduce the high non-wage labour cost of jobs at the lower sections of the wage distribution. Increase substantially the inclusion of unemployed in active labour market measures, in particular women and Roma. Involve closely all relevant actors for the country-wide roll-out of dual learning. Accelerate the envisaged reforms for better targeting of social assistance. Further attention should be devoted to tackling undeclared work.

ANNEX: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The government adopted and formally submitted the Economic Reform Programme on 31 January 2018. The programme is in line with the medium-term fiscal strategy and the 2018 budget and covers the period 2018-2020. In conformity with the new approach to economic governance, the programme includes an enhanced description of structural reform priorities.

Inter-ministerial coordination

The preparation of the programme was centrally coordinated by the Ministry of Finance, which established an ERP working group. Relevant ministries and other institutions (the National Bank of Serbia, the National Employment Service, and the Statistical Office of the Republic of Serbia) are associated with the work and have contributed in their areas of responsibility.

Stakeholder consultation

Two public consultations were conducted to give social partners, civil society and all relevant stakeholders an opportunity to contribute, especially to the drafting of chapter 4 on structural reforms. However, the draft ERP was not discussed in the Economic and Social Council of Serbia.

Macro framework

The programme presents a clear and concise picture of past developments. It also covers all relevant data at the time of drafting it. The macroeconomic framework is sufficiently comprehensive and coherent. The baseline macroeconomic scenario is plausible and major uncertainties and risks are clearly outlined and recognised. The programme also presents an alternative macro-fiscal scenario, envisaging a lower growth path, slower narrowing of the budget deficit and higher debt levels.

Fiscal framework

The fiscal framework is based on the presented medium-term macroeconomic scenario and is coherent, consistent, sufficiently comprehensive and integrated with the overall policy objectives. Revenue and expenditure measures are well explained. The programme does not present long-term projections of population trends or of the implications of an ageing population on the labour market and public finances, in particular on health and pension systems. Significant further efforts would be needed to ensure ESA 2010 compatibility of fiscal data.

Structural reforms

The programme's structure does not always fully follow the guidance provided by the Commission. The reporting of the implementation of the policy guidance and the structural reform measures from 2017 is sufficient and up-to-date. The number of reforms and page length are within the limit. The measures are focused and planned with good detail; however, their scope of ambition often refers to a single procedural reform rather than a systemic long-term reform with real impact on competitiveness and inclusive growth. Contributions from the budget are provided for in all measures. However, the methodology for establishing this contribution varies from measure to measure and is not a reliable indicator of commitment. The annexed tables are filled in appropriately.

5. TURKEY

5.1. EXECUTIVE SUMMARY

The Turkish economy regained momentum in 2017 supported by a broad range of policy measures to stimulate the economy and a strengthening of foreign demand. In the second half of 2017, private domestic demand became an increasingly important driving force for economic growth. Private domestic demand will continue to drive the economy in the short term with strong employment growth supporting private consumption and high capacity utilisation and robust foreign demand growth requiring investments in manufacturing. As the elections approach (scheduled for 2019), government incentives are expected to increasingly influence economic developments as seen in the run-up to the 2017 referendum on the presidential system. While the Economic Reform Programme's (ERP) projections for domestic demand appear plausible, albeit with a rather high emphasis on private investments, the medium-term economic scenario sets out an unlikely combination of strong domestic demand, a more than halving of the annual inflation rate and a narrowing of the current account deficit. In such a scenario it is likely that, contrary to the ERP projections, net trade will become a drag on the economy as a consequence of high import growth. In addition, as the output gap turns positive, inflation will plausibly continue to be significantly above the central bank's target.

The positive output gap and risks of an overheating economy make it necessary to turn to a countercyclical fiscal policy stance. The ERP's estimate of potential output growth is estimated to be 5.3%, which is significantly higher than the forecasts of international institutions and market participants. The high inflation rate, the widening of the current account deficit and the high capacity utilisation rate suggest there is significant risk of an overheating economy. After a year of strong government stimulus, which turned out to be pro-cyclical, the budgetary stance now needs to become countercyclical. The current budget envisions only a limited reduction in the general government deficit and in the first two months of 2018 new policy proposals have already been launched that will have a sizeable impact on public finances.

The main challenges for future economic policy are the following:

- **The current account deficit has started to widen again as domestic demand has increased.** Continued strong domestic demand growth is expected to lead to a further widening of the current account deficit. Policies to encourage domestic savings should be preferred over those spurring loan growth, and investment incentives should be carefully targeted. Budgetary policy needs to become countercyclical and its predictability needs to be improved through more transparent budget planning.
- **Both headline and core inflation have recorded double digit figures continuously since August 2017, leading to unanchored inflation expectations.** This makes sustainably lowering inflation expectations harder as wage demands have followed suit. A credible monetary policy focused on a disinflationary trajectory is the policy option with the lowest risk of shocks to the economy.
- **The ongoing state of emergency and its impact on the rule of law had a detrimental effect on the investment climate and as such on the economy as a whole.** Turkey's substantial informal sector continues to hinder the establishment of a level playing field and fair competition between firms. Companies in addition face a considerable administrative burden in doing business. The ERP plans to address this by harmonising and simplifying procedures for starting a company. Additional work is however needed to shorten the lengthy and costly insolvency procedures. In addition, companies that were seized after the attempted coup need to have access to due process in which the separation of powers and the independence of the judiciary is respected.

- **Turkey's current institutional capacity and resources spent on R&D and the level of commercialisation of innovation are insufficient to enable its planned transformation process to higher added value production.** The national R&D strategy was updated (although not yet adopted) to target an increase in overall spending innovation and to promote and support the absorption of innovative knowledge by Turkey's private sector, including SMEs. Turkey's digital economy sector suffers from insufficient competition in telecom markets and excessive taxation and costs for operators and consumers of information and communication technologies.
- **Structural reforms in the labour market should be given higher priority.** The substantial financial support given to job creation represents a considerable reduction of labour costs of new hires, including in higher wage segments. Such active labour market measures should be more targeted to categories having difficulties in accessing employment, while adjustments in the labour market framework could ease the hiring of new workers.

The implementation of the policy guidance jointly adopted at the Economic and Financial Dialogue of 23 May 2017 has been limited. The ERP itself does not provide a dedicated section assessing the degree of implementation. However, according to the ERP, the structural balance of the general government has increased from -2.2% of potential GDP in 2015 to -3.1% in 2016 and -3.3% in 2017. A fiscal rule has not been introduced and budgetary policy making is increasingly characterised by ad hoc measures. The revised national accounting methodology has been taken into account in the new medium-term economic scenario but this appears not to be the case for the new medium-term budgetary scenario. The budgetary impact of major policy initiatives has not been made clear despite these being to lead to a significant increase in contingent liabilities. Regardless of the GDP rebound, there has not been clear communication to the public regarding a change in monetary policy or its framework that would sustainably lower the inflation rate and anchor inflation expectations.

Regarding the implementation of policy guidance on structural reforms, implementation has been weak since the state of emergency continues and the government took active control of close to 1000 companies accusations following alleged links with forces behind the attempted coup. Trustees assigned to the transferred companies are immune from administrative, financial and criminal liabilities. However, there was some progress as new judges and prosecutors were recruited following the dismissals after the attempted coup. The R&D strategy was updated by TUBITAK, the Scientific and Technological Research Council of Turkey, but this has not yet been adopted. The draft strategy focuses on an increase in total R&D spending. In addition, laws on industry and R&D activities were amended, enabling innovation support programmes. The policy guidance in the area of labour market policies has not been implemented. Skills development has been stepped up notably through the inclusion of workplace learning in vocational education and training. Education reforms are supported by a comprehensive Teacher Strategy 2017-2023.

Overall, the programme sets a combination of commendable objectives reflecting high levels of ambition but it would be better served by a more realistic stance. The Turkish authorities have shown high levels of ambition in the past, but momentum for reform has waned recently. The medium-term macro-fiscal scenario is highly optimistic in assuming that high growth ambitions can be combined with improving government finances, a reduction in the external imbalances, and a reduction in the inflation rate. Although longer-term improvements cannot be excluded, these depend on the implementation of an ambitious reform agenda. The implications of structural reforms for public finances have not been identified.

5.2. ECONOMIC OUTLOOK AND RISKS

The ERP sketches an optimistic baseline economic scenario. The Turkish authorities refer themselves to the figures in the economic scenario as growth objectives rather than a prudent economic scenario. These growth projections will be met if the global economy develops positively and the strong underlying momentum of the Turkish economy continues. The medium-term scenario combines relatively high economic growth (of 5.5% in every single year over the programme's period) with declining budget deficits, a declining current account deficit, a decreasing unemployment rate and a more than halving of the inflation rate. The likelihood of such a scenario is rather limited. For one thing, the output gap has closed and growth above potential would usually be associated with upward pressure on inflation. Secondly, the high economic growth forecast in the ERP is grounded in buoyant private consumption and investment. That would usually be associated with a widening current account deficit as both the trade balance and income balance turn more negative. Thirdly, the dynamics behind such a scenario are more likely to play out over a longer term and only after implementing an ambitious reform agenda that encourages investment in human capital and innovation. This year's medium-term economic scenario is based on the revised national accounting methodology as was agreed in the 2017 joint policy guidance.

Table 1:

Comparison of macroeconomic developments and forecasts										
	2016		2017		2018		2019		2020	
	COM	ERP	COM	ERP	COM	ERP	COM	ERP	COM	ERP
Real GDP (% change)	3.2	3.2	5.3	5.5	4.0	5.5	3.2	5.5	n.a.	5.5
<i>Contributions:</i>										
- Final domestic demand	4.2	4.2	4.5	4.7	4.5	4.5	4.9	4.8	n.a.	4.7
- Change in inventories	0.3	0.3	0.3	-0.4	0.0	0.1	0.0	0.0	n.a.	0.1
- External balance of goods and services	-1.3	-1.3	0.4	1.3	-0.4	0.8	-0.8	0.7	n.a.	0.7
Employment (% change)	2.2	2.7	2.8	3.5	3.1	3.7	3.1	3.7	n.a.	3.6
Unemployment rate (%)	11.0	10.9	11.3	10.8	11.0	10.5	10.7	9.9	n.a.	9.6
GDP deflator (% change)	8.1	8.1	10.3	10.3	8.8	7.6	7.6	6.5	n.a.	5.8
CPI inflation (%)	7.0	8.5	11.0	11.9	8.5	7.0	7.4	6.0	n.a.	5.0
Current account balance (% of GDP)	-3.8	-3.8	-3.9	-4.6	-4.2	-4.3	-4.4	-4.1	n.a.	-3.9
General government balance* (% of GDP)	-1.3	-1.3	-2.4	-2.4	-1.8	-1.9	-2.6	-1.9	n.a.	-1.3
Government gross debt (% of GDP)	28.1	28.1	28.2	28.5	27.9	28.5	28.0	28.0	n.a.	27.5
* excluding privatisation revenues										
Sources: Economic Reform Program 2018 (ERP), Commission Autumn 2017 forecast (COM)										

The economy is likely to continue growing at a brisk pace in 2018 after strong growth in 2017. Growth in the first half of 2017 was spurred by sizeable stimulus measures which have abated but are expected to surge again as elections approach. Annual growth was a spectacular 11.2% in the third quarter of 2017 and a solid 7.3% in the fourth quarter, resulting in very strong 7.2% growth over full 2017. Whereas nearly half of the strong annual growth in the third quarter could be explained by one-off effects, i.e. a different number of calendar days, and a base effect due to low economic activity in the aftermath of the failed coup attempt, the fourth quarter showed renewed momentum. The shift observed in growth drivers from government stimulus to private demand during 2017 is positive for Turkey's economic outlook and in line with the European Commission's 2017 Autumn Forecast. Industrial production and household consumption registered strong growth numbers in the fourth quarter bolstering domestic demand but investment continued to lag expectations. Imports registered very high increases

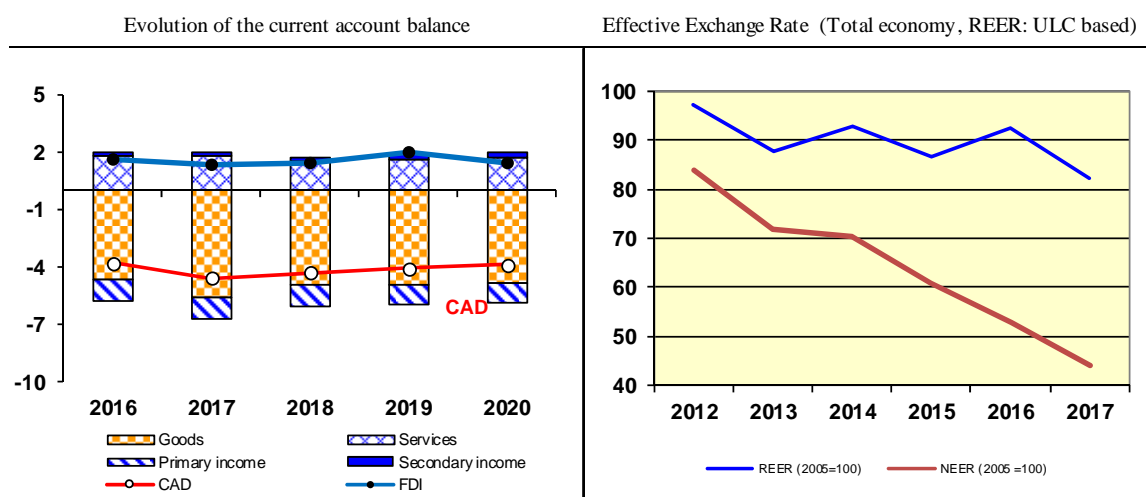
whereas exports grew more modest, leading to an increase in the trade imbalance. In the Commission's view, private consumption will be supported in 2018 by higher employment growth, improved confidence and lower inflation in combination with a boost for purchasing power from high nominal wage growth. The contribution of net trade will turn negative as a consequence of higher private domestic demand. As the elections approach (scheduled for 2019), government incentives are expected to increasingly influence economic developments as seen in the run-up to the 2017 referendum on the presidential system.

Potential growth is easily overestimated in the current context. Gross fixed capital formation is expected to contribute 3.7 percentage points to potential output growth of 5.3 %. Estimating the potential output growth rate and the contribution of gross fixed capital formation is, however, complicated by the large contribution from construction to recent growth performance under the revised national accounting methodology. Since the beginning of the revised national accounts series (2009 – 2016) construction investment grew a total of 52 % more than investment in machinery and equipment. Construction investment represented 56 % of gross fixed capital formation in 2016 (52 % in 2009) whereas that in machinery and equipment 37 % (39 % in 2009). Predicting the contribution from increases in the capital stock to future potential growth is, therefore, prone to a high margin of error. Using trend estimates to determine future capital stock is likely to lead to overestimating this. High inflation, high loan growth and a depreciating currency further complicate disentangling real economic developments from nominal economic developments and temporary from structural factors. The precision of the national accounts may also be compromised by dropping the survey method and switching exclusively to administrative accounts¹. Other anomalies, like the decreasing labour input into construction and the co-movement of construction and the nominal effective exchange rate, further complicate the estimation of trends in the constituent components of a potential output growth rate with a production function approach. The other factors that would contribute to potential growth seem to be more realistic. Going forward, total factor productivity growth will likely continue to contribute in a limited way as the structural reform agenda still needs to be implemented and human capital increased. In addition, higher labour force participation is associated with generally lower productivity as those with lower productivity enter the labour market. The ERP, therefore, rightly expects total factor productivity (TFP) growth to contribute little to GDP growth in the medium term. All in all, a conservative estimate of potential output growth would be well below the 5.3% estimated in the ERP and closer to 4 %.

Inflation expectations have become increasingly unanchored, as core inflation reached double digits. In the ERP, a drop in the inflation rate is foreseen from 11.9% in 2017 to the central bank target of 5 % in 2020. The pattern of inflation expectations is similar to last year's, although shifted by 1 year, e.g. instead of 7.0 % in 2017 the expectation is now for 7.0 % inflation in 2018. Given Turkey's recent inflation history, reaching this downward inflation path is highly ambitious. Capacity utilisation is near a historic high, employment growth is strengthening, wage growth is already high, money growth has outpaced nominal GDP growth by a wide margin and the ERP's economic scenario projects economic growth above potential. It would therefore require a strong anchoring of inflation expectations and low money growth combined with declining energy prices and an appreciating currency to decisively reach lower inflation. The use of the emergency window as the sole policy channel is unlikely to accomplish the shift needed in the credibility of central bank policy. The use of the Late Liquidity Window may actually stimulate moral hazard as there is no emergency window at a punitive rate left in the monetary policy tool box, the determination of liquidity provision becomes more judgemental compared to an ordinary monetary policy framework of a central rate with a band and it could raise expectations that normalisation will come with lower rates. It should, therefore, not be seen as a sustainable simplification of monetary policy and is unlikely to raise credibility. It is also not the simplification envisioned in the policy guidance from the 2017 exercise.

¹ For one, there is no cross check of results. Second, the administrative accounts are based on government tax collection. This is prone to lead to a bias resulting from tax optimisation by companies which might be difficult to correct. An indication of a possible issue is the almost perfect correlation between the difference in the growth rate of VAT on imports and domestic and GDP growth. One would expect this difference to be less related to GDP growth as both should be correlated with GDP growth.

Graph 1: External competitiveness and Current account



Source: Economic Reform Program 2018, European Commission and Macrobond

Higher private consumption will weigh on external imbalances which require a sustainable improvement in competitiveness. The net trade balance can be expected to turn more negative as private domestic demand continues to be the main driver of economic growth in 2018. However, the ERP predicts both a strengthening of domestic demand from increased investment and an improvement in the current account balance. Government incentives to save have not yet had the positive savings impact that is needed. The most important incentive provided in 2017 was the obligatory enrolment in pension systems for large companies, in which the government gives a 25 % bonus on premiums paid. The strong incentives provided in 2017 to increase loans, high inflation and low real interest rates have not helped to increase net domestic savings. The current account balance is also at risk from the pressure on Turkish competitiveness and from higher risk aversion of international investors. The strong depreciation of the Turkish lira in recent years (see graph 1) has supported the trade balance in goods. High inflation and nominal wage growth have, however, erased much of the competitiveness gains from nominal exchange rate developments. Second-round effects now risk further undoing the gains in competitiveness. Low expected productivity growth further adds to Turkey's competitiveness. To address competitiveness, the authorities have the ambition to increase the technology content of Turkish exports. Exports to the euro area have a relatively high technology content, and there have been increased exports to the euro area. Medium to high technology industries represented 38.5 % of exported value in 2017 (36.6 % in 2016). However, part of the challenge will be to broaden the range of export goods with a high technology content. In addition, educational attainment scores and the stubbornly high unemployment rate for the proportion of the labour force that have completed higher education suggest that Turkey faces challenges in increasing its use of human capital in production. An increase in the technology content of exports will need sustained policy efforts that will only pay off after several years. On the positive side, the recovery of services exports through an increase in tourism visits to Turkey will support the trade balance, but total revenues remain subdued as spending per tourist has been trending lower since 2013.

