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2006 Pre-accession Economic Programmes
of candidate countries

by Directorate-General for Economic and Financial Affairs

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INTRODUCTION

In this Occasional Paper the Directorate General for Economic and Financial Affairs publishes its overview and assessments of the 2006 Pre-accession Economic Programmes of the candidate countries (Croatia, the former Yugoslav Republic of Macedonia and Turkey).

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

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

The PEPs were to be submitted between mid October and 1 December 2006, which all countries complied with. They have been made public by the countries and can be found on the web under following addresses:

Croatia	http://www.mfin.hr/download.php?id=1046
The former Yugoslav Republic of Macedonia	http://www.finance.gov.mk/mk/mp/pre-accession_economic_programme_macedonia.pdf
Turkey	http://ekutup.dpt.gov.tr/ab/kep/PEP2006.pdf

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OVERVIEW

1. SUMMARY AND CONCLUSIONS

Croatia, the former Yugoslav Republic of Macedonia and Turkey submitted by 1 December 2006 their annual *Pre-accession Economic Programmes* (PEPs). The drafting, assessing and discussing of these programmes serve to strengthen economic planning capacity in the countries as such and to prepare them for the next step, i.e. economic and fiscal surveillance procedure of candidate countries and, eventually, participation in the economic policy co-ordination and budgetary surveillance mechanisms of Economic and Monetary Union (EMU).

The submitted programmes have made valuable contributions to this objective. They contain very useful overviews of economic policy plans over a broad range of issues until 2009. In particular they show the governments' determination to maintain stability and advance structural reforms, productivity gains and alignment with the EU *acquis* and EU best practices in order to allow sufficiently high growth in order to catch up with, and prepare for membership in, the European Union. The degree of ambition and precision in policy implementation across the programmes is not uniform. The first submission by the former Yugoslav Republic of Macedonia demonstrates again that establishing sufficient political determination and administrative skills for such a programme takes dedicated efforts over an extended period of time.

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

2. BACKGROUND

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

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

The PEPs have developed into increasingly important platforms for the authorities to develop and communicate consistent economic, fiscal and structural policies over the

medium term. Their preparation serves a twofold purpose: to strengthen economic planning capacity in the countries as such and to specifically prepare them for participation in the economic policy co-ordination and budgetary surveillance mechanisms of Economic and Monetary Union (EMU). Consequently, the timing, scope and methodology of the PEPs follow closely reporting obligations of Member States participating in EMU. The PEPs and their assessments are therefore discussed in multilateral policy framework with Member States and candidate countries, ending with the annual policy dialogue of the ECOFIN Council with candidate countries. The development of the institutional capacity to co-ordinate between the various ministries, government agencies and the central bank is a particularly important aspect ensuring the success of the Pre-Accession Fiscal Surveillance Procedure.

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

3. THE 2006 PROGRAMMES

Countries were requested to submit their programmes by 1 December 2006. All countries complied with this deadline. The former Yugoslav Republic of Macedonia submitted in 2006 its first PEP¹. All programmes have been made public by the countries².

Overall, the submissions show that

- the three PEPs provide overall for consistent and partly ambitious policy frameworks for economic stabilisation, fiscal policy and structural reform. Their methodology and presentation has improved in many cases vis-à-vis previous years. In the case of the former Yugoslav Republic of Macedonia it has been the first submission of the PEP. The administrative capacity of the countries in developing consistent and appropriate economic and fiscal policies has further improved³. Countries are committed to prepare and adjust policies and political and administrative capacities with the view of eventually joining Economic and Monetary Union;
- all programmes are based on a fairly consistent macroeconomic and fiscal framework. In line with the overall favourable economic performance during the recent years, the candidate countries are optimistic, expecting annual output growth between 4.5% and 6.5% over the programme period (see table). Croatia foresees annual economic growth of around 4.5% to 5%. The former Yugoslav Republic of Macedonia foresees a marked increase in output growth, from 4% in 2006 to 6.5% in 2009. The Turkish PEP foresees GDP growth to slightly decelerate from 6% in 2006 to 5% in 2007, reflecting the impact of the financial crisis in Spring 2006, and a small reacceleration to 6% by 2009;
- the scenarios foresee that in all countries growth will be based mainly on capital deepening and overall efficiency gains. From the demand side, a fairly favourable external contribution and investment demand will underpin growth;

¹ following the Council decision of 17 December 2005 to recognise the country as candidate country

² Croatia: <http://www.mfin.hr/download.php?id=1046>; The former Yugoslav Republic of Macedonia: http://www.finance.gov.mk/mk/mp/pre-accession_economic_programme_macedonia.pdf; Turkey: <http://ekutup.dpt.gov.tr/ab/kep/PEP2006.pdf>

³ except for the former Yugoslav Republic of Macedonia, which submitted in 2006 its first PEP, and for which therefore a comparison to previous years is not possible.