Financial risk metrics attest to the overall soundness of the Turkish financial sector but high loan growth implies a larger dependence on foreign financing for the Turkish private sector. The capital adequacy ratio is well above the regulatory requirement although it benefited from a change in risk weights in 2016 and from a large increase in the value of the equity share in 2017. Profitability is generally high in the banking sector and has registered strong growth in 2016 (44 % y-o-y) and 2017 (31 % y-o-y). Non-performing loans are also a relatively small portion of total loans and largely covered by provisions. Nonetheless, loans have grown fast helped by prudential relaxation, increased government guarantees and by expectations of rising inflation. Domestic deposit growth could not keep up with domestic loan growth, leading to a need for foreign financing. As a consequence, Turkish banks have

become increasingly reliant on foreign financing. In the global context of ample liquidity, Turkish banks could attract this finance in domestic currency and with longer maturity. In addition, the squeezing of the money market by the central bank towards the Late Liquidity Window might have had repercussions for interbank funding up to three months. While liquidity through overnight funding is easily available, banks' liquidity in the period up to three months is less so and relies heavily on derivatives, in particular swaps. The new law on foreign financing will reduce the risks for the non-financial corporate sector by prohibiting smaller firms with no large foreign cash inflows from borrowing in foreign currency. However, careful monitoring is needed to see whether banks take a larger currency risk as a consequence.

Table 2:
Financial sector indicators

	2012	2013	2014	2015	2016
Total assets of the banking system, mEUR	582	623	742	751	740
Foreign ownership of banking system	16.9	18.5	19.2	30.3	29.4
Credit growth	36.4	31.7	18.5	18.5	16.8
Bank loans to the private sector ratio	98.7	98.8	98.9	99.0	98.9
Deposit growth	11.1	22.5	11.3	18.2	16.7
Loan to deposit ratio	101.2	108.5	114.8	117.2	117.4
Financial soundness indicators					
- non-performing loans	2.8	2.7	2.8	3.1	3.2
- net capital to risk weighted assets	17.9	15.3	16.3	15.6	15.6
- liquid to total assets	17.5	14.2	14.0	13.0	13.6
- return on equity	12.9	12.7	10.6	9.9	12.5
- forex loans to total loans %	25.9	28.2	29.0	31.8	34.8

Sources: BDDK Banking Regulation and Supervisory Authority, Macrobond

5.3. PUBLIC FINANCE

Public finances have deteriorated in the last two years, due to ad hoc budgetary measures on both the expenditure and revenue side. Until 2016, public finances had been improving. The government benefited from lower interest payments and the primary balance was in surplus. The budgetary figures also improved because of the revised national accounting methodology that led to the large increase in GDP and due to accounting rules under ESA2010. No budget figures under the ESA2010 methodology have been published since December 2016 when the revised budget figures were presented for the years 2009-2015. The document does not make explicit which methodology was used to present the new public finance figures. The 2018 budget has not been presented under ESA2010 and the fiscal medium term scenario uses still ESA95 methodology (in contrast with the macro-economic medium term scenario). Clearly, the government has embarked on a trajectory of fiscal stimulus in the aftermath of the failed coup attempt and the run-up to the presidential referendum. The presented figures confirm that government initiatives (like lowering VAT on white goods, waving social security contributions and the employment scheme) negatively impacted government finances. For 2016 and 2017, the general government's primary balance deteriorated by 1.5% and 1.1% of GDP respectively compared to the previous year². At the same time, contingent liabilities from public-private partnership (PPP) commitments, from government guarantees to the KGF credit fund and in state-owned banks have built up.

Table 3:

Composition of the budgetary adjustment (% of GDP)

	2016	2017	2018	2019	2020	Change: 2017-20
Revenues	40.9	41.9	41.4	40.3	39.7	-2.2
- Taxes and social security contributions	27.5	26.9	26.7	26.2	25.8	-1.1
- Other (residual)	7.1	6.4	6.2	5.8	5.7	-0.7
Expenditure	41.0	43.7	43.0	42.0	40.6	-3.1
- Primary expenditure	39.0	41.7	40.8	39.7	38.3	-3.4
<i>of which:</i>						
Gross fixed capital formation	3.5	3.6	3.3	3.2	3.0	-0.6
Consumption	18.3	20.0	19.2	18.6	18.0	-2.0
Social transfers & subsidies	8.1	8.0	7.9	7.6	7.5	-0.5
Other (residual)	9.1	10.1	10.4	10.3	9.8	-0.3
- Interest payments	2.0	2.0	2.2	2.3	2.3	0.3
Budget balance	-0.1	-1.8	-1.6	-1.7	-0.9	0.9
Structural balance	-3.1	-3.3	-2.6	-2.3	-1.7	1.6
Primary balance	-0.7	0.4	-0.2	-0.5	-1.1	-1.5
Gross debt level	28.1	28.5	28.5	28.0	27.5	-1.0

Sources: Economic Reform Program (ERP) 2017, ECFIN calculations, differences due to rounding

In 2017, government spending was more than 5% above the budget, necessitating a budget revision that was approved by Parliament in October 2017. The stimulus given to the economy is most notable in the structural balance which fell from -2.2% of potential GDP in 2015 to -3.3% in 2017. With the benefit of hindsight, pushing the structural budget balance further into deficit, the government acted pro-cyclically. The stimulus was even larger than was visible in the structural budget balance as it also

² Note that "primary surplus" in tables 3.2 and 3.3 should read "primary deficit".

included macro-prudential relaxation, increased government loan guarantees and very low real interest rates. Despite this, because of high nominal GDP growth and better than expected revenue development the central budget deficit was only 0.1 percentage point higher than the originally budgeted 1.9% of GDP according to the ERP³. More recent indications are that the central government budget deficit benefited from surprisingly strong tax revenues towards the end of 2017 and reached 1½ % of GDP. Over the whole year in 2017, revenues increased by 14.8% year-on-year while expenditures increased by 15.3 %. High inflation, however, implies that the real growth of government expenditures and revenues was below real GDP growth and the nominal revenues above nominal budget expectations to which the ERP refers can in part be attributed to higher increases in the price level. The exceptionally positive developments are in company profit taxation and in VAT on imports, lifting overall revenues as together these account for a quarter of central government revenues.

The stated aim of preserving strong public finances is within reach but the risks are sizeable. On 22 December, Parliament adopted the central government budget for 2018, targeting a budget deficit of 1.9% of GDP or TRY 66bn. Box 1 discusses the 2018 budget and gives an overview of the main policy measures. The programme provides for a tightening of budgetary policy over the medium term mostly on account of reducing spending while keeping taxes at roughly the same level. General government expenditures are projected to decline from 35.8 % of GDP in 2017 to 32.7 % in 2020. The Commission's Autumn Forecast predicts that the political cycle will have an impact on the budgetary cycle. Elections are scheduled for March and November 2019. As a consequence, budgetary policy is expected to become more expansionary in 2019. Regardless of the adoption of 2018 budget by Parliament at the very end of 2017, new ideas were floated already at the beginning of 2018 that are likely to have a noticeable impact on the budget realisations. The speed at which new policy ideas (Istanbul canal, investment incentives, targeted VAT rate reductions for the EurAsia tunnel, labour market incentives) have been floated after the finalisation of the 2018 budget suggests that some expansionary policy measures will be frontloaded compared to the Autumn Forecast focus on 2019. The absence of a strong budgetary framework increases the need for a political commitment to maintain strong public finances. The main risk on the revenue side is the increasing dependence on taxes on imported goods, i.e. the VAT on imports and the special consumption tax (nearly half of which is levied on petroleum and natural gas but very little on coke). The reform of the VAT law, sent to Parliament on 27 February 2018, aims to strongly reduce the time required for companies to receive the VAT rebates they are entitled to on investments. The total amount of rebates still on companies' balance sheets is estimated to have reached TRY 140 billion in the first half of 2017.

The trend of increasing transfers is likely to complicate the envisaged expenditure consolidation in the coming years. The proportion of total primary expenditures provided by transfers has increased from about 50 % in 2010 to 59 % in 2017. Central government transfers have been driven up by a trend of increasing health expenditure and the legacy of public-private partnerships, i.e. the need to supplement shortfalls in earnings below the guaranteed revenues. Spending on defence goods is likely to see upward pressure. However, the impact on the budget balance of spending on defence goods will differ between ESA95 and ESA2010 accounting because, in the latter, these expenditures are (partly) accounted for as investments, and therefore on an accrual basis, rather than as current expenditure, and therefore on a cash basis. This difference could be as large as 0.5 % of GDP for the recorded budget deficit, which was the size of spending on this budget item in 2016. From the ERP, it is not clear which specific policy measures are expected to reduce spending and what budgetary impact they will have. Relief could come, firstly, from the public sector payrolls. The modest increase in pay for public sector employees agreed for 2018 will help create some budgetary space. Secondly, the assumptions on interest payments for the next two years appear to offer some buffer. The Treasury has used advantageous global financing conditions to lengthen debt maturity against favourable rates. The yield curve for domestic debt has been negative in 2017. The proportion of total government debt provided by foreign currency denominated debt has, however, come under upward pressure due to the depreciation of the lira. Overall, the envisaged reduction

³ The general government recorded a deficit of 2.4 % of GDP according to the ERP.

in government expenditures is on the optimistic side. The fiscal consolidation effort is back-loaded to the last year of the programme and less ambitious than in last year's ERP.

Box: The 2018 budget

The Grand National Assembly of Turkey adopted the 2018 budget on 22 December 2017. According to the ERP, the 2018 budget ('the annual programme') is included in its figures. Although the deficit figure as a proportion of GDP is the same, the ERP does not list the main policy measures with their budgetary impact. More generally, in the absence of comparable figures (nominal terms in budget, shares of GDP in ERP), comparison between the budgetary measures and the ERP's budgetary scenario is difficult. This box lists the highlights of the budget for 2018, while the main text is based on the ERP.

In the 2018 budget, increased spending on security is funded through increases in the corporate taxes and in taxes on motor vehicles. The central government budget is predicted to record a TRY 66 billion deficit (a 6.8 % increase over 2017). Expenditures are forecast to amount to TRY 763 billion, while revenues are expected to reach TRY 697 billion with rises in company taxation and motor vehicle taxation.

Employee expenditures are forecast to be TRY 183.1 billion, while the social security institutions' state premium is expected to be TRY 30.8 billion, procurement of goods and services to be TRY 66.1 billion, current transfers (social aid, subsidies etc.) to be TRY 299.4 billion, capital expenditures to be TRY 68.8 billion, capital transfers to be TRY 15.3 billion, and interest payments are expected to be TRY 71.7 billion. In the 2018 budget, TRY 134 billion will be allocated to education, representing 17.6 % of the budget. Healthcare expenditure has been allocated a budget of TRY 127 billion and investment a budget of TRY 85.1 billion, of which 30 % will be allocated to transportation. Defence modernisation has been allocated TRY 18 bn.

The reduction in government revenues as a proportion of GDP is expected to come predominantly from lower social security contributions and from lower returns on state assets ('factor incomes').

Five sixths of the reduction in the government revenues from 33.3 % of GDP in 2017 to 31.5 % in 2020 is expected to come from a reduction in returns on state assets, called 'factor incomes', (1.0 percentage point reduction) and social security contributions (0.8 percentage point). The ERP does not substantiate this. In the 2017 ERP, factor incomes were also the largest contributor to the reduction in the fiscal burden but, in fact, the size of factor incomes relative to GDP has been broadly stable in the past five years at 5 % of GDP. The reduction in social security contributions is hard to square with an increase in the participation rate, unless the contribution per employee is reduced. It is also unclear what the impact is of the government's waiver for companies on social security benefits. Over the past few years, the increase in labour force participation has gone in tandem with an increase in social security contributions, except for 2017 when there was a waiver for social contributions. The total from taxes (indirect and direct) is expected to increase slightly from 17.6 % of GDP in 2017 to 17.8 % of GDP in 2018, before declining to 17.3 % in 2020. In 2018, the government will increase the corporate tax rate, which is expected to increase tax revenues by 0.2 % of GDP. Corporate taxes have provided a relatively minor proportion of tax revenues (2.5 % of total revenues), however. Tax revenues are more likely to benefit from increased imports (VAT on imports amounted to 17.8 % of total tax revenues in 2017) and the return of tourists leading to increased income from the special consumption tax (21.9 % of total tax revenues in 2017). However, the increasing dependence on tax revenues from imported goods also implies increased exposure to external developments and can easily lead to a pro-cyclical bias, as the value of taxed imports is more susceptible to cyclical developments than domestic demand.

Turkish public finances would benefit from improved budgetary planning and discipline. The transparency of the budget and predictability of its outcome continue to be a challenge in tracking Turkish public finances. First, in Autumn the Turkish parliament approved a supplementary budget that turned out

to be unnecessary as the 2017 deficit (1.5% of GDP) came out better than the originally planned (1.7% of GDP). Second, although the Parliament approved the 2018 budget on 22 December 2017, the government floated new policy initiatives with sizable budgetary impacts in early 2018. Although the government bases its budget for the year on a medium-term program, public finances are thus effectively characterised by ad hoc measures that can even be introduced within a short time of completing the budget. To improve budget making, the budget should be based on a conservative medium-term macro-fiscal scenario and budgetary transparency should be improved by presenting an inventory of contingent liabilities, which would go beyond those covered in the ERP to include all contingent liabilities such as those from all Public Private Partnerships, the Turkish Wealth Fund, state banks and other sources.

Government debt is sustainable in almost every scenario. The ERP sets out a debt sensitivity analysis that now, reportedly, takes into account the interaction between macroeconomic variables and debt dynamics. Although the scenario does not include the contingent liabilities built up by policy incentives in 2017 (government loan guarantees, relaxation of macro-prudential regulation, Turkey's Sovereign Wealth Fund), publicly owned banks and PPP liabilities built up over the years (EurAsia tunnel, third bridge over the Bosphorus, the new airport near Istanbul) it does confirm that government debt seems to be firmly on a sustainable footing.

Box: Debt dynamics

Table 4:
Composition of changes in the debt ratio (% of GDP)

	2016	2017	2018	2019	2020
Gross debt ratio [1]	28.1	28.5	28.5	28.0	27.5
Change in the ratio	-	0.4	0.0	-0.5	-0.5
<i>Contributions [2]:</i>					
1. Primary balance	-0.7	0.4	-0.2	-0.5	-1.1
2. "Snow-ball" effect	-1.2	-2.7	-1.7	-1.2	-0.9
<i>Of which:</i>					
Interest expenditure	2.0	2.0	2.2	2.3	2.3
Growth effect	-3.2	-4.7	-3.9	-3.5	-3.2
3. Other	2.5	2.7	1.9	1.2	1.5

Notes:

[1] End of period.

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

Source: Economic Reform Program (ERP) 2018, ECFIN calculations

Government debt is forecast to decline over the programme's horizon in the ERP. The biggest contribution to the reduction in government debt comes from the increase in nominal GDP ("growth effect"). Since the forecast for the GDP deflator assumes a strong decline in prices, which is on the optimistic side, the decline in the government debt ratio appears to be on the conservative side. However, the realised debt ratio underperformed in comparison with projections in 2017. When taking into account the large increase in GDP (20% for volume alone) under the revised accounting methodology, the debt ratio should have been much lower (1.5 % of GDP if accounting for changes in GDP volume only).

The difference appears to come from the category of "other" adjustments in the table above. This most likely reflects the effect of the depreciation of the lira because privatisation revenues were only 0.1 percentage point lower than budgeted. Foreign currency denominated debt formed 38 % of total debt in 2016 with two thirds of debt denominated in USD and one third in EUR. The ERP does not explain the "other" adjustment category. As discussed elsewhere, the expected primary balance looks optimistic given the political cycle.

5.4. STRUCTURAL REFORMS

Several bottlenecks to sustainably raise Turkish growth and competitiveness remain. One of them is the uncertain business environment for companies caused by the state of emergency. Under the ongoing state of emergency businesses continue to face the possibility of expropriation. Since the attempted coup, the management of close to 1000 companies has been brought under the trusteeship of the Savings Deposit Insurance Fund (TMSF). These companies represent a total value of assets of TL 47.6 billion (EUR 9.8 billion). The business environment is also hampered by challenges in the judicial system. Some progress was made in recruiting new judges and public prosecutors following the large scale dismissals in the aftermath of the attempted coup, but the judiciary still faces capacity problems and a considerable backlog of commercial cases. Another major impediment to the business environment is the burden of bureaucratic procedures, especially in the areas of resolving insolvency, dealing with construction permits and paying taxes. Turkey's current institutional capacity and resources spent on R&D and the level of commercialisation of innovation are insufficient to enable its planned transformation process to higher added value production. Moreover, the rigid labour market framework impedes job creation. While these bottlenecks are broadly recognised by the ERP, it does not clearly identify obstacles to inclusive growth and competitiveness through a proper diagnostic exercise. In general, obstacles to growth can only indirectly be derived from the stated policy goals. The ERP is silent on the rule of law and the judiciary and on Turkey's considerable informal sector.

Compared to last year, Turkey made progress in identifying 10 specific measures for its structural reforms. However, this small number of measures and their nature calls into question the comprehensiveness and prioritisation of the suggested reform agenda. Three measures relate to health tourism. While this sector in itself might have potential, the focus is disproportionate. Another measure encourages public institutions to make savings and as such has no direct link to competitiveness. Activities under the measures often lack a clear timeframe and budget. This, in combination with the weak diagnostic exercise, makes it difficult to assess the effectiveness of the measures in improving competitiveness. The Commission assessment from 2017, in which this was also mentioned, has not been taken into account. Given the above, the reform assessments below are to a large extent based on information provided by Turkey during the visit by Commission staff in February 2018 and other available data. As such, the area assessments are limited in scope. In general, the role played by the ERP in Turkey's strategic planning is rather limited, while the Medium Term Plan and the Development Plan are more prominent in this process.

Public finance management

Turkey's budget planning and execution process suffers from a lack of transparency and predictability. Monitoring and evaluation of the effectiveness of public spending in achieving policy objectives are insufficient. Concerns remain over the accountability of the off-budget sovereign wealth fund, which is exempt from public auditing.

The performance based budgeting measure – if implemented correctly – can be expected to increase efficiency in public spending and to lead to a better resource allocation. The aim is to use public funds more effectively in supporting public policies. The ERP mentions "partial" implementation of the activities planned under this measure in 2017, but does not provide details. The success of the reform will depend on all central government institutions implementing appropriate monitoring and evaluation procedures. The ERP states that the new approach will be adopted in 2018, but this seems too ambitious given the required preparations. No activities are specified for 2019 and 2020. The second measure under public finance management relates to financial incentives for public institutions to make savings and as such belongs under the public finance part of the ERP rather than under structural reforms.

Energy and transport market reform

Turkey's energy sector relies to a large extent on imports and suffers from a lack of price competition, while its transport sector is characterised by low diversification in transport modes, road transport being dominant. The ERP does not contain a description of obstacles to competitiveness in the energy sector, nor any measures beyond draft legislation pending adoption. It mentions the need to create a competitive and liberalised energy sector compatible with EU energy legislation, but without giving a timeline for this. It also notes supply side developments in power generation and the need for more renewable energy for security of supply, but fails to mention the ongoing nuclear power projects, the potential of energy efficiency measures and the forthcoming diversification of supply through the Trans-Anatolian Pipeline (TANAP). The ERP includes a limited analysis of obstacles to the transport sector and highlights the dominance in Turkey of road transport as opposed to other modes of transport, generating environmental and traffic safety problems. The logistics master plan, referred to in last year's ERP and providing for a more balanced, multimodal approach for transport, is not finalised yet. Urban mobility issues that constitute an increasing threat to economic efficiency are not mentioned.

For the transport sector, the programme envisages Turkey's railway transport liberalisation. This measure in itself is relevant, as private sector participation and competition in the railway sector remain low. However, activities planned under this measure are limited to the adoption of four by-laws and no other activities are expected after 2018. It is unclear what the costs of this measure are. To achieve real liberalisation, additional measures are required relating to the status and functioning of the economic regulator, the safety authority, the infrastructure manager and the state owned company managing rolling stock. Implementing these reforms would help boost private investments in the sector.

Sectoral development

Agricultural sector development

Key obstacles to growth in the agricultural sector are related to access to finance, lack of a predictable support system, low innovation leading to low productivity, lack of reliable agricultural data, land fragmentation and weak irrigation systems. The ERP identifies some of these shortcomings, but there is no overall strategy on agriculture to address them. Despite the importance of agriculture for Turkey's economy (7% of gross value added and 19.5% of employment in 2016), the ERP does not contain measures in this sector. It does however mention the EU project to set up a common market organisation, including support for advisory services. The ERP does not address the protectionist aspects of Turkey's agricultural policy, an important issue not only for CAP alignment, but also for further possible liberalisation of agriculture in the framework of potential negotiations on the modernisation of the EU-Turkey Customs Union.

Industry sector development

Turkey's industrial sector suffers from low productivity, a low proportion of high technology sectors in its value added, regional disparities in industrial development and a high dependency on foreign energy sources and raw materials. The ERP acknowledges most of these obstacles but does not contain any measures in relation to this area. As a main objective, it mentions increasing the proportion of high technology in industries. This in itself is logical, given Turkey's desire to move its production up in global value chains. No link is however made with the issue of the skills mismatch (covered under the education heading). In addition, given Turkey's large labour supply and the fact that industry still takes up 20% of overall employment, attention also seems warranted on developing more basic manufacturing sectors.

Service sector development

The service sector accounted for almost 61% of gross value added and almost 54% of employment in 2016. Within the services sector, the ERP focuses heavily on tourism, in particular on health tourism. It briefly mentions construction, but fails to mention any other areas, such as financial or transport services, and does not contain an analysis of the obstacles to competitiveness for services in general. No information is given on further alignment with EU legislation on the right of establishment and freedom to provide services, despite possible upcoming negotiations on modernising the Customs Union, including further liberalisation of the services market.

The three measures covering health tourism could improve Turkey's competitiveness, especially given Turkey's comparative cost advantage in this area; however, their overall effectiveness is difficult to assess. Activities are not spelled out in detail over the three year time period; neither are budgets, nor the involvement required from the private sector. There is a disproportionate focus on the health tourism sector in the ERP with three measures (out of a total of ten).

Business environment and reduction of the informal economy

The ongoing state of emergency, its impact on the rule of law, the large informal economy and widespread corruption remain concerns for the business environment. The ERP rightly identifies the informal sector and bureaucratic processes as obstacles to the business environment, but it does not acknowledge the uncertainty the state of emergency creates for both domestic and foreign investors. It does not mention the targeted actions against business people, the seizure of private companies and the dismissal of large numbers of judges and prosecutors in the aftermath of the attempted coup, nor whether adequate means of legal redress are available in these cases. No information is provided on follow up to last year's joint policy guidance to strengthen the rule of law and the judiciary to improve investors' confidence. Upon request, the authorities provided information that the recruitment process for some 3600 judges and prosecutors has been completed. It will, however, take time before they acquire the necessary professional experience. Although improvements have been made in recent years, the informal economy in Turkey remains substantial, with a proportion of 26.8% of GDP. The ERP states that the informal economy will be reduced further during 2018-2020. However, no details are given on how to achieve this.

The measure to harmonise and simplify procedures for opening a business has the potential to improve the business environment. The government plans to eliminate differences between the central administration and local government for the process of opening a business and obtaining a working licence, and to reduce the number of approvals and documents required. However, no activities are planned in relation to this after 2018 and the costs are not specified. Reforms which are not noted in the ERP but which are likely to improve the business environment include resolving insolvency (procedures for which are still costly and lengthy) and introducing a regulatory impact assessment on new legislation that is expected to have an impact on companies.

Research, development and innovation and the digital economy

Turkey's current institutional capacity and efforts spent on innovation are insufficient to enable its planned transformation process to provide higher added value production and to move up in global value chains. Commercialisation of innovation also remains a challenge, especially for SMEs. Like last year, the ERP recognises this in its area diagnostic section. Research needs to be sustained as a long term national priority with the aim to increase the number of researchers. Turkey's digital economy sector suffers from insufficient competition in telecom markets and excessive taxation and costs for operators and consumers of information and communications technologies. The ERP does not acknowledge this and does not contain an analysis of the main bottlenecks in this area.

The measure through which research centres are supported on a performance basis was partially implemented in 2017 with the collection of data, site visits and the selection of four institutes as candidates for support. The measure can be expected to contribute to competitiveness by improving Turkey's public and private research infrastructure. However, the ERP does not give sufficient information (especially with regard to the number of institutes to be supported) to assess whether the cost estimate (EUR 90 million for 2018-2020) is appropriate.

Trade related reforms

Further integration into global value chains is hampered by a weak logistics infrastructure and a relatively low innovative component of locally produced goods. The ERP rightly identifies these elements as main challenges in improving competitiveness. Whereas some of the measures under this programme may be effective, others (stimulating preferences for domestic products) may be at odds with competition legislation and Turkey's existing international obligations, such as the Customs Union with the EU. Despite the high level of Turkey's legislative alignment with EU law under the Customs Union, several non-tariff barriers remain in Turkey which restrict imports and exports in several sectors (e.g. the requirement for foreign firms exporting pharmaceutical products to relocate part of their production to Turkey, export restrictions in certain sectors, excessive testing and certification requirements at customs, heavy import surveillance, etc.).

The modernisation of the Customs Union is presented as a measure, while it should instead be considered a policy objective, as its realisation does not solely depend on Turkey. If it happens, this modernisation can indeed be expected to have a positive impact on Turkey's competitiveness, resulting from further liberalisation of trade in the agricultural and services sectors and a harmonisation of policy on public procurement. The timeframe set out in the ERP for the negotiation process currently does not seem realistic. In the meantime, Turkey is advised to improve its implementation of the existing EU-Turkey Customs Union, inter alia by removing current non-tariff barriers to trade. This would further improve Turkey's trade relations with the EU and third countries. The removal of additional duties that Turkey applies to third country imports would also contribute to increased trade flows.

Education and skills

Improving the quality of education is an essential factor for addressing Turkey's socioeconomic challenges. After a period of improvements in education outcomes, the results of the PISA 2015 round revealed a drop in Turkey's relative performance below the level of 2003. Turkey ranked 52nd in science, 49th in mathematics, and 50th in reading skills among 70 countries. Nearly one in four youth aged 15-24 is not in employment, education or training (NEET).

Despite the importance attached to skills development and the stated objective to move towards production with high technological content, the ERP does not include a specific reform measure in this area. Still, a number of important domestic policy initiatives are currently being implemented. Pre-school education of 5 year-olds will be expanded from currently 60% to full coverage and become obligatory in the next two to three years. In view of the introduction of a one-shift school system for all pupils by 2019, large infrastructure investments of around EUR 1 billion are planned in 2018. To address longstanding issues of education quality, the first comprehensive Teacher Strategy 2017-2023 has recently been adopted. Another priority is to increase the share of private education institutions from 8% to 25%.

Substantial investments into the development of a vocational training system in tune with labour market needs continued. The aim is to raise the share of students attending VET schools to 60%. To this end, in addition to the public VET schools, VET provided in company schools in the so-called organised industrial zones was financially supported for 40.000 students in 2017. Furthermore, around 200.000 apprentices are now supported per year at the level of 30% of minimum wage per month. In sum, around

EUR 1.63 billion were spent in 2017 from the unemployment insurance fund to support apprentices and trainees. The Employment Agency funds another 390.000 beneficiaries per year in continuous VET and on-the-job training. It will be important to assess the effectiveness of these measures over time.

Employment and labour markets

The steady increase in labour force participation and a substantial rise in employment marked labour market dynamics in 2017. The labour force grew to 31.6 million people in 2017, up by 1.1 million. The labour force participation rate (15+) reached 52.8 %, up 0.8 percentage points, in the age group 15-64 it increased by 1 percentage points to 58 %. Employment rose by 0.98 million to 28.2 million, primarily in non-agricultural sectors (22.7 million). Female labour market participation (15-64) continued to increase at a modest pace (up 1.4percentage points to 37.6 %), but the gender gap remains huge (40.6 percentage points). Unemployment (15-64) stood at 11.1 %, unchanged to 2016. Despite employment growth, youth unemployment increased by 1.2 percentage points up to 20.8%, and significantly more for young women (+2.4 percentage points up to 26.1 %) than men (+0.4 percentage points up to 17.8 %).

It remains unclear to what extent job creation in Turkey in 2017 was natural or owed to large scale employment incentives. Despite solid employment growth of 3.6% year-on-year in 2017, following slow employment growth in the second half of 2016 twelve employment support programmes were implemented by different institutions providing financial support to job creation. Subsidies per new hire are in the order of TL 350-775 per month, which is up to one third of the employer's total net cost of TL 2000 for a worker at minimum wage. Policies are not clearly targeted to specific groups that would need particular support. Information about the budget and the number of beneficiaries is not available. In 2018 further new specific employment incentives will be given to the ICT and manufacturing sector. The level of support (as percentage of the monthly wage) can be applied to monthly wages up to TL 5200. A main objective of this support is probably to lower the labour cost for the employer, but this could be achieved through more adequate measures than untargeted direct financial support. Furthermore, the impacts of all support measures should be monitored.

Structural reforms in the labour market are not advancing. The ERP does not spell out any specific labour market measure beyond listing some priorities. Reform plans for the severance pay system have not been developed due to lack of consensus on the direction to take. The legal framework for temporary agency work adopted in 2015 is not yet fully effective. There is no progress in the reduction of informal work despite an increase in monitoring and soft measures. The proportion of unregistered workers increased by 0.5 pps to 34.0% (29.2% for men and 44.6% for women) and 22.1% in the non-agricultural sector (2017). In addition, there are an estimated 700,000 to 800,000 unregistered Syrian workers.

Social inclusion, poverty reduction and equal opportunities

Turkish income inequality is higher than in all European countries. The Gini coefficient is 0.404, and the P80/P20 ratio stands at 7.7. The poverty line defined as 50% of median equalised household income classified 14.3% of households as poor. Poverty is strongly correlated to education levels. Half of all individuals identified as poor do not have any diploma, whereas only 1.7% of college graduates were poor. The rate of chronic poverty based on SILC data stands at 14.6%.

Initiatives and investments for poverty reduction remain limited. The measure aiming at the establishment of a Family Support Programme is rolled over from last year. The key feature of this measure is the establishment of a country-wide network of social workers who are assisting families in need. In a first pilot wave of the programme, 1500 social workers have been trained. The target is to reach 3000 and to aim at a ratio of 1 worker per 5000 families in need. The time frame of the reform is three to five years; in 2018 work focuses primarily on establishing the IT system funded by donors.

A small scale measure for reintegrating social assistance beneficiaries into the labour market has been implemented. The Job Orientation and Job Starting Assistance covers the costs for attending a job interview, a one-off support of 1/3 monthly minimum wage in case the job is obtained, and the continuation of social assistance paid to the family of the worker for one year. In 2018 this measure will be stepped up by a one year rebate on the social security contribution for the worker. The budget provision for this measure is however marginal in comparison to the employment incentives; in 2018 a budget for 1880 families is available.

5.5. IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2017

2017 policy guidance	Summary assessment (jointly with EEAS delegation)
<p>PG 1:</p> <p>Lower external imbalances in light of high external funding needs constituting a substantial risk for the Turkish economy.</p> <p>Promote domestic savings by incentivising higher private sector savings and by following a sufficiently tight fiscal stance over the medium term in light of external vulnerabilities built up over the years.</p> <p>The adoption of a fiscal rule would enhance budget transparency, provide an important fiscal anchor and enhance credibility.</p>	<p>There has been limited implementation of PG 1.</p> <p>No implementation: Current account deficit increased in 2017.</p> <p>Partially implemented: The Treasury started to issue gold-denominated bonds and lease certificates in view of attracting the gold kept under-the-mattress and bringing it into the economy.</p> <p>No implementation: No fiscal rule was introduced.</p>
<p>PG 2:</p> <p>Update the macro-fiscal scenario taking into account the revised national accounting methodology</p> <p>Update the budgetary impact of new policy initiatives, such as the Turkish sovereign wealth fund and the new credit guarantee scheme</p>	<p>There has been limited implementation of PG 2.</p> <p>Partially implemented: while the medium term economic outlook is based on the revised national accounting methodology, this is not the case for the fiscal scenario.</p> <p>Not implemented: Despite the massive set of assets transferred under its control, the SWF failed to carry out any concrete steps towards the financing of major infrastructure projects so far, which was announced to be its main raison d'être. The adoption of the SWF's strategic plan by the Cabinet is still pending. It should be also noted that according to State of Emergency Decree 690 the Turkish Wealth Fund (TWF) can take over the foreign debts of companies and sub-funds established under the Fund or the companies whose 50% of shares are owned by TWF or by the public sphere. With this decree, it is also possible to provide a Treasury guarantee. As a result, the TWF will be indirectly borrowing from external sources through the companies under its trustee. The impact of the new guarantees under the credit guarantee fund has not been made explicit in the ERP.</p>

<p>PG 3:</p> <p>Intensify efforts to sustainably achieve price stability.</p> <p>Better anchor inflation expectations by pursuing a more credible and tighter monetary policy stance as soon as GDP growth rebounds and by clearly communicating this to the public.</p> <p>The central bank should not step backwards in terms of its self-imposed objective to simplify the monetary policy framework</p>	<p>There has been limited implementation of PG3:</p> <ul style="list-style-type: none"> • Limited implementation: The monetary tightening that was undertaken was not sufficient to prevent a further rise in both headline and core inflation. • Not implemented: Inflation expectations were constantly above the target and continued on a rising path. Moreover, the limited tightening of the monetary policy stance was counteracted by the strong expansion of the credit guarantee fund, which contributed to a surge in credit growth. • Limited implementation: All funding was shifted to the late liquidity window. However, the framework is still distant from a transparent and predictable operational setting under an inflation targeting regime, with the main policy rate being the key signaling instrument for the monetary policy stance.
<p>PG 4:</p> <p>Strengthen the rule of law and the judiciary with a view to improving the business environment and investors' confidence.</p>	<p>There has been limited implementation of PG 4:</p> <ul style="list-style-type: none"> • The state of emergency continues and the government took active control of close to 1000 companies over accusations of alleged links with forces behind the attempted coup. Investigations into these companies continue. • New judges and prosecutors were recruited following the dismissals after the attempted coup.
<p>PG 5:</p> <p>Update the strategy in support of research and development;</p> <p>this should target an increase in total spending on research and development</p> <p>and include financial and legislative initiatives to support the capacity of companies, notably SMEs, to adopt and implement innovative production processes.</p>	<p>Turkey has partially implemented PG 5:</p> <ul style="list-style-type: none"> • The R&D strategy has been updated by TUBITAK but not adopted yet. • The draft focuses on increasing total R&D spending. • Laws on support for industry and support for R&D activities have already been amended, enabling support programmes and incentives for SMEs, the establishment of technology development zones, the employment of R&D staff and support for R&D activities.
<p>PG 6:</p> <p>Focus skill developments on sectors with growth potential and skills needs, and expand provision of relevant vocational training.</p> <p>Reform the severance pay system in order to reduce labour market rigidity.</p>	<p>There has been limited implemented of PG6:</p> <ul style="list-style-type: none"> • Partial implementation: Vocational training is being expanded across the board in a rather non-focussed manner. • No implementation: Reform continues to be discussed, but no concrete legislative initiatives so far. • No implementation: Informal employment level

<p>Reduce informal employment through, <i>inter alia</i>, increase of inspection capacities, with particular focus on non-agricultural employment.</p> <p>Improve teacher training and improve the performance of the education system towards international best practices.</p> <p>Promote the professional education and labour participation of women.</p>	<p>unchanged. Inspection capacities in Turkey are overall decreasing, since the number of inspectors is not following the increase in workforce.</p> <ul style="list-style-type: none"> • Substantial implementation: Adoption of the Teacher Strategy Document 2017-2023, which includes continuous professional development of teachers among its objectives. Pre-school education became mandatory in 22 provinces, in a pilot initiative. In the school year 2017-18, foreign language teaching in grade 5 rolled out to 110.000 students. • Partial implementation: The draft « Empowerment of Women Strategy Document and Action Plan 2018-2023 » includes measures for promoting gender balance in the private sector, job coaching for women with disabilities, and measures for promoting access to employment for women who are currently unpaid family workers (mainly in agriculture).
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5.6. THE 2018 POLICY GUIDANCE

JOINT CONCLUSIONS OF THE ECONOMIC AND FINANCIAL DIALOGUE BETWEEN THE EU AND THE WESTERN BALKANS AND TURKEY

The Economic and Financial Dialogue between the EU and the Western Balkans and Turkey

Brussels, 25 May 2018

[...]

In light of this assessment, Participants hereby invite Turkey to:

1. Lower external imbalances in light of high external funding needs constituting a substantial risk for the Turkish economy. Promote domestic savings by incentivising higher private sector savings and by following a sufficiently tight fiscal stance over the medium term in light of external vulnerabilities built up over the years.
2. Increase the prudence and transparency of fiscal policy by (i) making a sufficiently prudent inventory of risks to public finances stemming from Public Private Partnerships and other contingent liabilities (ii) limiting the accumulation of new contingent liabilities reflected in the budget (iii) avoiding ad hoc increases in tax exemptions and subsidies, and (iv) making the medium-term economic scenario more conservative.
3. Focus monetary policy on the pursuit of price stability and ensure that the monetary policy stance is sufficiently tight to bring inflation back to the target band, anchor inflation expectations and increase trust in the local currency. Simplify the monetary policy framework by returning to the main policy rate as the key signalling device for the monetary policy stance in order to increase transparency of monetary policy. Closely monitor asset quality amid buoyant credit growth, especially for loans backed by the credit guarantee fund. Continue addressing possible risks associated with corporate forex borrowing.
4. With a view to improving the business environment, strengthen the rule of law and the judiciary. Further reduce the administrative burden for companies including by shortening the timing and lowering the cost of insolvency procedures through the effective implementation of the amended law on bankruptcy.
5. Adopt the strategy in support of research and development. Encourage private companies' uptake of innovative production processes.
6. Ensure a balanced regulation of the labour market combining flexibility with security including the reform of the severance pay system, and reduce informal employment through, inter alia, increase of inspection capacities, with particular focus on non-agricultural employment. Target support for job creation to youth and women. Focus support to the expanded provision of vocational training on sectors with growth potential and skills needs.