- the monetary frameworks foresee no major changes to the current frameworks, which amount to inflation targeting and free float in the case of Turkey and a de-facto peg of the respective currency to the euro in the other two countries.
- the fiscal frameworks foresee a continued narrowing of deficits in Croatia, while Turkey and the former Yugoslav Republic of Macedonia envisage maintaining their deficits close to balance. Croatia expects a further reduction in the deficit from -2.2% in 2006 to -1.5% in 2009, while the former Yugoslav Republic of Macedonia intends to maintain the balance close to -1% of GDP. Turkey foresees a surplus of 2.7% of GDP in 2006 and for the following years a balance of close to zero. All countries expect a substantial reduction in their debt ratios, reaching 29% of GDP in the former Yugoslav Republic of Macedonia, 38% in Croatia and 49% in Turkey;
- the structural reform agendas of the PEPs are vast and partly ambitious. Croatia's emphasis is put on economic restructuring, enhance competition, stimulate employment and rationalise social spending. The PEP of the former Yugoslav Republic of Macedonia emphasises liberalising network industries, privatising the last remaining state property, strengthening the rule of law, improving the business climate and strengthening the competitiveness of the country's enterprises as main priorities. The Turkish PEP is concentrating on labour market and social security reforms and privatisation. Often, however, the PEPs only describe ongoing activities, and the links to the macroeconomic and fiscal frameworks within the PEPs remain less than fully clear.

Pre-accession Economic Programmes 2006: Key indicators

	2005	2006	2007	2008	2009
Real GDP growth (% change)					
Croatia	4.3	4.6	4.6	4.8	5.0
The former Yugoslav Republic of Macedonia	4.0	4.0	6.0	6.0	6.5
Turkey	7.4	6.0	5.0	5.6	5.9
Unemployment rate (% , LFS)					
Croatia	12.7	11.8	11.7	11.5	11.0
The former Yugoslav Republic of Macedonia	37.3	36.3	35.3	34.3	33.2
Turkey	10.3	10.1	9.8	9.8	9.7
Current account balance (% of GDP)					
Croatia	-6.4	-7.5	-7.8	-7.4	-7.0
The former Yugoslav Republic of Macedonia	-1.3	-1.2	-3.3	-2.5	-2.0
Turkey	-6.4	-7.9	-7.4	-6.5	-5.7
Inflation (CPI, annual % change)					
Croatia	3.3	3.5	3.2	3.0	2.8
The former Yugoslav Republic of Macedonia	0.5	3.3	3.0	2.5	2.5
Turkey	8.2	9.5	7.1	4.0	4.0
General government balance (% of GDP)					
Croatia	-2.9	-2.2	-1.8	-1.7	-1.5
The former Yugoslav Republic of Macedonia	0.3	-0.8	-1.0	-1.2	-0.8
Turkey	-0.2	2.7	-0.6	0.0	-0.3
General government gross debt (% of GDP)					
Croatia	44.2	42.1	40.5	39.3	38.1
The former Yugoslav Republic of Macedonia	40.9	35.6	34.0	31.7	28.7
Turkey	69.2	63.4	57.7	53.1	48.4

Source: PEP 2006

4. THE PEPs AND PRE-ACCESSION STRATEGY

The programmes lay out policy strategies, which are to a large degree compatible with and conducive to the economic priorities of the Accession or European Partnerships and, more widely, to the general objective of meeting the Copenhagen economic criteria for accession, i.e. establishing a functioning market economy and raising competitiveness to a level which would allow the countries to meet competitive pressure within the European Union⁴. In

⁴ The Commission concluded in November 2006, in the enlargement package, that Croatia and Turkey can (already) be regarded as functioning market economies.

some cases, though, clearer and more convincing information on the specific implementation of these objectives would have been useful.