ANNEX: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The Economic Reform Programme 2018-2020 was sent to the Commission on 31 January 2018. Overall, adherence to the Commission Guidance Note is weak. The ERP does not contain information on the implementation of the policy guidance from 23 May 2017. The area diagnostics are largely missing from section 4.3., as is a description of potential risks and possible mitigating actions. Section 5 on budgetary implications of structural reforms is completely missing, as is table 9 on selected employment and social indicators. Table 10 on the matrix of policy commitments does not include all structural reforms measures.

Inter-ministerial coordination

The ERP was centrally coordinated by the Ministry of Development. Proposed reform priorities of line ministries were only partially taken over by the Ministry of Development, mostly in cases where these were already included in Turkey's Medium-Term Programme (on which the ERP is largely based). The input from line-ministries in several cases was incomplete, leading to weak area diagnostics, describing past achievements and future plans rather than key obstacles to growth and competitiveness. Line ministries were not consistently informed by the Ministry of Development on reasons why their proposed priorities were not taken over. Communication should therefore be improved and the ERP process itself should start earlier (line ministries' input was only requested mid-October, after the finalisation of the Medium Term Programme).

Stakeholder consultation

No consultation with external stakeholders took place. External stakeholders should be given the possibility to comment on a draft ERP before it is finalised and adopted.

Macroeconomic framework

The set-up of the chapter on the macroeconomic framework broadly follows the outline given by the guidance note. It covers nearly all the main elements. Some rebalancing between the section on recent economic developments and the sections on the medium-term scenario and, in particular, on alternative scenarios and risks would be welcome. The guidance notes suggests the first section to be very brief (it is 11 pages in the 2018 ERP) whereas the section "main risks in projections" is less than one page. The medium-term scenario does not explain differences with the Commission services forecast. It is also not fully clear how the IMF World Economic Outlook of October 2017 and its update of January 2018 are integrated in the forecast (second and third footnote of the annex' table 6).

Fiscal framework

The set-up of the chapter on the fiscal framework closely follows the outline given by the guidance note. It covers all of the main elements and gives significant detail on some elements which helps assessing the state of the Turkish public finances and its medium-term scenario. This year, a more elaborate analysis of debt sustainability is added which is welcome. Still, how the 2018 budget fits into the medium-term fiscal scenario is unclear. The section on contingent liabilities covers only Treasury-related contingent liabilities and excluded contingent liabilities of line ministries and state-owned financial institutions (including the KGF credit guarantee fund and the Turkish Wealth Fund).

Structural reforms

The structural reforms priorities section does not follow the guidance note and for most areas does not identify key obstacles to competitiveness and long-term growth. The reporting on the implementation of

the policy guidance is completely missing, whereas the reporting on the implementation of the structural reform measures for 2017-2019 is inconsistent with last year's programme and also contains measures from the ERP 2018-2020. The 2018-2020 ERP includes 10 reform measures. This low number of measures (the guidance note prescribing 15-20) calls into question the comprehensiveness of the suggested reform agenda and the role played by the ERP in Turkey's strategic planning. The reform measures are better specified than last year, but in many cases still not accompanied by well-defined activities planned over the programme's three-year lifetime. Clear timelines and budget information are often lacking and the level of concrete detail is low. Table 10 on policy commitments does not include all 10 measures and contains a measure in transport (national transport master plan) which is not included in the programme.

6. BOSNIA AND HERZEGOVINA

6.1. EXECUTIVE SUMMARY

Bosnia and Herzegovina's economic reform programme (ERP) was received by the Commission on 2 March 2018, i.e. one month after the deadline. Due to the late submission, the present assessment is limited to the main features of the programme.

The ERP is based on a moderately strengthening economy. Output growth is expected to accelerate from 3.4 % in 2018 to 3.9 % in 2020. This acceleration is forecast to be driven by investment, which is seen as picking up after performing weakly for years, and private consumption, which has benefited from rising employment and low inflation. There are mainly downside risks to this scenario. The much-needed pick-up in investment depends on a clear improvement in the country's investment climate, improved governance and policy commitment, and on progress with long overdue public investment.

Fiscal projections envisage a significant expenditure-driven consolidation, targeting increasing budgetary surpluses. Both revenue and expenditure are expected to fall substantially as a share of GDP, to an extent unprecedented in the country's recent history. The already low level of public investment would also be reduced further, which is contrary to the country's needs and also not in line with the programme's growth assumptions. There is a lack of quantitative information underpinning the measures presented. Based on the ambitious fiscal projections, public debt would fall from 36.8 % of GDP in 2017 to below 30 % in 2020.

Bosnia and Herzegovina needs to accelerate structural reforms to improve its growth prospects. The country suffers from below-potential growth, which is delaying a swift reduction of unacceptably high unemployment. Frequent political stalemates impede progress with long overdue structural reforms. The main challenges include the following:

- **Fiscal policy is insufficiently geared towards improving the quality of public spending by focusing on growth-enhancing areas like public investment and education.** The country's access to international financing is limited and domestic sources are already stretched, although recent reforms, such as increases in excises, will unlock significant IFI funds to finance overdue public investment projects. Public spending remains heavily biased towards consumption and redistribution, clearly neglecting medium-term needs in the areas of education and infrastructure.
- **The quality of short and medium-term fiscal planning remains weak.** Besides insufficient political commitment towards medium-term policy challenges, limited administrative capacities remain a key constraint. Fragmented responsibilities and insufficient cooperation and coordination among the various stakeholders slow down necessary reforms. Weak statistics and outdated accounting approaches are also major impediments to better policy design.
- **Bosnia and Herzegovina's competitiveness continues to be hampered by the absence of a single economic space with a unified approach to enterprise policy.** The oversized and inefficient public sector, running up considerable arrears in payments, leaves little room for boosting growth-friendly public investment. In spite of some ongoing efforts to facilitate business registration, the process remains cumbersome, including non-recognition of business registration across the country.
- **Bosnia and Herzegovina lacks a country-wide energy strategy and a legal framework in compliance with its obligations under the Energy Community Treaty, reflecting shortcomings in coordination and cooperation between government levels.** This limits opportunities for growth in

this sector. The ERP is addressing this issue by proposing a reform measure related to adopting a framework energy strategy.

- **Despite some positive developments on the labour market, most of the structural challenges remain.** Low pre-school participation and poor performance in basic education hamper people in increasing their skills and training as it negatively affects achievements in later stages of education. The education system in Bosnia and Herzegovina does not correspond to the country's labour market needs and the link between education and the economy is weak, resulting in both vertical and horizontal skills mismatches. Weak activation and employment support are coupled with disincentives to work, linked to untargeted social benefits schemes and unsupportive taxation. Stronger action towards career counselling, outreach to jobseekers, profiling and strengthened cooperation with employers is needed. There is also a need for comprehensive "mapping" of social benefits and for transition from status-based to needs-based assistance. Data collection also remains an issue.

The policy guidance jointly adopted at the Economic and Financial Dialogue of 23 May 2017 has been implemented to a limited extent. Political tensions during most of last year have slowed down progress with necessary reforms. There is still no country-wide energy strategy, nor a legal framework in place that complies with the Energy Community Treaty. Company registration procedures still differ between the two entities (the Federation of Bosnia and Herzegovina (FBiH) and Republika Srpska (RS)) and remain cumbersome and costly. Some efforts were made to simplify business registration procedures through one stop shops and online registration, but the law on electronic signature has not yet been fully implemented. Some activities were carried out aiming to further develop and implement the qualifications framework for lifelong learning. Active labour market measures have not been implemented effectively and unemployment among the targeted population remains high.

The macroeconomic projections are slightly optimistic, with key elements strongly depending on structural reforms being swiftly implemented. The fiscal framework fails to shift towards a more growth-enhancing spending structure. The analysis of structural obstacles to competitiveness largely matches the reform needs identified by the Commission. However, despite some progress, the diagnostic still focuses too much on the entities rather than the country's whole economy. Most measures presented in the ERP are not country-wide and only include entity-specific activities. This highlights the absence of a thorough consultation on country-wide challenges and reform measures among the two entities. Having a common reform strategy is a pre-requisite for addressing the challenges the country faces. In the absence of a country-wide Economic Reform Programme it is not possible to assess whether the country-wide priorities match those identified by the Commission. The weak co-operation between the entities reduces the potential benefit of the ERP. Only very limited progress has been made regarding the ERP's quality and relevance as the document lacks political ownership and support. Bosnia and Herzegovina must put in place a functioning coordination and consultation mechanism for the ERP process.

6.2. ECONOMIC OUTLOOK AND RISKS

The ERP projects growth to pick up, relying on a marked acceleration of investment and solid private consumption. The programme expects a moderate acceleration of output growth, from 3.4 % in 2018 to 3.9 % in 2020. As in the previous programme, the macroeconomic scenario envisages a significant increase in investment (by some 10 % annually), reflecting an improved business environment and a stronger inflow of international loans. Private consumption is expected to increase on average by 2.5 % annually, which is above the country's recent five-year average. Public consumption is projected to increase only by some 0.6 % on average, reflecting commitments to contain public spending. Growth in exports is expected to slow down, from 7.1 % in 2018 to 4.5 % in 2020, while imports are forecast to increase at a slightly lower rate. This brings average annual GDP growth to 3.7 % during 2018-2020, compared to 3.1 % over 2016-2017. The programme expects a continued annual increase of registered employment by 2.5 % on average, compared to 3.1 % in 2017 and 2.1 % in 2016.

The programme's macroeconomic scenario is plausible, but strongly relies on structural reforms being successfully implemented. The strong increase in investment might otherwise be difficult to achieve. The expected import growth is relatively low when taking into account the strong growth of private consumption and of often import-intensive investment. Risks appear to be largely on the downside.

Table 1:

Macroeconomic developments and forecasts

	2016	2017	2018	2019	2020
Real GDP (% change)	2.9	3.4	3.4	3.8	3.9
<i>Contributions:</i>					
- Final domestic demand	1.8	2.6	3.8	3.9	3.9
- Change in inventories	1.5	0.1	-0.5	0.1	0.5
- External balance of goods and services	-0.4	0.7	0.0	-0.2	-0.5
Employment (% change)	0.9	1.8	2.5	2.6	2.7
Unemployment rate (%), LFS definition	:	:	:	:	:
GDP deflator (% change)	1.1	-0.1	1.3	1.4	1.6
CPI inflation (%)	-1.1	1.1	1.2	1.4	1.5
Current account balance (% of GDP)	:	:	:	:	:

Sources: Economic Reform Programme (ERP) 2018

Inflation is expected to remain subdued, and the external position and its financing still appear to be largely unchanged. The programme does not expect any significant domestic price pressures resulting from increases in taxes, duties and fees, which, in combination with expected low increases in international prices, results in rather low inflation of between 1.2 % — 1.5 % annually. Domestic price pressures are expected to remain moderate, given the country's high unemployment and moderate growth expectations. The current account deficit is expected to remain at around 4 % of GDP during the programme period, partly thanks to improved export growth. The financing of the current account deficit is expected to come primarily through foreign direct investment (FDI) and other capital inflows. This profile appears to be optimistic given the risk of higher imports should the envisaged investment increase.

6.3. PUBLIC FINANCE

The programme provides neither consistent data on the country's actual fiscal performance in 2017 nor on the adopted budgets for 2018. However, the document presents a medium-term fiscal projection, adopted in October 2017, providing data for 2016-2020. For 2017, the programme expects a budget surplus of 0.9 % of GDP, after a surplus of 1.2 % in 2016, resulting from a slightly stronger increase in spending (+4.2 % year-on-year) rather than of revenues (3.5 % year-on-year). Data on the fiscal performance in 2017 are not complete, not consistent, nor aggregated at country level. Unfortunately, information on the adopted budgets for 2018 is largely missing.

Table 2:
Composition of the budgetary adjustment (% of GDP)

	2016	2017	2018	2019	2020	Change: 2017-20
Revenues	39.7	39.8	38.1	36.6	35.2	-4.6
- Taxes	21.1	21.7	21.3	20.6	19.9	-1.8
- Social security contributions	14.4	14.0	13.4	12.9	12.4	-1.6
- Other (residual)	4.2	4.1	3.4	3.1	2.9	-1.2
Expenditure	38.5	38.9	36.7	34.9	33.4	-5.5
- Primary expenditure	37.7	37.9	35.8	34.0	32.6	-5.3
<i>of which:</i>						
Public consumption	17.3	17.4	16.6	15.7	15.0	-2.4
thereof: compensation of employees	10.8	10.7	10.1	9.7	9.2	-1.5
Social transfers	15.4	15.0	14.5	13.9	13.3	-1.7
Subsidies	1.2	1.5	1.2	1.1	1.1	-0.4
Gross fixed capital formation	2.3	2.6	2.0	1.7	1.7	-0.9
Other (residual)	2.7	2.9	2.7	2.7	2.6	-0.3
- Interest payments	0.8	1.0	0.9	0.9	0.8	-0.2
Budget balance	1.2	0.9	1.4	1.7	1.8	0.9
- Cyclically adjusted	1.0	1.2	1.4	1.6	1.7	0.5
Primary balance	2.0	1.9	2.3	2.6	2.6	0.7
Gross debt level	39.2	36.8	34.7	31.7	28.3	-8.5

Sources: 2018 Economic Reform Programme (ERP), ECFIN calculations

The fiscal framework for 2018-2020 envisages a further increase in the budget surplus, while the spending structure is set to further deteriorate. The fiscal surplus is expected to rise from +0.9 % of GDP in 2017 to +1.8 % of GDP in 2020. Like in previous programmes, the overall level of nominal spending is envisaged to remain largely unchanged, while nominal revenues are expected to increase moderately, by 3 % during 2018-2020, while nominal GDP is projected to increase by about 16 % over the same period. This results in a drop of the spending-to-GDP ratio by 5.5 percentage points, while the revenue-to-GDP ratio will fall by only 4.6 percentage points. About half of the spending reduction is supposed to come from subdued public consumption, while another third will be due to contained spending on social transfers. Spending on public investment is scheduled to drop by 19 % and 13 % in nominal terms in 2018 and 2019, declining from a share of 2.6 % of GDP in 2017 to 1.7 % in 2020. This is in sharp contrast to the projections in the macroeconomic part, where public investment is expected to increase by 35 % and 28 % in 2018 and 2019, respectively. In terms of spending structure, the share of social transfers in total expenditure is set to increase by 1 percentage point, while the share of capital

spending is envisaged to drop by 1.5 percentage points. This reduction in investment is not in line with the policy guidance jointly adopted in the last two years. Overall, like in previous years, the policy orientation of the medium-term fiscal framework is not geared towards the country's main policy challenges, such as improving education and the country's capital endowment.

Like in previous programmes, the document provides no detailed information on the underlying measures. A reduction in both revenues and spending of such a magnitude is quite unprecedented in the country's recent history. Compared to the previous programme, the current programme is frontloaded, with the main adjustment happening in 2018, which is positive but a bit surprising in view of upcoming general elections scheduled for October. More information would have been welcome, particularly on the concrete fiscal effects of planned measures. The link to an overarching policy strategy is missing. The programme also remains largely silent on areas with pressing reform needs, such as pensions, public administration and healthcare. The projection of revenues is not consistent with the macroeconomic scenario. The underlying economic dynamics and plans to broaden the tax base should allow for stronger revenue growth in 2018-2020.

The quality of public finance and budget planning remains weak. The programme refers to the importance of improving the quality of public finance management, but fails to mention concrete reform projects and their expected fiscal impact. Medium-term budget planning remains weak and is impeded by fragmented responsibilities across the country's entities.

Box: Debt dynamics

Table 3:
Composition of changes in the debt ratio (% of GDP)

	2016	2017	2018	2019	2020
Gross debt ratio [1]	39.1	36.7	34.7	31.7	28.3
Change in the ratio	-1.5	-2.4	-2.0	-2.9	-3.4
Contributions [2]:					
1. Primary balance	-2.0	-1.9	-2.3	-2.6	-2.7
2. 'Snowball' effect	-0.7	-0.3	-0.8	-0.8	-0.8
<i>Of which:</i>					
Interest expenditure	0.8	1.0	0.9	0.9	0.8
Growth effect	-1.1	-1.3	-1.2	-1.3	-1.2
Inflation effect	-0.4	0.0	-0.5	-0.5	-0.5
3. Stock-flow adjustment	1.2	-0.2	1.0	0.5	0.1

Notes:

[1] End of period.

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

Source: 2018 Economic Reform Programme (ERP), ECFIN calculations

The programme envisages accelerated debt reduction. The key reasons for the drop in the debt ratio are primary surpluses and nominal growth, while the costs of debt servicing raise the debt level by about one percentage point of GDP per year. However, a breakdown of the debt dynamics into various components also points to a substantial debt-increasing factor, presented in the table as 'Stock-flow adjustment', raising the debt ratio by 1 % of GDP in 2018 and by 0.5 % of GDP in 2019. Unfortunately, the programme does not provide more details on the underlying assumptions driving this envisaged debt profile.

Public debt dropped by nearly 4 percentage points of GDP in 2016 and 2017, mainly driven by sizeable primary surpluses. However, there are risks of rising financing costs and debt-rollover risks, mainly related to domestic debt or public debt at foreign-owned banks. Public debt doubled after the 2008 financial crisis, reaching its peak in 2015 of about 42 % of GDP. In 2017, public debt declined to some 37 % of GDP, mainly thanks to primary surpluses. International financial institutions such as the World Bank, the EIB and the IMF are key lenders, given the country's difficulties in accessing international financial markets and the shallowness of the domestic financial market. The average implicit interest rate has been low at some 2 %, but this rate is projected to rise to nearly 3 % by 2020. There are also significant refinancing risks. Furthermore, there is a significant difference in the indebtedness of the two entities, with the Republika Srpska entity registering a significantly higher debt ratio than the rest of the country.

6.4. STRUCTURAL REFORMS

The main factors weighing on competitiveness are the (i) large, inefficient, complex and burdensome public sector that dominates the economy and (ii) the absence of a single economic space. Complex and inefficient administrative structures and high political and regulatory uncertainty exacerbate the high cost of doing business. Investment is discouraged due to fragmented and poorly functioning product and labour markets, a weak rule of law and a still poor business environment. The skills mismatch and poor quality of the education system trigger structural unemployment. Weak employment activation and disincentives to work negatively affect labour market participation at all levels. The country-wide diagnostic in the ERP largely identifies the relevant obstacles to long-term growth, while the area diagnostics tend to be too fragmented and do not provide a full-fledged country-wide analysis.

There are only nine reform measures in the programme that have the potential to cover the whole country. They are spread across six different areas with a focus on public finance management (PFM) and agriculture. Measures often lack focus and prioritisation. In addition, they attempt to cover a range of activities that is too wide. Many measures are expressed as desired outcomes and they lack information on precise activities, cost estimates and the expected impact on competitiveness, although some progress has been made in providing information on implementation timelines. The Commission's recommendation to identify a list of 15-20 measures that address common country-wide obstacles to competitiveness and growth has been ignored to a large extent.

Public finance management

The lack of a PFM reform programme has resulted in (i) a poorly controlled public finance system with an oversized and inefficient public sector and (ii) low and inefficient public investment. The public sector is accumulating substantial arrears, reflecting a lack of fiscal discipline and accountability in subnational governments, extra-budgetary funds, healthcare systems and State Owned Enterprises. Public procurement procedures represent a high administrative burden for businesses and lack transparency. By pointing to an inefficient public administration, high fiscal burden on labour, numerous para-fiscal fees and the largely unreformed health sector, the ERP identifies some of the key country-wide challenges to PFM that hamper growth and competitiveness.

All levels of government view the strengthening of PFM as a priority. In line with the Reform Agenda¹, efforts have increased to present three partly rolled over reform measures from the last ERP with country-wide coverage. The measures to pursue fiscal consolidation, to lower the tax burden on labour and to address arrears in the health sector have the potential to further improve the sustainability of public finances and financial accountability. However, a measure to prepare a country wide PFM strategy is missing.

Energy and transport market reform

Fragmented and weak regulatory and legal frameworks in the energy and transport markets, which reflect the lack of coordination and cooperation between government levels, hamper foreign direct investment and private sector development. Bosnia and Herzegovina still lacks a country-wide energy strategy and a legal framework in compliance with its obligations under the Energy Community Treaty, particularly for the natural gas sector. The ERP diagnostic largely recognises these shortcomings. The country has a very large gap of strategic transport infrastructure, notably of its railway network. The motorway network also needs to be completed.

¹ The Reform Agenda for 2015-2018 was adopted by all levels of government in July 2015 and consists of a package of socio-economic, public administration and rule of law reforms.

The measure to draw up a country-wide energy strategy continues not only to be relevant but essential, and the delays in implementing it continue to have adverse effects on the country's economy. Restructuring of the railways should have been included as a common measure since both entities are working on similar reforms. Such a measure would make railway companies more efficient, financially sustainable and commercially focused and would increase the railway modal share.

Sectoral development

Agricultural sector development

Bosnia and Herzegovina faces many obstacles to increasing agricultural productivity and opportunities. These include low overall investment and administrative capacities, land fragmentation, the large proportion of small farms in the sector, low productivity and outdated manufacturing and processing capacities. The diagnostic recognises these shortcomings and identifies the lack of an agricultural information system and an agricultural census as major challenges.

The two measures on fulfilling the pre-requisite for using funds under the EU's Instrument for Pre-Accession Assistance and on amendments to the laws on veterinary practice, food and agriculture, and rural development will further develop and integrate the agricultural market into the European and global market. The recent adoption of a country-wide Strategic Plan for rural development is important for improving the country's competitiveness.

Industry sector development

The industry sector still suffers from the lack of a single economic area. The ERP does not make reference to this nor does it contain a country-wide analysis, but it describes the industrial base as underdeveloped and insufficiently diversified, with industrial output focusing on lower value-added products. The industrial sector covers a narrow range of traditional low and medium value-added industries in mining, metal and wood processing, machinery, textiles, tobacco, ammunition and domestic appliances, with little or no innovation.

Service sector development

The service sector is the largest in terms of employment and value generation with 66.2% of gross value added and almost 53% of employment in 2015. However, this reflects to a large extent the dominant size of the public sector. Tourism remains a key driver of growth. While the ERP recognises its potential, it fails to provide a country-wide analysis of the services sector.

Business environment and reduction of the informal economy

The overall business environment is adversely affected by the lack of a single economic space, political uncertainty and several structural obstacles. Access to finance, a significant informal economy and corruption continue to be serious problems. The diagnostic largely recognises some of these challenges, but does not sufficiently address issues related to (i) numerous para-fiscal charges, (ii) a fragmented and overly complex regulatory environment, (iii) non-recognition of business registration across the country, (iv) high costs of compliance with regulations, (v) a large and inefficient public sector and an (vi) unsupportive labour taxation system. No sufficient explanation has been provided why the measure to introduce electronic signatures was dropped.

The measure on harmonisation of the quality infrastructure is highly relevant and will contribute to creating a single economic space and to facilitating trade. Cross-cutting coordination between the relevant institutions at different levels of government has yet to be ensured. The reform measure does not

specify timelines, concrete activities or impact and will require proper cooperation between all levels of government.

Research, development and innovation and the digital economy

Bosnia and Herzegovina's research capacity remains limited. Public investment in research and innovation (0.24% of GDP in 2016) is extremely low. The ERP provides a fairly good assessment of the deficiencies in the Research, Development and Innovation (RDI) system by referring for instance to insufficient technological innovation in enterprises, the lack of support programmes for businesses, the lack of networking with research and education institutions as well as insufficient broadband infrastructure. The country should increase its investment to ensure the building of the necessary long term research capacity, aiming also to increase the low number of researchers. The country could benefit from a smart specialisation strategy. Bosnia and Herzegovina should focus on measures to address the lack of ICT strategies and broadband development

Trade related reforms

The country is one of the least economically integrated in the region, with an export share of 36% of GDP in 2017, down from 98% prior to the 1992–1995 war. It still lags behind its neighbours due to burdensome administrative procedures for trading and limited export promotion capacities. Main areas of concern include: (i) a fragmented domestic market, (ii) complex export procedures, (iii) the absence of coordinated border controls and (iv) the absence of a comprehensive approach to meet EU food safety and sanitary and phytosanitary standards. The ERP identifies some of these concerns.

The new measure to develop an export promotion strategy is relevant and overdue. Bosnia and Herzegovina can use parts of an existing draft strategy which addresses priorities, such as boosting exports, reducing the foreign trade deficit and addressing the structural problems of exports. Envisaged legislation related to FDI and external trade policies should support the strategy's implementation. The timeframe, costing and impact of the measure are vague.

Education and skills

The formal education system in Bosnia and Herzegovina is weak and does not correspond to labour market needs. Enrolment in pre-school education is low, as is the performance in basic education. Development of a level 5 qualification would serve as a bridge between post-secondary education and labour market needs. Data on higher education show a falling number of students, relatively low completion rates and an oversupply of graduates in certain fields of study. The development of entrepreneurial and digital skills needs strengthening, especially for young people, to improve their employability and competitiveness on the labour market. There is no country-wide measure included on education and skills.

Employment and labour markets

Despite some positive developments in the labour market, most of the structural challenges remain. Structural unemployment and low activity rates persist, mostly affecting women, young people and the long-term unemployed. Weak activation and employment services are coupled with disincentives to work (untargeted social benefits schemes and unsupportive taxation). The share of undeclared work also remains high. Active labour market policies are mostly focused on employment subsidies and not training programmes. Data collection is also an issue.

One country-wide reform measure aims to improve the targeting of active labour market policies and to reduce the administrative burden on the public employment services. Stronger activation, such as career counselling and outreach to jobseekers and profiling, including cooperation with

employers, is needed. Many actions require legislative or institutional changes, which increases the risk of delays.

Social inclusion, poverty reduction and equal opportunities

Despite a high level of poverty and other social challenges, the social protection system is underdeveloped and the effectiveness of social transfers is limited. The Roma community, women and young people are more likely to be poor, economically excluded or in economic dependency. Social benefits are insufficient to fulfil basic needs and their targeting is weak. There is no comprehensive “mapping” of social benefits and no plans to move from status-based to needs-based assistance. Social benefit schemes also discourage people from entering the formal labour market and stimulate informal employment without sufficient coordination with active labour market policies. Monitoring of poverty, inequality and social indicators need improvement. The reforms are not tackling the problems identified on a country-wide level, making the proposed measures insufficient to address the key structural challenges.

6.5. IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2017

2017 policy guidance	Summary assessment
<p>PG 1:</p> <p>Enhance the growth-friendliness of public finances; in particular, create fiscal space for public investment by containing spending on public consumption, and</p> <p>Improving the targeting of social spending.</p> <p>Take steps to reduce public sector payment arrears, including social security contributions.</p>	<p>There has been limited implementation of PG 1:</p> <ul style="list-style-type: none"> • Partial implementation: The authorities made efforts to contain spending on public consumption. • No implementation: No progress has been made towards implementing a better targeting of social spending. • Limited implementation: First steps have been taken to prepare an inventory of public sector payment arrears.
<p>PG 2:</p> <p>Improve the provision of timely and exhaustive statistics, in particular government finance, national accounts and labour market statistics.</p> <p>Strengthen capacities for consolidated macro-fiscal analysis and planning at country level by enhancing coordination between the various stakeholders.</p> <p>Apply the current medium-term fiscal planning instrument in a policy-oriented way.</p> <p>Strengthen the country-wide public debt management capacities at all levels, in particular the cooperation and flow of adequate and full information from all data providers.</p>	<p>There has been limited implementation of PG 2:</p> <ul style="list-style-type: none"> • Limited implementation: There has been some progress in improving the provision of data for some statistical areas (mainly for national accounts' main aggregates and government finance statistics), but the overall situation with respect to the timeliness and exhaustiveness of provided data has remained weak. • No implementation • No implementation • Limited implementation: Steps have been taken to strengthen debt management, such as improving the analysis of debt sustainability and adopting a medium-term debt strategy. However, cooperation and the flow of information from local data providers to the state level have not improved significantly.
<p>PG 3:</p> <p>Follow up on ongoing legislative changes and develop a comprehensive strategy fostering the resolution of NPLs to address the fragilities of bank balance sheets and thus help remove supply-</p>	<p>There has been limited implementation of PG 3:</p> <ul style="list-style-type: none"> • Limited implementation: While the new banking laws, which have strengthened the supervisory powers of the banking agencies and introduced a modern bank resolution

<p>side bottlenecks to credit extension.</p> <p>Strengthen the bank resolution framework by ensuring sufficient coordination among the bodies entrusted with resolution.</p> <p>Establish a bank lending and inflation expectations survey.</p>	<p>framework, are a step in the right direction, the framework of recovering and resolving NPLs needs to be improved by facilitating out-of-court restructurings and amending the tax treatment of NPL sales to specialised companies.</p> <ul style="list-style-type: none"> • Limited implementation: The financial stability memorandum of understanding has yet to be signed, limiting the space for cooperation and coordination among financial sector regulators and supervisors, and the Law on Deposit Insurance has not been approved yet, which is an integral part of the bank resolution framework. • No implementation: No progress has been made regarding the analytical and policy toolkit of the Central Bank of Bosnia and Herzegovina. The Central Bank still does not perform any bank lending or inflation expectations surveys
<p>PG 4:</p> <p>Adopt a country-wide energy sector reform strategy</p> <p>and a legal framework in compliance with the Energy Community Treaty.</p>	<p>There was limited implementation of PG 4:</p> <ul style="list-style-type: none"> • Limited implementation: Although a draft framework energy strategy has been developed, the process of getting opinions from relevant bodies is still ongoing. • No implementation.
<p>PG 5:</p> <p>Simplify, harmonise and ensure mutual recognition of business registration procedures between entities, including concessions, licensing and allowing branch office registration across entities.</p> <p>Introduce e-payment services on taxation</p>	<p>There was limited implementation of PG 5:</p> <ul style="list-style-type: none"> • Limited implementation: Some simplification of business registration procedures through one stop shops and online registration has taken place. In RS, company registration can be carried out through a one-stop procedure managed by the Agency for Intermediary, IT and Financial Services. In the FBiH, efforts are ongoing to establish a one-stop procedure (via the Financial Information Agency)..RS has started the digitalisation of documents of all businesses as a precursor for online registration. • Limited implementation: In early 2018, the ITA introduced e-services for the payment of VAT for large companies. As electronic signature is not yet fully implemented, ITA uses a temporary solution (web based authentication). The ITA has not yet received a reply from the Ministry of Communications and Transport regarding their request to become a

<p>and fully implement the law on electronic signature.</p>	<ul style="list-style-type: none"> • Limited implementation: The 2006 law on electronic signature has not yet been fully implemented. The Office for Supervision and Accreditation within the BiH Ministry of Communication and Transport has started to function as of mid-January 2018 when staffing of this body progressed. Nevertheless, applications from bodies looking to become certification authorities for e-signature have still not been processed.
<p>PG 6:</p> <p>Strengthen the employment services to better assist job seekers, in particular youth, women and long-term unemployed.</p> <p>Reduce the tax wedge</p> <p>and reinforce delineation of employment and social policy measures.</p> <p>Increase enrolment in pre-school education.</p> <p>Address skills mismatches by increasing participation in vocational and higher education programmes relevant for labour market needs.</p>	<p>There was limited implementation of PG 6:</p> <ul style="list-style-type: none"> • Limited implementation: Some steps were taken to strengthen employment services, including the adoption of a decision on labour market policy guidelines and active employment measures in BiH. Limited staff training for new working methods was undertaken in employment bureaus. However, active labour market measures including training, internships, self-employment and public works intended to support the employment of vulnerable groups have not been effectively implemented and unemployment among the targeted population remains high. Additional capacity and financing are needed to stimulate people to actively search for jobs. Passive labour market measures remain dominant. • Limited implementation: Measures announced but delayed. • Limited implementation: The draft laws on mediation in employment have been prepared, but are still pending adoption. The laws aim at improving unemployment registration and social security for the unemployed by strengthening obligations of the unemployed for active job search, obligation by employers to deliver information on employees and by the employment services regarding the provision of the right to unemployment benefits. • Limited implementation: The Council of Ministers adopted the platform for development of preschool education in BiH. • Limited implementation: Some activities were carried out aiming to further develop and

	<p>implement the qualifications framework for lifelong learning in general, vocational and adult education. There was some progress in higher education: a state-level policy document setting priorities for 2016-2026 was adopted in March 2017; the RS adopted its own education development strategy for 2016-2021 in April 2017. In the FBiH, the situation varies depending on the canton.</p>
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6.6. THE 2018 POLICY GUIDANCE

JOINT CONCLUSIONS OF THE ECONOMIC AND FINANCIAL DIALOGUE BETWEEN THE EU AND THE WESTERN BALKANS AND TURKEY

The Economic and Financial Dialogue between the EU and the Western Balkans and Turkey

Brussels, 25 May 2018

[...]

In light of this assessment, and also taking into account the Reform Agenda, Participants hereby invite Bosnia and Herzegovina to:

1. Improve the current medium-term fiscal planning framework to become an effective policy planning tool for public finance. Strengthen the analytical capacities of the various stakeholders producing macro-fiscal analysis and forecasts. In order to better support policy analysis, improve the provision of timely and exhaustive statistics, in particular government finance, national accounts and labour market statistics. Strengthen the country-wide public debt management capacities, at all levels, in particular the cooperation and flow of adequate and full information from all data providers.
2. Create fiscal space for public investment by containing spending on public consumption and improving the targeting of social spending. Furthermore, take steps to reduce public-sector payment arrears and lower the tax burden on labour, including social security contributions while ensuring sustainable public finances.
3. Safeguard the integrity of the currency board arrangement as the anchor of monetary stability. Enhance further the analytical and forecasting capacity of the CBBH, and develop its toolkit by establishing a bank lending and inflation expectations survey. Follow up on ongoing legislative changes and develop a comprehensive strategy fostering the resolution of NPLs to help remove supply-side bottlenecks to credit extension. Strengthen the bank resolution framework by ensuring sufficient coordination among the bodies entrusted with resolution. Develop a macroprudential framework so as to mitigate systemic risk in the financial system.
4. Adopt a credible and relevant country-wide Public Financial Management strategic framework with a performance based monitoring and reporting system. Adopt a countrywide energy sector reform strategy and a legal framework in compliance with the Energy Community Treaty.
5. Simplify and harmonise business registration procedures between entities. Introduce e- payment services on taxation and fully implement the law on electronic signature.
6. Reduce the tax wedge and disincentives to work. Ensure better coordination between employment activation measures and social benefit schemes. Increase enrolment in preschool education. Undertake a review of secondary and higher education enrolment policies in order to improve their links with the labour market needs.

ANNEX: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The Council of Ministers adopted with reservations the ERP 2018-2020 on 30 January 2018 and it was not submitted to the Commission by the deadline (31 January 2018). The ERP was officially submitted to the Commission on 2 March, after a delay of over 1 month.

Inter-ministerial coordination

The preparation of the ERP was centrally coordinated by the Directorate for Economic Planning (DEP). Contributions to the ERP were prepared and endorsed at entity level, with measures the entities wanted to be implemented. No single country-wide programme was presented due to lack of ownership of the exercise and not enough political support.

Stakeholder consultation

The draft ERP was published on the DEP website less than two weeks before the deadline for submission to the Commission. Invitations to comment were sent out to relevant stakeholders, but no comments were received due to the very short deadline.

Macroeconomic framework

The programme does not provide the full set of the required data; in some areas, the data provided are incomplete, inconsistent, fragmented and not comparable. The recent macroeconomic performance is adequately described. The macroeconomic framework is sufficiently comprehensive. However, key features, such as labour market developments, should have been explained in greater detail and be supported with underlying data. Consistency with other parts of the programme, particularly with the fiscal framework, is still very limited.

Fiscal framework

The fiscal framework is still poorly integrated with the other parts of the programme: in particular, the public sector's investment plans are insufficiently linked to the macroeconomic framework, and the fiscal section remains largely silent on the links between public revenue/spending and structural reforms, presented in Section 4. The chosen policy approach, i.e. a marked reduction in revenue and spending, may be consistent with the objective of reducing the State's role in the economy. However, the reasons for this policy choice are not sufficiently explained. Furthermore, there are hardly any references to any other policy objectives discussed in other parts of the programme or to the Commission's assessment in the 2016 Country Report. In addition, the ERP provides hardly any quantitative analysis of measures briefly mentioned. The compilation and presentation of fiscal data is not in line with the European System of National Accounts (ESA 2010), and the programme does not present a road map for aligning the country's statistical system with EU standards or for submitting a fiscal notification.

Structural reforms

The sections on structural reforms (4, 5 and 6) do not follow the programme requirements, and do not present one coherent country-wide reform programme. This reflects the absence of a thorough consultation among the entities on country-wide challenges and reform priorities. The reporting on the implementation of the policy guidance and the structural reform measures from the 2017-2019 ERP is insufficient. There are 30 reform measures listed instead of 20 and the page limit for Section 4 is greatly exceeded.

7. KOSOVO*

7.1. EXECUTIVE SUMMARY

Kosovo's economic growth is stable but new sources of growth remain scarce. The baseline scenario of the economic reform programme (ERP) is somewhat optimistic, and forecasts GDP growth of 4.7 % on average in 2018-2020, which is above Kosovo's long term average. Private consumption should remain the main driver of growth supported by remittances, rising social transfers and partially recovering employment. The projected acceleration relies on ambitious public investment plans which should drive the overall investment growth. The contribution of public consumption to growth is expected to remain subdued because of Kosovo's limited fiscal capacity following the recent increases in categorical benefits. Shortcomings in public investment execution, a weak electricity supply and political instability remain the main downside risks to the economy. The possible construction of a major new power plant constitutes an upside risk.