CROATIA

1. SUMMARY AND CONCLUSIONS

The ECOFIN Council of 26/27 November 2000 considered: *"...that a regular in-depth dialogue with accession countries on a large spectrum of macro-economic policy and financial stability issues will assist the accession process. It could be used both as a means to identify risks and vulnerabilities in these countries and as a way to help them define their strategy for economic integration into the EU. Such a dialogue would further enhance the cooperation and the exchange of information between existing and future Member States ahead of their accession. (...) The Commission is invited to report each year to the Council (Ecofin) on its assessment of the fiscal notification and the Pre-accession Economic Programmes"*.

In December 2006, Croatia submitted its third Pre-Accession Economic Programme (the "2006 PEP"), covering the period 2007-2009. The document partly complies with the content, form and data requested. It takes into account comments and suggestions made in last year's PEP assessment and it reflects progress made in enhancing the institutional and analytical capacity. It presents a generally coherent macroeconomic framework, including medium-term fiscal targets and projections for key macroeconomic variables. It builds on earlier policy documents, such as the "Strategic Development Framework 2006-2013" and the "Fiscal Policy Guidelines 2007-2009" and appears consistent with the 2007 budget and its medium term projections adopted last December.

The programme's key objective is to maintain macroeconomic stability, ensure sustainable growth and improve the standard of living of the Croatian population. The fiscal programme aims at continued and moderate fiscal consolidation, also with a view to reducing external imbalances. Monetary policy remains geared towards low inflation and exchange rate stability. The structural reform agenda aims to foster economic restructuring, enhance competition, stimulate employment and rationalise social spending. Also, further legislative alignment with EU rules in a broad range of policy areas remains an important priority. Policy objectives are sometimes less precisely defined compared to the previous submission.

The 2006 PEP is based on a scenario of relatively robust real GDP growth, accelerating gradually from 4.6% in 2006 to 5% in 2009. Growth rates are about half a percentage point higher per year than in last year's PEP, mainly due to stronger expected domestic demand. Private consumption growth is expected to stay at around 3.8% while the growth of investment will accelerate over the reference period. The PEP assumes a favourable external environment, boosting average export growth above the growth of imports. Annual employment growth is projected to facilitate a gradual reduction of the unemployment rate. Macroeconomic projections seem overall plausible, broadly in line with the stability-oriented policy mix of the programme and do largely concur with the European Commission's autumn 2006 forecast.

The programme projects the current account deficit to hover around 7-8% over the PEP period. This seems plausible for a small catching up economy with significant investment needs and easy access to foreign financing, and more realistic than the previous submissions' projection of a significant narrowing of the current account deficit. The projected increase in the private sector savings investment gap is in line with the PEP's reform and growth scenario. While total net capital inflows are likely to remain strong, projections of net FDI inflows seems slightly optimistic. Privatisation-related flows are

bound to decline while the scope for a significant increase in greenfield investments may still be constrained, due to remaining difficulties in the overall business environment.

The 2006 PEP rightly concludes that the tightly managed float remains an appropriate policy framework to sustain price and exchange rate stability. Widespread euroisation of the financial system seems to limit the scope for monetary policy discretion. In particular, larger exchange rate flexibility would imply significant credit risks due to large un-hedged non-financial sector balances. The PEP mentions the possibility of additional administrative measures to contain banks' foreign borrowing and credit growth. It however lacks an in-depth discussion on the effectiveness of those instruments as well as on possible policy alternatives, also in light of further capital account liberalisation. The projected gradual reduction of inflation to 2.6% in 2009 appears plausible and broadly concurs with the Commission's autumn 2006 forecast. At the same time, risks of higher inflation could result from stronger domestic demand and continued real appreciation pressures, resulting from persistent and strong capital inflows.

Like the previous submission, the fiscal strategy of the 2006 PEP envisages a process of continued and moderate fiscal consolidation. The general government deficit is set to decline from an estimated 2.4% of GDP in 2006 to 1.5% of GDP in 2009 in ESA 95 terms. The primary balance will gradually change from a zero balance in 2006 to a small surplus of 0.4% of GDP in 2009. Fiscal consolidation is based on a noticeable reduction of public spending by around half a percentage point of GDP in 2007 and one percentage point in 2008 and 2009 each (from 47.2% of GDP in 2006 to 44.7% of GDP in 2009). In particular, spending on wages, subsidies, social transfers and public investments is, relative to GDP, programmed to be reduced. The revenue-to-GDP ratio is planned to decline by 1.7 percentage points over 2006 to 2009, in line with the stated objective to reduce the relatively high tax burden on the economy. The general government debt ratio is projected to decrease from an estimated 42.1% of GDP in 2006 to 38.1% in 2009, mainly driven by a reduction of primary balances and an acceleration of GDP growth.

The fiscal objective of continued deficit reduction remains appropriate against the background of relatively high spending ratios and significant state intervention in the economy. The recent widening of the current account deficit and an increase in foreign debt may suggest that an even stronger-than-envisaged fiscal adjustment might be warranted to address external vulnerabilities. The programme would have benefited from a more systematic and comprehensive description of envisaged economic policy measures to support the process of fiscal consolidation. In particular, the fiscal effects of the social security reform and enterprise restructuring remain unclear. The programme does not explicitly elaborate on envisaged wage and employment policies of the public sector. Some policy measures outlined in the policy matrix appear to contribute to an increase rather than a reduction of social spending in percent of GDP. Overall, on the basis of information provided it is difficult to assess whether the fiscal strategy is sufficiently backed by concrete policies. At the same time, significant fiscal risks of over-spending in the area of pension, wages and subsidies remain and important off-budget operations add uncertainties as to the overall fiscal stance and its effect on domestic demand. Enhancing the transparency and efficiency of public debt management remains a particular challenge.

The 2006 PEP covers a broad range of structural reforms related to the enterprise and financial sector, labour market and social welfare system, agricultural sector, public administration, education, health care, judiciary, environment and public procurement. Reforms of product markets focus on continued enterprise restructuring (railways, shipbuilding, steel). This may imply significant fiscal costs due to necessary debt write-offs which are however not quantified. The programme does not foresee an explicit time frame

for the privatisation of assets held by the State Privatisation Fund and appears in this respect less ambitious than the previous PEP. A strengthening of competition and state aid control authorities could in principle support the intended subsidy reduction, but the programme does not provide details in this respect. A large number of support schemes to foster SME development may suggest the need for some streamlining to provide efficient and well-targeted support. Labour market reforms focus on active labour market policies, in particular on employment subsidies for specific target groups. Policy reforms that are potentially conducive to increasing the flexibility of labour markets, such as measures related to tax/benefits, employment protection or wage bargaining systems are apparently not foreseen over the medium term. Additionally, the assessment would benefit from emphasizing the need to ensure appropriate links between macroeconomic and employment policies in line with the Lisbon agenda. The orientation of the structural reform agenda remains generally appropriate, but more emphasis could have been given to measures to improve the overall business environment. Although the programme provides some useful information on the link between structural reforms and the fiscal strategy, it would benefit from a more detailed and systematic assessment, indicating more clearly to what extent and in which particular areas the structural reform agenda could underpin the implementation of the fiscal strategy.

Table 1: **Comparison of key macroeconomic and budgetary projections**

		2005	2006	2007	2008	2009
Real GDP growth	COM	4.3	4.5	4.6	4.5	n.a.
(% change)	PEP 2006	4.3	4.6	4.6	4.8	5.0
Consumer price	COM	3.3	3.4	3.1	3.0	n.a.
inflation (%)	PEP 2006	3.3	3.5	3.2	3.0	2.8
General government	COM	-3.9	-3.5	-3.6	-3.3	n.a.
balance (% of GDP)	PEP 2006	-2.9	-2.2	-1.8	-1.7	-1.5
Primary balance	COM					
(% of GDP)	PEP 2006	-0.7	0.1	0.3	0.3	0.4
Government gross	COM	44.2	44.5	44.3	44.0	n.a.
debt (% of GDP)	PEP 2006	44.2	42.1	40.5	39.3	38.1