Maintaining fiscal sustainability and addressing large investment needs are the main public finance objectives in 2018-2020. Revenue growth is expected to rely mainly on economic growth and improved tax compliance. The projected increase in public expenditure is driven by a steep rise in capital spending. This is due to the expected start in 2018 of several infrastructure projects supported by international financial institutions (IFIs). The deficit is projected to be 3.8 % of GDP on average in 2018-2020 (1.4 % when adjusted for capital spending excluded under the fiscal rule) and public debt is set to rise to 21% of GDP by 2020. Immediate fiscal risks stem from the still unknown final cost of the war veteran pension scheme, and the persistent pressure from large interest groups for increases in entitlements and transfers.

The main challenges facing Kosovo include the following:

- **Kosovo faces numerous development challenges which call for a judicious use of its limited fiscal space.** Preserving high shares of capital spending and improving the efficiency and efficacy of current spending remains paramount. Pressures from social groups for new transfers and entitlements risk crowding out much-needed spending on health and education. Other important areas requiring the allocation of adequate resources include social assistance for the poor and infrastructure maintenance. Against this background, prioritisation, planning and coordination of different policies are essential, while new policies should be properly evaluated and costed before adoption. However, Kosovo has so far struggled to build adequate capacities for policy evaluation, macro-fiscal forecasting, budget planning, and fiscal oversight.
- **Capital projects are regularly delayed because of the weak capacity to implement projects.** On average around 15% of the capital budget remains unused every year. This is even higher at the local level and for projects funded by the International Financial Institutions (IFIs). Furthermore, the cost of large infrastructure projects is systematically underestimated in the budget, leading to a regular reallocating of funds at the expense of other smaller projects. Boosting the administrative authorities' capacity to appraise and select projects, perform multiyear budgeting, and ensure independent project assessment and auditing will be essential if Kosovo is to achieve the ambitious public investment growth envisaged in the ERP.
- **Kosovo's business environment continues to be hampered by the large informal economy.** This results in unfair competition from unregistered companies and in problems with accessing finance, which, in turn, hampers the ability of registered business to grow and innovate. Undeclared turnover

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

and work also have negative effects on public revenue collection and workers' rights. The ERP recognises the informal economy as a problem, and proposes some measures which partially try to address it (i.e. addressing informality in the immovable property or the general inspection reform) but does not propose to address it in a comprehensive manner.

- **The unreliable supply of energy continues to be a major constraint for Kosovo's competitiveness.** Kosovan firms face the most frequent power outages in the region and there is a lot of potential to improve energy efficiency. The ERP proposes the continuation of two important measures to overcome these obstacles, including new investments in power generation (thermal and renewable sources) and energy efficiency. However, the proposed energy efficiency measures will only have a limited impact if they continue to ignore the residential sector, which is the largest consumer of electricity. The new investments in energy generation will also require a plan to gradually adjust energy tariffs to reflect new and higher costs.
- **The level of employment in the private sector is still very low.** The position of women in the labour market is marginal and is even on a declining trend. Kosovo's labour market is mostly requiring technical profiles, which the vocational education and training system does not yet deliver in sufficient quantity and quality. The education system does not provide a sufficient level of pre-primary level education, which would be an important contribution to boosting Kosovo's socioeconomic development in the longer term.

The policy guidance jointly adopted at the Economic and Financial Dialogue of 23 May 2017 has been partially implemented. Capacity constraints still hinder macroeconomic forecasting and budget planning, while no options paper was prepared for establishing a fiscal oversight body. Capacities for public procurement on local level have improved but there was no progress on limiting the costs of war veteran programmes or improving their targeting and means-testing. On the fight against the informal economy, some initial sector risk assessments have been carried out and the Strategy and Action Plan are now being reviewed and will have to be adopted. On energy, full deregulation of generation prices was achieved and some positive steps were taken towards gradual deregulation of prices for commercial consumers. However, no significant energy efficiency measures have been adopted for the private sector. The Action Plan on youth employment has been adopted and the Employment Agency has become a self-standing body.

The ERP sets out reform plans that are broadly in line with the priorities identified by the Commission. The ERP reflects the government's commitment to stable public finances and to preserving the share of capital spending. The ERP also mentions the need to support private sector development. However, recently enacted or announced fiscal policy measures are not always aligned with these goals. The ERP correctly identifies the weak quality of education and the large skills gap as major obstacles to labour market participation and employment, and to private sector development and innovation. Weaknesses in electricity supply, access to finance, contract enforcement and the large informal economy are also recognised as major impediments.

7.2. ECONOMIC OUTLOOK AND RISKS

The ERP projects a significantly more optimistic growth scenario than last years' programme. This scenario is supported by a more favourable external environment, more optimistic expectations of investment and exports growth, and strong credit growth. GDP growth is expected to gradually strengthen from the estimated 4.3% in 2017 to 5.1% in 2020. Private consumption growth, 4.6% on average in 2018-2020, is projected to continue contributing the most to GDP growth, despite surprisingly low contribution of private consumption of 0.4pp to GDP growth in 2017, which rather raises a question of data reliability. Disposable income is expected to benefit from stronger remittances, increased social transfers and rising employment. Public consumption should increase by 3.6% in 2018 due to new hiring in healthcare and judiciary sectors and more spending on infrastructure maintenance, but is set to remain subdued during the rest of the period. Investment growth is projected to moderate compared to double digit rates in 2016 and 2017, to around 7.6% on average. The ambitious public investment plan (17% average growth 2018-2020) rests on the strong implementation of IFI supported projects and final distribution of privatisation related funds. Private sector investment is expected to significantly contribute to growth only towards the end of the period, as the full impact of the recent improvements in business environment and the new incentive measures for domestic production takes time to materialise. Because of Kosovo's narrow export base, the recovery of export growth, which is expected to average 3.6% in 2018-2020, will primarily depend on external demand for metals, despite signs of stronger service exports and some export diversification. Expected import growth of on average 3.9% during this period seems underestimated given the historical trend and the substantial import component of investments.

Table 1:

Macroeconomic developments and forecasts					
	2016	2017	2018	2019	2020
Real GDP (% change)	4.1	4.3	4.6	4.9	5.1
<i>Contributions:</i>					
- Final domestic demand	7.2	4.2	6.0	5.6	6.3
- Change in inventories	0.0	0.6	-0.2	0.3	0.2
- External balance of goods and services	-3.1	-0.5	-1.1	-1.0	-1.4
Employment (% change)	11.7	:	:	:	:
Unemployment rate (%) LFS	27.5	:	:	:	:
GDP deflator (% change)	0.5	0.2	1.5	0.9	1.7
CPI inflation (%)	0.3	1.7	1.3	1.1	1.2
Current account balance (% of GDP)	-8.3	-9.0	-9.5	-10.1	-10.8

Sources: Economic Reform Programme (ERP) 2018

On the production side, GVA is expected to increase by 6.8% on average during the period driven primarily by the services sector. The expected agriculture sector growth (6.9% on average) seems overoptimistic given the historical performance and marginal policy change. The construction sector (8.9% average growth) will likely remain dependent on large public investment projects. Overall, the expected growth contribution of GVA surpasses the expected growth of GDP resulting in a negative growth contribution of net taxes in 2019 and 2020. As the ERP foresees neither the large changes in tax policy nor substantial increases in subsidies this does not seem consistent with the scenario.

The baseline scenario of accelerating growth is broadly plausible, but rather on the optimistic side as downside risks stemming from investment under-execution, unreliable electricity supply and political instability represent medium term challenges. Underperformance of public capital spending is a recurrent risk due to overoptimistic planning and poor capacity for project management and implementation. In 2018, out of budget capital spending is projected to increase by 16.7%. In addition significant absorption of IFI funds and a large disbursement from the Kosovo Privatisation Agency (PAK) are planned. This might be overly ambitious given Kosovo's limited institutional capacity and poor track record in absorbing IFI funds. Furthermore a downside risk relates to the PAK disbursements which have already been postponed for several years due to administrative issues. Lower investment expectations are reflected in somewhat less optimistic growth forecasts from the IMF (4% on average in 2018-2020). Another downside risk to growth stems from Kosovo's insufficient electricity production capacities which are prone to malfunctions. While plans to build a new power plant have advanced, any supply disturbances would cause energy imports to rise, increasing costs for the electricity production and distribution companies. Political instability and reform delays could further undermine a business environment already struggling with an inefficient judiciary, weak contract enforcement, a widespread informal economy, and an inefficient and unaccountable public administration. The ERP low growth scenario takes account of these and some other potential downside risks resulting in 3.1% average growth in 2018-2020.

The announced construction of the new power plant has the potential to significantly boost growth during the construction phase and strengthen potential growth in the medium term. This upside risk is not incorporated in the baseline projection. The construction of the new 'Kosova e re' lignite fired power plant could begin in 2018 and become operational by 2023. This would be a largest individual investment in the history of Kosovo, estimated at over EUR 1 billion (around 15% of GDP), and would provide gross electrical capacity of 500 MW. A project of such magnitude will have a major impact on growth dynamics already in the short term through higher investment, although it will be partially offset by higher imports. Another upside risk comes from possibly stronger private investment following the adoption of a comprehensive reform agenda to improve doing business and provide incentives for domestic production. The ERP's high growth scenario foresees 5.8% average growth in 2018-2020. However, given the still pending financial agreement regarding the construction and operation of the new power plant, and the traditionally slow implementation of reforms in Kosovo, the balance of risks surrounding the baseline assumptions is tilted to the downside.

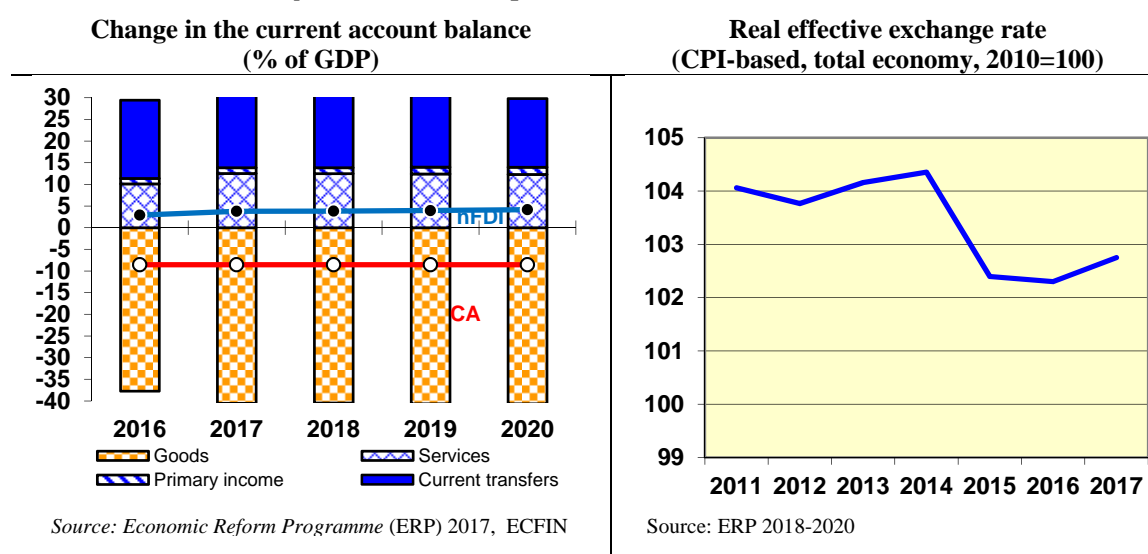
Because Kosovo is a small economy with large import components, price developments are largely determined by global commodity prices and inflation in the main trading partners. Following negative inflation in 2015 and price stagnation in 2016, inflation, rose to 1.5% in 2017, driven by food and energy prices. Core inflation stood at 1%. The ERP expects inflation to remain subdued at 1.2% on average throughout 2018-2020. This might be underestimated given the projected acceleration of GDP growth, higher inflation projections for the EU-28, 1.7% and 1.8% for 2018-2019, respectively, and the regional peers.

High trade and current account deficits reflect Kosovo's narrow production base and limited competitiveness. Current account is estimated at 9 % of GDP in 2017 but it is difficult to compare with the previous years' because of changes in methodology. Nevertheless, the trade deficit of goods and services stood at 28.4% of GDP in 2017. Net transfers (mainly remittances) were the main offsetting factor, at 19.4% of GDP. In line with expectations of higher investment and import growth, the current account balance is expected to deteriorate throughout the forecasting period to around 10.8% of GDP in 2020. Kosovo's exports still consist mostly of metals, minerals and low-value added products although the improving Herfindahl-Hirschman Index points to some export diversification.

Foreign direct investment (FDI) inflows cover part of the current account deficit but they are tilted towards non-tradable sectors. Net FDI inflows (mainly originating from the large Kosovo diaspora abroad) increased to 3.9% of GDP in 2017. However, their sectoral structure is still dominated by real

estate and construction which take up over three quarters of the total. Inflows in manufacturing and agriculture were even negative pointing to weak prospects for greenfield investments in tradable production sectors. Despite the entry into force of the Stabilisation and Association Agreement (SAA) with the EU in April 2016, Kosovo's attractiveness for investors remains undermined by major weaknesses in the business environment. FDI is projected to stay at around 4 % of GDP on average thus covering only a part of the rising current account deficit.

Graph 1: External competitiveness and the current account



Despite a slight recovery of employment due to continued growth, Kosovo's labour market conditions remain a serious concern. In the first three quarters of 2017 employment grew by 9.7% compared to the same period in 2016 bringing the employment rate to 29.7%. However, due to an increase in labour force participation the unemployment rate increased by 3.3 percentage points to 30.4% in the same period. The ERP does not provide forecasts for employment growth or the unemployment and activity rates; however with a large annual inflow of young people to the labour force and so far modest growth in employment, so far major changes in the labour market outcomes can hardly be expected. The proportion of long-term and unemployed young people is likely to remain high. The potential risk to the already weak labour market outcomes comes from the initiative to raise the minimum wage from EUR 170 (EUR 135 for young workers) to EUR 250 euro. Despite minimum wage not being adjusted from 2011 a 38 % real increase (around 74% for youth) could be detrimental to the employment of low-skilled workers.

The banking sector remains stable, liquid and profitable, but also heavily under-utilised. In 2017 Kosovo experienced the strongest credit growth (11.5%) since 2011. This was driven by demand from both households and businesses and supported by the easing of credit standards and lower loan interest rates for loans. The loans to deposits ratio increased by 3.5 percentage points to 80.4% in December 2017. The banking sector remains underutilised (total loans represent 39.3% of GDP) as mortgage lending is poorly developed and widespread informality excludes businesses from financial markets. Banking-sector risks remain contained. Non-performing loans (NPLs) reached a record low of 3.1% and are fully provisioned. The banking sector increased its profitability (21.3% return on equity in 2017 compared to 18.5% in 2016). The ERP again does not provide numerical forecasts for the financial sector. It can be assumed that credit growth would accelerate as private consumption and investment are expected to be the main drivers of growth.

Table 2:

Financial sector indicators

	2013	2014	2015	2016	2017
Total assets of the banking system, mEUR	3,059	3,187	3,387	3,637	3,877
Credit growth	2.4	4.2	7.3	10.4	11.5
Bank loans to the private sector %	50.5	44.9	41.5	40.0	
Deposit growth	7.5	3.6	6.5	7.2	6.7
Loan to deposit ratio	78.0	74.9	75.3	78.4	79.7
Financial soundness indicators					
- non-performing loans	8.7	8.3	6.2	4.9	3.1
- net capital to risk weighted assets	16.8	17.8	19.0	17.9	18.0
- liquid assets to short-term liabilities	48	43.6	44.9	41.5	38.2
- return on equity	9.4	20.2	26.4	18.5	21.3
- forex loans to total loans	0.0	0.0	0.0	0.0	0.0

Sources: National Central Bank

7.3. PUBLIC FINANCE

The sustainability of public finances was preserved in 2017, despite a significant underestimation of war veteran spending. Strong economic growth and better revenue collection contributed to revenue growth of 5.2% in 2017 compared to 2016. Revenue from indirect taxes grew by 7.2% adding to evidence of strong consumption growth. Only municipal revenue slightly underperformed as local elections caused delays in service provision. Budget expenditure slightly underperformed compared to the budget plan (95% of the plan) but still grew 4.9% compared to 2016. While overall current expenditure growth was contained, the costs of the war veteran pension scheme reached 1% of GDP instead of the projected 0.7 % as the number of certified recipients turned out to be significantly higher than expected. The share of capital spending increased for a second consecutive year to 26.9% of total expenditure (7.4% of GDP), despite lack of any disbursement by the IFIs. The overall deficit stood at 1.2% of GDP², and the fiscal rule adjusted deficit stood at 0.7% of GDP, well below the 2% ceiling.

Maintaining fiscal sustainability and addressing large investment needs are the main public finance objective in 2018-2020. The 2018-2020 budget framework predicts a 7 % average growth in revenue, with a stronger growth in 2018 (8.3 %) and moderation after that. Direct taxes are projected to grow on average 10% annually, due to a broadening of the property tax base resulting from the introduction of the new tax on land. Indirect taxes are expected to increase on average 6% with the largest contribution coming from the VAT and the announced increase in excise duties on tobacco. Non-tax revenue is projected to stagnate throughout the period owing to the announced streamlining of administrative fees. Similarly expenditure is expected to rise 19.7 % in 2018 and 4.8 % on average after that. The large increase results from IFI-funded infrastructure projects which are expected to begin in 2018. The resulting budget deficit should stand at an average 3.8 % of GDP and 1.4% of GDP using the methodology of the fiscal rule (see next paragraph). Public debt should steadily rise to 20% of GDP by 2020 while government deposits used as fiscal buffers should remain at the legally required level of 4.5 % of GDP on average.

² The text comments on actual 2017 budget execution while the ERP at times reports the expected deficit according to the 2017 revised budget

Kosovo's strengthened rules-based fiscal framework should contribute to fiscal stability while safeguarding high out-of-budget capital spending. The main pillars of the fiscal framework are the adjusted deficit rule (2% of GDP) and the debt ceiling (40% of GDP). To create sufficient fiscal space for addressing the large infrastructure needs in a fiscally sustainable manner, capital expenditure funded by concessional IFI financing and from privatisation proceeds is deducted from the deficit³. To safeguard against ad-hoc increases in current spending two expenditure rules were introduced in 2016 and 2017. To avoid large increases in public wages which occurred in previous election years, the growth rate for the annual wage bill has been limited to the nominal GDP growth rate starting in 2018. Furthermore the amendment to the law on war veterans limits the expenditure on war veteran pensions to 0.7% of GDP annually. Enforcement of this limit is however pending on completion of the reclassification of beneficiaries. The efficiency and efficacy of current expenditure in Kosovo are low as spending increases have so far been dominated by short sighted, ad-hoc rises in public wages, pensions and other transfers and subsidies, very few of which were targeted or means tested. Given the strong pressures to increase current spending and large spending needs on health and education, and investments, the available fiscal space needs to be clearly prioritised. In this regard Kosovo could benefit from establishing Medium Term Expenditure Framework (MTEF) that would support better expenditure prioritisation and planning. Furthermore, Kosovo could benefit from creating a fiscal body to oversee the implementation of the budget, assess policy proposals and contribute to the debate on fiscal policy.