The 2006 PEP reports on a number of measures that should improve the quality of public finances over the medium term. These include the continued implementation of fiscal impact assessments, ongoing reform of the single treasury system as well as the strengthening of financial management and control through a wider resort to internal audits. The establishment of a coherent, effective and fully functioning public procurement system in line with EU practice is another priority. Simplifying the tax system and reducing the relatively high tax burden of the economy remain important objectives, but the programme does apparently not foresee any significant changes in tax policy. The PEP highlights the importance of the reform of education and science, but does not explicitly foresee a re-orientation of spending in line with policy priorities. The 2006 PEP contains a separate section on the long-term sustainability of public finances, which is a welcome improvement. Long-term projections differ markedly from those provided in last years' PEP, as they are for the first time based on explicit population projections. Measures envisaged to boost employment may alleviate long term pressures provided they are successful in increasing participation rates. At the same time, ensuring the sustainability of the pension system will certainly require from the authorities to withhold occasional claims from strong pensioners constituencies for higher pensions. Further pension reforms are not foreseen over the PEP horizon. The reform of health care remains an important policy

priority, but the PEP 2006 falls however short in fully assessing the effects of health reforms on the long term sustainability of public finance.

It can thus be concluded:

- Croatia's third Pre-Accession Economic Programme for 2007-2009 is a comprehensive economic policy document, which presents a sound and coherent medium-term macroeconomic and fiscal framework and a broad agenda for structural reforms. The programme largely complies with content, form and data requested. It takes into account comments and suggestions made in last years' PEP assessment, reflects progress made in enhancing institutional and analytical capacity, and contains technical improvements, including a first attempt to report fiscal data on the basis of ESA 95 standards. Policy objectives are sometimes less precisely defined compared to the previous submission. Overall, the programme can provide important guidance for economic policy making, in particular with the view of fully meeting the Copenhagen economic criteria for accession.
- The Croatian economy has recently performed relatively well with stronger growth, relatively low inflation and exchange rate stability. Fiscal consolidation has continued, but external imbalances have increased, as the current account deficit has widened and foreign debt has further risen. The programme's macroeconomic projections seem overall realistic in the context of the envisaged policy mix and on the assumption of a relatively benign external environment. They largely concur with the European Commission's autumn 2006 forecast.
- The policy mix of continued fiscal consolidation and stability-oriented monetary policies remains appropriate. An even stronger fiscal adjustment might however be warranted to effectively address external vulnerabilities that have increased recently. The programmes' objective to reduce public spending over the medium term is welcome in light of a relatively high spending-to-GDP ratio and significant state intervention in the economy. Yet, the programme remains rather vague on the underlying fiscal and structural measures and their respective budgetary effects. At the same time, significant fiscal risks of over-spending in the area of pensions, wages and subsidies remain and important off-budget operations add uncertainties to the overall fiscal stance and their effects on domestic demand.
- The structural reform agenda outlined in the document aim to foster economic restructuring, enhance competition, stimulate employment and rationalise social spending. This orientation remains appropriate and should be conducive to fostering growth over the medium term. At the same time it will require a strong commitment and continued efforts by the Croatian authorities to accelerate reforms in a large number of areas. More emphasis could have been given to improving the overall business environment, given the pertaining administrative obstacles still in place. The programme's reform agenda would have benefited from establishing a closer link between the structural reform agenda and its relevance for the implementation of the fiscal policy strategy, but is broadly aligned with the reform requirements in view of the country's EU accession perspective, as spelled out in the latest Progress Report and the European Partnership.

2. INTRODUCTION

On 1 December 2006, the Croatian Minister of Finance, Mr Ivan Suker, submitted the third Pre-Accession Economic Programme (the “2006 PEP”) of Croatia to the Commission, following government adoption and earlier consultation of social partners. The programme covers the period 2007-2009. It builds on earlier policy documents, such as the "Strategic Development Framework for 2006-2013" and the "Economic and Fiscal Policy Guidelines 2007-2009". The programme is consistent with the budget framework for 2007 and its medium-term budgetary projections, adopted last December. The document largely complies with the content, form and data requested. It takes into account comments and suggestions made in last years' PEP assessment, and it generally reflects progress made in the institutional and analytical capacity of the relevant parts of administration. It presents a coherent macroeconomic framework and a fiscal consolidation programme which aims at gradual reduction of the general government deficit over the PEP period. The programme's general objectives are to maintain macroeconomic stability, to ensure sustainable growth, and to improve the standard of living of Croatian citizens. Unlike the previous submission, the PEP avoids quantifying public and external debt targets. The structural reform agenda puts emphasis on increasing the competitiveness of the Croatian economy, notably through a continuation of enterprise restructuring and privatisation. The document follows the structure in the consolidated outline and provides the requested data in an overall accurate manner. While the programme contains some important technical improvements compared to the previous submission, it would have benefited from further editing.

3. MACROECONOMIC DEVELOPMENTS

3.1. Recent macroeconomic developments

In the fourth quarter of 2006, GDP growth accelerated to 4.8% year-on-year, bringing the annual growth rate in 2006 to 4.8%, up from 4.3% in 2005. Growth in 2006 continued to be driven by strong domestic demand. In particular, investment spending accelerated markedly to 10.9% year-on-year, up from 4.8% in 2005, while private consumption growth remained at around 3.5%. Imports of goods and services grew slightly stronger (7.3%) than exports (6.9%). Industrial output growth decelerated to 4.5% year on year in 2006, from 5.1% a year before, but accelerated again early 2007. Data from the labour force survey reported a decline in the unemployment rate to 11.8% in the first half of 2006, down from 13.1% in the first half of 2005. Average annual consumer price inflation stood at 3.2% in 2006, slightly below the rate in 2005 (3.3%), and came further down to 2.8% in February 2007. The current account deficit widened to 7.7% of GDP in 2006, up from 6.4% in 2005, due an increase in the merchandise trade deficit and lower surpluses in the balance of services and transfers. Net FDI inflows increased significantly and fully covered the current account deficit in 2006.

The 2006 PEP gives a rather comprehensive and up-to-date overview of recent macroeconomic developments at the time of submission. In some cases it provides useful explanations for deviations of actual developments from estimates presented in the 2005 PEP. Comparisons of recent trends in 2006 with the relevant period in 2005 are not systematically provided for all key economic variables, and more references to the attached tables would have been useful. The presentation would have benefited from some more detailed information on developments of wages, labour productivity and unit labour costs. Overall, the quality of this chapter has improved compared to that of the 2005 PEP.

Table 2: Comparison of macroeconomic developments and forecasts

	2005		2006		2007		2008		2009	
	COM	PEP	COM	PEP	COM	PEP	COM	PEP	COM	PEP
Real GDP (% change)	4.3	4.3	4.5	4.6	4.6	4.6	4.5	4.8	n.a.	5.0
<i>Contributions:</i>										
- Final domestic demand	3.7	3.7	5.0	5.4	5.4	4.3	4.5	4.7	n.a.	5.1
- Change in inventories	0.6	0.6	-0.2	0.5	-0.1	1.1	0.0	0.5	n.a.	0.1
- External balance of goods and services	0.1	0.1	-0.3	-1.3	-0.7	-0.8	0.0	-0.4	n.a.	-0.2
Employment (% change)	0.8	0.7	1.5	1.9	1.8	1.9	0.8	1.8	n.a.	1.8
Unemployment rate (%)	12.4	12.7	11.5	11.8	10.9	11.7	10.7	11.5	n.a.	11.0
GDP deflator (% change)	3.2	3.2	3.0	3.5	3.5	3.4	3.3	3.2	n.a.	3.0
CPI inflation (%)	3.3	3.3	3.4	3.5	3.1	3.2	3.0	3.0	n.a.	2.8
Current account balance (% of GDP)	-6.4	-6.4	-7.0	-7.5	-7.2	-7.8	-6.9	-7.4	n.a.	-7.0

Sources: Pre-Accession Economic Programme (PEP); Commission services Autumn 2006 forecasts (COM)

3.2. Macroeconomic scenario

The 2006 PEP presents a coherent and comprehensive medium-term macroeconomic programme with projections for key economic variables, covering real sector, employment, wage, inflation as well as external developments. Alternative scenarios are not developed. The document does provide reasons for divergences from the previous submission. The key macroeconomic challenges and objectives of the programme could have been specified more explicitly from the start. Projections for key macroeconomic variables seem overall plausible, also in the context of the envisaged macroeconomic policy mix which has not changed compared to the previous submission and generally remains appropriate. External assumptions of the programme seem reasonable and broadly in line with the European Commission's forecast.