Table 3:

Composition of the budgetary adjustment (% of GDP)

	2016	2017	2018	2019	2020	Change: 2017-20
Revenues	26.5	27.2	27.1	27.2	27.1	0.0
- Taxes and social security contributions	24.0	24.3	24.4	24.7	24.9	0.6
- Other (residual)	2.5	2.9	2.7	2.5	2.3	-0.6
Expenditure	27.6	28.5	31.1	30.6	30.1	1.6
- Primary expenditure	27.2	28.2	30.7	30.3	29.8	1.7
<i>of which:</i>						
Gross fixed capital formation	7.3	7.9	10.3	10.5	10.8	3.0
Consumption	12.3	12.8	12.7	12.4	12.0	-0.8
Transfers & subsidies	7.8	7.8	7.8	7.5	7.0	-0.8
Other (residual)	-0.3	-0.3	-0.1	-0.1	-0.1	0.2
- Interest payments	0.4	0.4	0.4	0.3	0.3	-0.1
Budget balance	-1.1	-1.4	-3.9	-3.4	-3.0	-1.6
Budget balance as per fiscal rule	-0.9	-0.7	-1.8	-1.5	-0.9	-0.2
Primary balance	-0.7	-1.0	-3.6	-3.1	-2.7	-1.7
Gross debt level	14.0	15.8	17.6	19.2	20.0	4.2

Sources: Economic Reform Programme (ERP) 2018, ECFIN calculations

The budget revenue projections for 2018 are slightly ambitious and the budget foresees a large increase in capital spending. The 2018 budget, adopted by the Kosovo Assembly in December 2017, aims at a fiscal deficit of EUR 122 million or 1.8% of GDP⁴, in line with the fiscal rule. The budget is based on nominal GDP growth of 6.2%. Total revenue is expected to be 8.3% higher than the outcome in

³ These exceptions apply while the overall debt level is below 30% of GDP and the government deposits are above 4.5% of GDP.

⁴ This figure refers to the deficit calculated according to the fiscal rule which excludes from the fiscal balance some parts of capital spending (see more details above)

2017. With the only new revenue measure planned being the increase in excise duties on tobacco, significant contribution to revenue growth is expected from improvements in revenue collection and increased economic activity. In this regard, the key challenge is to preserve broad tax base through limiting losses from tax exemptions and tax evasion. Expenditure is forecast at 19.7% higher than the outcome in 2017. Current expenditure is expected to increase by 8.2%, mainly due to the agreed 4% rise in public wages and the need for new hiring in education, health and judicial sector, and a 20% increase in social welfare benefits. A substantial increase in goods and services spending (18.3% y/y) partially concerns much-needed higher spending on infrastructure maintenance. Foreseen improvements in health care service are expected to yield higher payments for pharmaceuticals and medical supplies. The forecasted growth in expenditure is mainly driven by capital spending which is ambitiously planned to increase by 48.3% in 2018. The increase is mainly due to the announced investment projects financed by IFIs (0.9% of GDP) and from the expected proceeds from privatisation (1.3% of GDP).

The ERP presents few new fiscal initiatives and focuses on the implementing already ongoing ones. On the expenditure side work to introduce a mandatory health insurance system is continuing. Collection of premiums for public sector employees is expected to start in 2019 along with the payments of contributions for exempted individuals. However these costs have not yet been included in the medium-term fiscal framework. The announced 20% increase in social welfare payments seems appropriate given the high poverty rate in Kosovo. Unlike the majority of transfers to the population, the scheme is well targeted and means-tested. The same cannot be said for agricultural subsidies which have not exhibited a strong connection to productivity gains in the sector. Nevertheless the government expects subsidies to lead to growth in agriculture productivity in 2018-2020 without any significant policy change in policy compared to previous years.

Table 4:

Composition of changes in the debt ratio (% of GDP)					
	2016	2017	2018	2019	2020
Gross debt ratio [1]	14.0	15.8	17.6	19.2	20.0⁵
Change in the ratio	1.2	1.7	1.9	1.5	0.8
<i>Contributions [2]:</i>					
1. Primary balance	1.1	1.4	3.9	3.4	3.0
2. Snow-ball effect	-0.2	-0.2	-0.6	-0.6	-0.9
<i>Of which:</i>					
Interest expenditure	0.4	0.4	0.4	0.3	0.3
Growth effect	-0.5	-0.6	-0.7	-0.8	-0.9
Inflation effect	-0.1	0.0	-0.2	-0.2	-0.3
3. Stock-flow adjustment	0.3	0.6	-1.5	-1.3	-1.3

Notes:

[1] End of period.

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

Source: *Economic Reform Programme (ERP) 2018; ECFIN calculations*

⁵ The ERP document at different points puts the debt-to-GDP ratio in 2020 at 20% and 21%

Significant public finance challenges need to be addressed to make public spending more growth-friendly. Underestimating current expenditure and overestimating capital spending are the main fiscal risks in 2018-2020. Spending on war veteran benefits will again turn out higher than the legally prescribed limit of 0.7 % of GDP unless the number of certified veterans is decreased irrespective of the reclassification process. So far the government has not expressed any willingness to do this and around 3000 new applicants are currently awaiting certification. On the other hand, underspending of the planned capital budget is likely. Investment worth around 6.9% of GDP is planned to be financed by the IFIs and from privatisation proceeds in 2018-2020. Although the projects concerned have been incorporated in the 2018 budget they are still in different stages of preparation and their implementation will likely spread over a longer period. Disbursements of proceeds from privatisation by the Privatisation Agency, mainly allocated to the Route 6 highway project, could be delayed for administrative reasons and because of incomplete judicial processes. In that case funds for other smaller projects might then have to be reallocated to the Route 6 project. This uncertainty creates disincentives and conflict-of-interest issues and disincentives to implementing sometimes more important local projects. The potential introduction of an early retirement scheme for policemen, which has been under discussion, constitutes another fiscal risk. This scheme would also set a dangerous precedent for other professions, potentially creating additional liabilities and squeezing funds available for investment. Nevertheless, under the fiscal framework fiscal stability should be maintained in the near term. In the medium term, implicit risks to public finances are related to contingent liabilities arising from poor performance of state owned enterprises. In this regard a large investment through public private partnership into a new power plant could create an additional challenge.

Public debt is low but increasing gradually. Public debt including guarantees stood at 16.4 % of GDP at end-2017, up 2 pps. from 2016. Around 55% of the debt is domestically issued, in the form of short-maturity treasury bills and bonds, while the rest is mainly held by the IFIs. With an unadjusted deficit of 3.8% on average over 2018-2020, the debt level is expected to reach 21% of GDP by 2020. The average weighted interest rate is projected to gradually decline to 1.6% in 2020 from 2.7 % in 2017. Gross financing needs will stand at around 9.3% of GDP throughout 2018-2020, 80% of which is expected to be accommodated on the domestic market. Only the debt taken on the basis of the 'investment clause' will come from external sources. The average maturity of the domestic debt increased to 24 months at the end of 2017 compared to 15 months in 2016, as Kosovo has issued debt with longer maturities more regularly, including the first ever issuance of a seven year bond in 2017. Kosovo still does not have access to international debt markets due to the lack of an international credit rating and the relatively large fixed costs involved. An adequate fiscal buffer is provided by government deposits which were further increased to 5.3% of GDP in 2017 and are projected to remain at the level implied by the fiscal rule (4.5% of GDP) throughout 2018-2020.

7.4. STRUCTURAL REFORMS

The unreliable, and health hazardous energy supply, a very large informal economy (estimated at 31% of GDP), the weak rule of law, corruption and the labour market mismatch continue to be the key obstacles to improving competitiveness, employment and social development. The energy sector suffers from outdated production capacity, low energy efficiency, a non-liberalised energy market and a tariff system that does not reflect real costs. The informal economy distorts competition, and reduces public revenue collection and workers' rights. Low educational attainment levels of the working age population and higher education degrees not matching labour market needs impede labour market matching despite the large working age population. The ERP properly identifies these and other constraints to growth. The difficulty of accessing finance is not seen as a key structural obstacle anymore. While conditions have improved, obtaining finance remains a major constraint, especially for start-ups and microenterprises.

The reform measures included are mostly rolled out from last year's ERP (17 out of 20) and overall respond to the challenges identified. This shows stability and consistency of the government's medium-term economic planning. Some areas are given more focus by including more than one measure, including the energy market, the agricultural sector, the business environment, trade and education and skills. This is broadly justified by the severity of the problems and/or the sector's potential. Most of the measures directly tackle important economic challenges, such as the poor quality of education, the large informal sector, a problematic energy supply and inefficiencies in the agricultural sector. Moreover, the ERP has an increased coverage of informality and youth unemployment, which is in line with the policy guidance jointly adopted in May 2017. While one measure was fully implemented, another one was dropped without justification. There is an adequate mix of legislative, administrative, and infrastructure reforms. Budget contributions are planned for all but one measure, but in some cases the budget allocation is not consistent with the ambition of the reform. The budgetary impact of the measures during the three year period is high, although many measures are co-financed by IFIs or donors. The 2017 Commission assessment was only partially taken into account.

Public finance management

Despite a relatively solid strategic framework, Kosovo's public finance management (PFM) system still faces challenges, notably when it comes to implementation, external and internal control and public procurement. Public procurement is still characterised by low transparency. This inhibits competition and makes public procurement vulnerable to corruption. The lack of transparency negatively affects the capacity of small and medium-sized enterprises (SMEs) to compete for public contracts and reduces confidence in state institutions. The ERP highlights the weak transparency, efficiency, integrity and accountability and weak oversight of the implementation of public procurement, but it does not elaborate on the important shortcomings linked to the non-functioning remedy system and the limited capacity of the Central Procurement Agency. The ERP suggests public procurement as the main barrier to competitiveness. While the analysis of the overall PFM system recognises the importance of a healthy (external and internal) control it does not elaborate on the essential role of managerial accountability, sound risk management and an effective implementation of financial control at all levels of the administration and publicly owned enterprises.

The implementation of the measure to improve public procurement by applying electronic procurement advanced slowly. Most notably, the use of e-procurement became mandatory for all contracting authorities, but this has not yet been fully implemented, in particular by the Central Procurement Agency. Moreover, only a limited number of modules of the e-procurement system are in place and other significant issues such as oversight and monitoring of contract management have not yet been implemented. The measure could help reduce costs and increase transparency, with positive effects for companies and for the economy's overall competitiveness. However, the proposed activities for 2018 and 2019 in this year's ERP were initially to be implemented in 2017. Such delays are worrisome. The introduction of capacity building for economic operators, in addition to the procurement officers, is welcome. This should help to ensure the system does not discourage competition, which is especially important considering the still very low percentage of electronic bids submitted by SMEs.

Energy and transport market reform

Kosovo's unreliable energy supply and the dysfunctional energy market continue to hamper its competitiveness and the transport infrastructure is poorly maintained. Outdated and highly polluting energy production capacities and big distribution losses due to poor infrastructure result in the supply of energy being unreliable. The lack of incentives to consume electricity efficiently further increases the costs. The energy market is not functioning on free market principles and tariff subsidies hinder efforts to improve the competitiveness of the business sector. The ERP properly acknowledges these problems, but does not sufficiently recognise the importance of pending regulatory reforms, like the final adoption of Kosovo's energy strategy and action plan, or the capacity building of the Energy Regulatory Office

(ERO). In transport, the ERP also highlights the inadequacy and poor maintenance of roads and railway networks as main weaknesses but does not cover other challenges such as recent cuts in railway services hampering the use of this form of transport.

The measure reducing energy consumption through energy efficiency measures is not ambitious enough to have the intended impact on competitiveness. Implementation is also lagging. There are no specific targets for savings, and the measure does not give any proper assessment of the expected impact (only limited estimations are provided of energy savings from the activities supported by the World Bank). Future activities have been expanded to include the adoption of a legislative framework for energy efficiency and the evaluation of financing mechanisms. This is positive, but considering the importance of energy for Kosovo's economy, the measure needs to be more ambitious. As they stand the planned energy efficiency investments still focus exclusively on public buildings. They ignore the residential sector which is the largest consumer of energy in Kosovo and neglect the policy guidance adopted at the joint Ministerial meeting in 2017. On the other hand, other activities could be removed as they are not really linked to energy efficiency (i.e. construction of a biomass power plant in Gjakova).

The measure to further develop energy generation capacity has seen some progress in 2017, but it does not mention the important risks associated with its implementation. The activities planned in 2017 advanced, notably with the signing of the technical and commercial agreement to build the Kosova e Re power plant. For the coming years, however, no consideration is given to the important risks that go with the plant's financing, construction and possible environmental, social and fiscal impact. The new investments will also require a plan to gradually adjust energy tariffs to reflect actual costs and to assess potential mitigation mechanisms to minimise the impact on the poor and vulnerable in a fiscally sustainable manner. Of the 33 small hydro power plants to be built by 2020, only one of them meets EU environmental standards.

Sectoral development

Agricultural sector development

Although Kosovo's agricultural sector represents 13.4% of gross value added in 2016, it still suffers from low productivity and low added value. The ERP's diagnostic highlights the main obstacles to the sector's competitiveness, i.e. the fragmentation of agricultural land, the small size of farms, the poor irrigation infrastructure, the dysfunctional links between primary producers and processors and the market and the lack of specialisation. However, it does not sufficiently recognise the importance of addressing the problems of the agricultural sector as an integrated system, with a value chain approach. It also does not analyse the persistent obstacles hampering the proper use and consolidation of agricultural land (such as property issues, use of agricultural land for construction, cultural perceptions etc.).

In this context, the measure on investments in agricultural infrastructure and agro-processing are relevant and could help to increase productivity in the sector. However, given that the planned activities are too vague, it will not be possible to assess them next year; thus, the reform measure should set clear targets, notably the expected reduction in agricultural imports, the expected growth of exports and increase in the percentage of irrigated land per year. The focus continues to be on the provision of subsidies in the current system, but its impact in the overall agricultural sector can only be limited unless real progress is made in managing land, investing in farmer's knowledge and improving agro-food standards.

The measure to regulate and consolidate agricultural land continues to suffer from a vague definition. Neither baseline data are provided, nor the expected results (increased percentage of consolidated arable land) to be achieved each year. As such, it is not possible to estimate the scope, ambition and expected impact of this reform. The expected impact on the economy's competitiveness should be quantified to better understand the scope of the measure.

Industry sector development

Kosovo's industry is characterised by low added value and low diversification. The sector is dominated by micro and small and medium sized enterprises with a low level of integration in global value chains in the domestic and export markets, little innovation and not much FDI. The ERP diagnostic correctly points out the lack of product quality, weak cooperation among companies, low production capacities and low skilled labour force as key underlying problems. But it still does not elaborate on the lack of a comprehensive policy framework, the structural problems affecting the support services for SMEs, such as the inadequate inter-ministerial coordination, or the insufficient capacity of responsible institutions like KIESA. It also does not refer to the problem that start-ups and micro enterprises have of accessing finance.

The measure to boost private sector competitiveness by supporting industrial SMEs is an expanded version of the measure to develop industrial clusters in the 2017-2019 ERP. Clearly, closer cooperation between SMEs, more dialogue between the public and private sector, integration in global value chains and improved access to finance are central to an economy's competitiveness. However, the scope of this reform is too broad and lacks clear targets. Illustrative of this is the fact that only very limited progress was made in the activities planned for 2017. The future activities include a good combination of legislative and analytical work together with practical support to SMEs. However, overall they are vaguely described and do not contain any specific targets to monitor their progress. It is also not clear whether the resources allocated are sufficient to achieve the expected results, especially since the reform measure relies mostly on resources allocated to KIESA, and the ERP mentions these resources will decrease by over 28% in 2019 compared to 2018.

Service sector development

The service sector contributes 57.3% of gross value added, and it is the fastest growing export sector. The ERP, however, again does not provide any proper analysis of the services sector as a whole and merely refers to general figures of trade in services, identifying only some obstacles in the tourism sector. The situation of other services such as ICT, retail and wholesale trade and professional services is not mentioned. Also, major obstacles to developing the services sector such as a lack of skills, the incomplete legal framework and an inadequate system of mutual recognition of professional qualifications are not analysed.

The measure to develop tourism products in Kosovo's tourist regions is not ambitious enough to have a significant impact on the economy. The measure continues to reflect several of the deficiencies mentioned in last year's assessment, which partly explains the limited progress that was made in the activities that had been planned in 2017. This was notably the case for improving the policy framework. The planned activities continue to suffer from a lack of strategic vision for the tourism sector. Moreover the resources allocated (only EUR 10 000 annually from the Kosovo budget) reflect a lack of real commitment to this measure for it to have any significant impact on the competitiveness of the economy as a whole.

Business environment and reduction of the informal economy

Kosovo has made good progress on improving the business environment, but some important structural challenges remain. Unfair competition from the informal sector, weak rule of law, corruption and access to finance continue to be among the main challenges to private sector development and to competitiveness. In 2017, several important regulatory reforms improved the business environment (notably to start a business, get credit and resolve insolvency), making Kosovo jump from 60th to 40th place in the World Bank's *Doing Business* report. Indeed, access to finance has improved, but SMEs still face obstacles linked to asset register-related issues and the lack of alternative sources of funding. Also, micro enterprises and start-ups continue to face serious difficulties accessing finance. The ERP

acknowledges the persistence of other negative features of Kosovo's investment climate, such as informality, slow and inconsistent contract enforcement, weak property rights and financial reporting and an uncoordinated and costly market surveillance system.

The ERP includes four measures to improve the business environment and tackle informalities. Three of them are rolled over from the 2017-2019 ERP while one is new. The adoption of evidence-based policies and reduction of the administrative burden only has a weak link to private sector development and competitiveness. The proposed activities could be much more specifically geared to the private sector and less generally applicable to public administration reform. As mentioned above, Kosovo has made very good progress in reducing the administrative burden linked to starting a business, getting credit and resolving insolvency. However, these improvements are not necessarily the result of the activities implemented under this measure in 2017.

The measure to secure property rights by addressing informality in the immovable property sector has advanced with the preparation of critical laws. Most of these laws are expected to be adopted in 2018. If achieved and duly implemented, these legislative changes could have an important impact on securing property rights, unlocking access to finance, and facilitating the settlement of disputes. These are all essential to provide legal certainty and attract local and foreign investment. It can also have a positive gender dimension, helping women to enjoy equal property rights and facilitating their economic independence. The reform measure is ambitious but its successful implementation will require continued strong political backing to push the reforms through, which is recognised in the ERP.

The implementation of the measure to increase judicial efficiency by reducing the backlog of court cases has been lagging for the past 2 years. The reform continues to be highly relevant and the adding of clear targets for the recruitment of judges and professional associates is positive. However, it is not clear if there are plans to address systemic issues on case management processes and practices in the courts, which hamper efficiency. Addressing those obstacles will be important to achieve the expected results. This is especially the case considering that the introduction of an electronic case management system will not include old cases and therefore its use for monitoring and managing the backlog will be limited.

The measure on the general inspection reform is new and can be relevant to address the unnecessary burden to businesses that frequent, uncoordinated and costly inspections represent. However, the diagnostic on the business environment does not provide sufficient information about the magnitude of the problem and its effect on businesses. Some important activities for the success of the reform have also not been sufficiently developed, for instance screening of sectoral laws and secondary legislation to align them with the new law on inspection; the implementation of the electronic data management system; or the need to sufficiently equip market inspections).

Two measures in last year's ERP in this area have been dropped. The full operationalisation of the Kosovo Credit Guarantee Fund was successfully implemented in 2017. The fund is now operational, and loan guarantee schemes have been agreed with most commercial banks operating in Kosovo. However, the measure to merge the Kosovo customs and tax administrations and establish a single Revenue Collection Agency was dropped without any justification.

Research, development and innovation and the digital economy

Kosovo's capacity to engage in research, development and innovation (RDI) is very low and faces important challenges linked to RDI policy governance, the involvement of the private sector in RDI and cooperation between business and academia. This reduces the ability of SMEs to create new competitive products and services. The ERP analysis recognises the lack of a legal and policy framework and the low level of political commitment to RDI, which is reflected in the very low public expenditure (0.1% of GDP). The analysis also adequately signals the lack of incentives for the private sector and

academia, and the limited extension of the broadband internet infrastructure which affects productivity and competitiveness.

The measure to improve entrepreneurship and the innovation environment (renamed from the 2017-2019 ERP) has experienced delays, in particular the delay in adopting the new law and strategy. The budget dedicated to this measure, which would directly support SMEs to become more innovative, is large and would undoubtedly support competitiveness if implemented. The measure's expected impact however, will only be achieved if it is complemented by more ambitious activities to assist and boost applied research activities in higher education, to substantially improve cooperation between research institutes and businesses and embed the measure into a wider smart specialisation strategy.

The measure to extend the ICT network infrastructure showed almost no progress in its implementation. The activities planned for 2017 have been carried over again in 2018. In 2019 and 2020, the reform now includes activities to develop human capacities and support digital business, but several of these actions are still rather general and do not include any specific targets. The activities should be quantified so that the implementation can be monitored properly. Traditional industries' support for digitalisation is not quantified and therefore it is difficult to estimate its potential impact. Moreover, in the past 2 years the ERP assessments highlighted the need to complement infrastructure investments with increased competition between operators and regulator independence. However, these have still not been addressed. To achieve the expected impact, the expansion of the ICT infrastructure should also be accompanied by the development of e-skills at different levels, from primary schools to vocational training. Finally it is not clear whether last year's Commission recommendation to review the definition of broadband in the KODE (from 512 kbps to e.g. 10-30 Mbps or higher) has been taken into account, and a clear target for the expected increase in the penetration rate is still missing.

Trade-related reforms

Kosovo remains poorly integrated in the global economy, with exports of goods and services representing only 22.5% of GDP in 2016. Kosovo's trade of goods is dominated by imports which are likely to increase further because of large infrastructure investment. While export diversification has moderately improved, the country mainly relies on a few basic products such as minerals and metals. Obstacles to trade openness include the high administrative costs linked to procedural, quality, logistical and border barriers, which reduce the level of exports and increase the price of imports. This is coupled with an underdeveloped quality infrastructure. The ERP fully recognises these challenges but the critical importance of engaging with the private sector and developing expertise in marketing and sales is not sufficiently considered.

The measure increasing the cost efficiency of international transactions (by simplifying and standardising border formalities and procedures) showed good implementation progress in 2017. However, there is still no proper analysis of the measure's expected impact on competitiveness (i.e. estimated reduction in time and costs for businesses to export). The budget for this measure is still very limited (EUR 10 000 per year) and the activities are expected to be supported by donors (although the level of support and overall cost of the measure is not clear). In terms of risks, the introduction of non-tariff barriers to 'protect' local manufacturers would undermine the measure's impact.

The measure on further development of quality infrastructure has been expanded to also cover stronger market surveillance. Both are highly relevant and central to implementing the Stabilisation and Association Agreement. The new activities included this year have a better combination of legislative development, and support to manufacturers to comply with EU standards. However, the activities to improve market surveillance are too limited to have a meaningful impact, and the scope of the support to companies is not clearly defined. Some of the deadlines seem rather ambitious. Overall, the expected impact of the measure is only very broadly analysed, and in spite of having a particular focus on one

sector (construction) it does not contain any specific targets (i.e. import substitution or increased exports planned as a result of the activities to be developed). This limits the potential impact and makes it difficult to monitor implementation. There is concern that the activities planned in 2017 have only been partially implemented and the continued lack of qualified staff and financial resources within the responsible agencies poses a major risk. While this is mentioned as a risk, no mitigating measures have been considered.

Education and skills

Improving the education system from pre-primary to higher education remains a paramount challenge and key factor in Kosovo's socioeconomic development. Due to historic low levels of participation, the educational attainment of the labour force is still very low; around 40% of working age population has no education beyond primary. The increased participation in education will over time raise attainment levels. In 2015-16, enrolment reached 95.6% in (compulsory) primary and 84.9% in secondary education. Some progress was made in closing the gaps in pre-school education. In 2016-17, the enrolment rate was 85.5% for children aged 5-6 (+5.9pps compared to 2014/15) and 46.6% for children aged 4-5 (+5.7pps), however this coverage remains far below European standards (EU2020 benchmark of 95%). The overall coverage of children up to 5 years is as low as 3.5% (2015-16).

The measure revising occupational profiles and standards and adjusting curricula in vocational education and training (VET) requires a stronger cooperation between public and private sector. Reforms in VET should indeed be prioritised, since job creation in Kosovo is mostly in jobs requiring these profiles. The activities planned in 2017 were only partially implemented. The reform would also need to be complemented by a skills intelligence process with skills needs analysis in sectors that have been prioritised in other ERP measures (woodworking, metal processing, textiles, tourism, etc.). The ERP does not reflect the overall budgetary impact of the reform nor include the substantial donor support Kosovo is supposed to receive to support VET reforms.

The measure for licensing and evaluation of teachers in pre-university education should put more focus on teacher training for the roll-out of new school curricula. This should include speedily making textbooks available, and putting in place mechanisms for ensuring effective classroom implementation. The budgetary impact of the new career system for teachers remains unclear; the retirement of large numbers of teachers in the coming years calls for a strategic approach to ensuring school education.

The long-pending amendment of the law on higher education should be completed without further delay in 2018. Kosovo should ensure that its domestic approach to quality assurance in higher education is in line with the requirements of European standards, including independence of the Quality Assurance Agency.

Employment and labour markets

Kosovo's labour market performance in 2017 is marked by a noticeable rise in labour force participation translating into unemployment increase. From 2016 to 2017, the labour force participation rate increased by 4.2pps to 42.8%, the employment rate by 1.7pps to 29.7% and unemployment by 2.9pps to 30.4%. Trends show a marked gender difference. Male labour force participation (+7pps) and employment (+3.6pps) improved considerably, whereas the position of women on the labour market remains extremely weak with 12.7% employment (no change) and 36.5% unemployment (+4.8pps), thus widening further the gender gap. Youth unemployment remained at stubbornly high levels (52.6%, up 0.4pps), whereas the NEET share of the youth population (27.4%, -2.7pps) decreased for both men (23.6%, -2.9pps) and women (31.3%, -2.8pps).

Kosovo needs to focus more vigorously on enabling job creation in the private sector. Interventions in the established labour market framework and the further increase of incomes from transfers should be carefully considered as to their potential effects. The recently adopted modification of the minimum wage formula was followed by a proposal to increase the minimum wage from EUR 170 to EUR 250. An increase of this size would not be in line with the cumulative GDP and productivity growth over the past years, and may negatively affect the employment of young people and low skilled workers. Furthermore, such rise would create an additional burden on public finances through its direct implications on the expenditure for war veterans' pensions, as they would increase accordingly.

The reform measure aiming at increasing the access of young people and women to the labour market is too limited in scope to have a significant impact on employment. It is again rolled over from the previous ERP and consists mainly in capacity building of the new Employment Agency of Kosovo, which became a separate functional entity in 2017, for delivering services including active labour market measures to job seekers. Most of this measure's budget is reserved for the functioning of the agency, while the available budget for active labour market measures is too modest to have any significant impact. The planned activity of developing VET profiles, standards and curricula is not embedded in the other ongoing VET reforms. A more focussed policy approach to improve the marginal position of women in the labour market should be considered in the future planning of active labour market policies.

Responding to the policy guidance of 2016 and 2017, the first ever action plan for youth unemployment has been adopted. Its scope is still very limited compared to the high number of youth needing active support. Implementation according to schedule will be important, and the monitoring and evaluation of the impact of measures, in order to inform the design of further policies supporting youth.

Social inclusion, poverty reduction and equal opportunities

Due to the very low work intensity in Kosovo, poverty remains high and many people do not have access to essential services such as health. According to the latest poverty estimates from the Kosovo Agency of Statistics (KAS), in 2015 17.6% of the population lived below the poverty line (set at EUR 1.82 per day), with 5.2% living below the extreme poverty line (EUR 1.30 per day). Lower educated persons are more likely to be poor; the poverty rate of individuals who did not complete primary education is 22.9% compared to 6.2% for those who have completed tertiary education. Female-headed households have a significantly higher poverty rate (23.7%) compared to those headed by males (17%). Poverty is also more pronounced among children. Roma and Ashkali communities face disproportionately high levels of poverty and social exclusion given their low education and marginal employment levels.

Kosovo has still not started the implementation of the general health insurance scheme. The ERP rolls over the reform aiming at improving social and health services, with the ultimate objective of establishing a universal health insurance for the whole population. It represents a major challenge in fiscal terms since only a fraction of the population would contribute to the fund with own contributions as share of their salary. For other categories, the contribution would need to be covered by the general budget. The methodology of a poverty test for granting exemptions from paying premiums has been developed in 2017 and should be applied without further delay. The estimated revenues composition of the health insurance fund once operational (85% of premiums from contributions, 15% from general budget) risks underestimating the funding needs of such a system.

Social transfers and assistance are not sufficient to lift people out of poverty. In 2015, 77% of household social assistance recipients were poor, representing 13% of the poor population. Pension recipients face a poverty rate of 27.8%; their share among the poor population is 13.7%, whilst 8.7% of total population. The targeting of the social assistance scheme is accurate, but coverage and adequacy have been low. To improve the situation, the ERP measure includes the increase of social welfare benefits

by 20% in 2018 and the introduction of support to specific categories. Further reform steps envisage the provision of social services at the local level.

7.5. IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2017

2017 policy guidance	Summary assessment
<p>PG 1:</p> <p>Enhance the institutional capacities and ensure appropriate staffing at the Ministry of Finance in order to improve macro-fiscal planning, forecasting and fiscal impact assessments.</p> <p>Prepare an options paper on the establishment of an independent body for fiscal oversight for further consultations with stakeholders, including the EU.</p>	<p>There has been limited implementation of PG 1:</p> <ul style="list-style-type: none"> • Limited implementation: Several activities have been implemented to upgrade the skills and train the existing staff and to recruit new staff for the department. The process of employment of additional staff for the Macro department started (but not yet finalised) • No implementation: No options paper was prepared for an independent body of fiscal oversight.
<p>PG 2:</p> <p>Strengthen institutional capacities at central and local government levels for public procurement, multiannual investment planning, and investment project preparation and management in order to improve the execution of capital spending.</p> <p>Take steps towards introducing targeting and means-testing to all war veteran programmes in order to further contain current expenditure.</p>	<p>There has been limited implementation of PG 2:</p> <ul style="list-style-type: none"> • Partial implementation: Capacity building concerning the e-procurement platform was carried out in 2017 for contracting authorities. The Ministry of Finance worked (assistance by GIZ) on drafting an Administrative Instruction on defining and setting criteria for the selection of capital projects. The Administrative Instruction aims at defining principles, criteria, procedures and rules pertaining to the evaluation, prioritisation and selection of capital projects. • No implementation: On the introduction of targeting and means-testing for all war veteran programmes no progress was made.
<p>PG 3:</p> <p>Further address the underlying legal and institutional factors hampering access to finance for corporates to improve banks' incentives to lend to enhance financial intermediation in the economy.</p> <p>Continue improving the central bank's analytical toolkit (including through the establishment of a reliable measure of private sector inflation expectations in order to better gauge underlying price dynamics)</p>	<p>There has been limited implementation of PG 3:</p> <ul style="list-style-type: none"> • Partial implementation: The Law on Enforcement procedures was amended, aiming at improving access to finance through reduced collateral requirements for borrowing and lower interest rates. The Kosovo Credit Guarantee Fund expanded its activity in 2017, and currently most banks are registered with the KCGF. • No implementation: • An inflation expectations survey has not been established. While the central bank is currently investigating practices applied by other countries and expects launching the first survey end-2018, no survey is yet in place.

<p>and develop a liquidation and bank resolution framework to strengthen the overall resilience of the banking sector.</p>	<ul style="list-style-type: none"> • Limited implementation: • The respective frameworks are currently being developed through technical assistance from the EBRD and the World Bank, but have not yet been finalised.]
<p>PG 4:</p> <p>Establish a financing mechanism to support energy efficiency measures and adopt energy efficiency incentives to the private sector and households.</p> <p>Complete the deregulation of energy generation prices, gradually deregulate electricity supply prices and gradually adjust energy tariffs to reflect actual costs.</p>	<p>PG 4 has been partially implemented:</p> <ul style="list-style-type: none"> • Limited implementation: The draft Law on Energy efficiency includes the establishment of an energy efficiency fund. It has been prepared and is expected to be adopted by June 2018. The EE Fund will not include energy efficiency incentives for private sector and households in a first phase. • Full implementation: Conventional generation prices were deregulated as of 1 April 2017. Electricity supply prices have been partially deregulated and the gradual adjustment of energy tariffs to reflect costs has started.
<p>PG 5:</p> <p>Complete the risk assessments focusing on the sectors and branches most vulnerable to informalities</p> <p>and identify and apply appropriate corrective measures.</p>	<p>There has been limited implementation of PG 5:</p> <ul style="list-style-type: none"> • Partial implementation: Risk assessments for 4 sectors (construction, gambling, agriculture and retail) have been completed • No implementation: No corrective measures adopted.
<p>PG 6:</p> <p>Adopt an action plan for tackling youth unemployment, based on a sound assessment of the challenges.</p> <p>Finalise the operationalisation of the Employment Agency.</p> <p>Target reforms in vocational education and training and higher education on business sectors with labour demand and job creation potential.</p>	<p>PG 6 has been partially implemented:</p> <ul style="list-style-type: none"> • Full implementation: The Action Plan has been adopted. • Substantial implementation: The Director of the Employment Agency has been appointed; this was the condition for the EA to become a self-standing body. Recruitment process for managerial and technical staff for the central level of the EA ongoing in 2018. • Limited implementation: 20 new occupational standards drafted in 2017; • Partial implementation: Enrolment figures increased by around 5pps for

Increase enrolment in pre-school education.	4-5 and 5-6 year olds, but no progress for children aged below 4.
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7.6. THE 2018 POLICY GUIDANCE

JOINT CONCLUSIONS OF THE ECONOMIC AND FINANCIAL DIALOGUE BETWEEN THE EU AND THE WESTERN BALKANS AND TURKEY

The Economic and Financial Dialogue between the EU and the Western Balkans and Turkey

Brussels, 25 May 2018

[...]

In light of this assessment, Participants hereby invite Kosovo to:

1. Enhance the institutional capacities and ensure appropriate staffing at the Ministry of Finance in order to improve macro-fiscal planning, forecasting and fiscal impact assessments. Prepare an options paper on the establishment of an independent body for fiscal oversight for further consultations with stakeholders, including the EU.
2. Complete the war veteran certification and reclassification processes with a view of decreasing costs of the war veteran pension scheme in line with the current legislation. Strengthen institutional capacities at central and local government levels for multiannual investment planning, and investment project preparation and management in order to improve the execution of capital spending.
3. Continue expanding the central bank's analytical toolkit by developing an inflation expectations survey. Ensure that central bank purchases of government bonds and bills on the secondary market do not amount to de facto central bank financing of the government. Further address the underlying legal and institutional factors hampering access to finance for SMEs, while monitoring carefully high lending growth to households. Finalise the bank resolution and the crisis management frameworks to strengthen the overall resilience of the banking sector.
4. Adopt the Energy Efficiency Law and establish the Energy Efficiency Fund. Adopt energy efficiency incentives to the private sector and households. Advance in the deregulation of electricity supply prices and conclude a study with the aim of adopting a plan for the gradual adjustment of energy tariffs to reflect actual costs.
5. Adopt the new Strategy and Action Plan 2019-2022 to fight the informal economy that should include qualitative and quantitative targets.
6. Monitor the implementation of the youth employment action plan and increase the scope of active labour market measures in particular for women. Conduct a skills needs analysis for identification of priority sectors to inform the review of occupational profiles and curricula. Complete the necessary steps for the introduction of the general health insurance scheme. Increase enrolment in pre-school education.

ANNEX: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The Economic Reform Programme 2018-2020 was adopted by the Government on 29 January 2018 and submitted to the Commission on 31st January 2018 within the deadline. It is in line with the previously approved medium-term fiscal strategy and national development strategy. No components of the ERP are missing.

Inter-ministerial coordination

The preparation of the ERP was centrally coordinated by the Ministry of Finance with the support of the Office for Strategic Planning in the Office of the Prime Minister (OPM). All relevant line ministries contributed to the drafting of the programme and were fully consulted.

Stakeholder consultation

Section 6 of the ERP provides information on the public consultation of the ERP. A draft ERP was made available to the public on the OPM website in December 2017 and was emailed to a number of external stakeholders. A meeting was also held to discuss the draft on 15 January, chaired by the Minister of Finance. . Written comments from stakeholders were annexed to the ERP.

Macroeconomic Framework

The presented macro-fiscal framework in the 2018 ERP is broadly plausible. External assumptions have been taken from the IMF October 2017 World Economic Outlook and the Commission's autumn 2017 forecast. Credibility of the fiscal framework has been largely maintained on the account of more conservative revenue projections. Both the low and the high growth alternative scenarios are useful to showcase the likely impact of some expected and unexpected developments in Kosovo's economy. Forecasts for the labour market and the financial sector are still missing. The cyclical analysis presented in the ERP has its limits given the short time series available.

Fiscal Framework

The fiscal framework was prepared based on the 2018 budget. It envisages broadly plausible revenue projections due to maintained growth. On the expenditure side the framework foresees a substantial fiscal expansion through higher investments. However, risks of capital under-spending and further ad-hoc increases of current spending remain. Unlike in previous years structural measures included in the ERP have all been budgeted in the 2018 budget.

Structural reforms

The structural reforms sections (4, 5 and 6) follow the guidance note. The reporting of the implementation of the policy guidance and the structural reform measures from the 2017-2019 ERP (table 12 in annex) is both sufficient and up-to-date. The number of reform measures is limited to 20 and the page limit (40) for section 4 is respected. The structure of the reform measures is good, in terms of scope and clarity of timeline and budget for activities planned in the three years of the programme. However, activities could be more precise. Tables 9-11 of the annex are filled in appropriately.

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