Real sector

The 2006 PEP is based on a scenario of relatively robust growth of real GDP. It accelerates from an expected rate of 4.6% in 2006 to 5% in 2009. As compared to the previous submission, real GDP growth projections have been significantly revised upwards, by around half a percentage point per year, mainly due to stronger than previously projected domestic demand. The document does not explicitly discuss reasons for deviations from the previous years' PEP. Growth of private consumption is projected to accelerate from an expected 3.2% in 2006 to an average of 3.8% over the PEP period. This is largely the result of real wage increases as well as one-off payments to pensioners during the first half of the programme period. Investment growth accelerates over the entire period from 6.8% in 2007 to 8.9% in 2009, as a result of stronger private investment. Due to a favourable external environment, real exports of goods and services are projected to increase by 7.4% on average, which is stronger than the average growth of imports (6.6%). As a result, the negative contribution of net exports to GDP (1.3 percentage points expected in 2006) will gradually decline to 0.2 percentage points in 2009. Growth projections seem overall plausible and broadly in line with the stability-oriented macroeconomic policy mix of the programme. They largely concur with the European Commission's recent autumn forecast, which projects the same GDP growth for 2007, but a slightly lower growth rate for 2008. On the supply side, projections of a growing contribution of industry and construction to

gross value added over the PEP period appear plausible, while the effect of pre-accession assistance on growth in agriculture may be somewhat overestimated. Projections of labour market trends are largely in line with the recent Commission's forecast. The 2006 PEP assumes an average employment growth of around 1.8% over the reference period, which facilitates a gradual reduction of the unemployment rate to 11% by 2009. The document would have benefited from a more detailed assessment of the determinants of employment and productivity developments and their effect on growth over the medium term.

External sector

The 2006 PEP projects a widening of the current account deficit from an expected 7.5% of GDP in 2006 to 7.8% of GDP in 2007, before it declines slightly to 7% of GDP in 2009. This scenario is a significant deviation from the previous PEP submission, which expected a narrowing of the current account deficit to 3.8% by 2008. The revision is reportedly driven by stronger than previously expected private consumption and investment growth foreseen over the PEP period, which will result in higher imports. The PEP foresees a continued strong growth of merchandise exports of around 12.3% on average per year over the reference period. Since merchandise imports are projected to grow at a lower 9.3% on average, the trade deficit is expected to shrink by one percentage point to 23.7% of GDP. The programme assumes increasing revenues from the net export of services, namely tourism, due to improvements in the quality of tourism infrastructure. However, the surplus in the trade with services remains constant at 16.6% in 2007 and 2008 and drops to 16.3% in 2009 and will in itself not contribute to a narrowing of the current account deficit. Net factor income from abroad is projected to decline as a percentage of GDP, mainly as a result of lower interest payments on foreign liabilities and an increase in the central bank's income on foreign exchange reserves. Moreover, the programme assumes a slower growth of dividends and retained earnings paid to non-residents. The surplus in the balance of net current transfers is projected to slightly decrease as a percent of GDP, due to an increase of pension payments abroad. The programme does not elaborate as to why EU transfers, which account for about 60% of total net transfers, will significantly decline as a percentage of GDP. Current account trend projections outlined in the 2006 PEP is generally plausible in the context of both external assumptions and the overall macroeconomic scenario. Relatively strong growth underpinned by progress with enterprise restructuring, privatisation and investment is likely to go hand in hand with a continuation of private sector balances as outlined in the programme. In that sense, the external part of the programme is more realistic compared to the previous PEP.

The PEP 2006 assumes that a significant part of the current account deficit over the programme period will be financed by net FDI inflows. In 2006, significant net FDI inflows of an expected 7.2% of GDP were largely fuelled by a takeover of a pharmaceutical company, the recapitalisation of some banks and a successful privatisation of parts of the country's oil company. The programme assumes that the EU accession perspective, a more qualified workforce, improved quality of infrastructure coupled with stronger investment promotion activities will help sustaining a strong inflow of net FDI. It would average at above 5% of GDP per year, providing 70% coverage of the current account deficit over the PEP period. These projections appear slightly optimistic, as the programme itself states that no significant privatisation projects are foreseen over the PEP period that could help boosting FDI in a considerable manner. At the same time, the scope for a strong increase in greenfield and other non-privatisation related investments may still be limited, due to remaining difficulties in the overall business environment. The PEP projects a continuation of strong net capital inflows, but does not provide a detailed analysis of their composition. Data provided suggest that foreign exchange reserves will grow at 7.4% on average over the PEP period.

3.3. Monetary and exchange rate policy

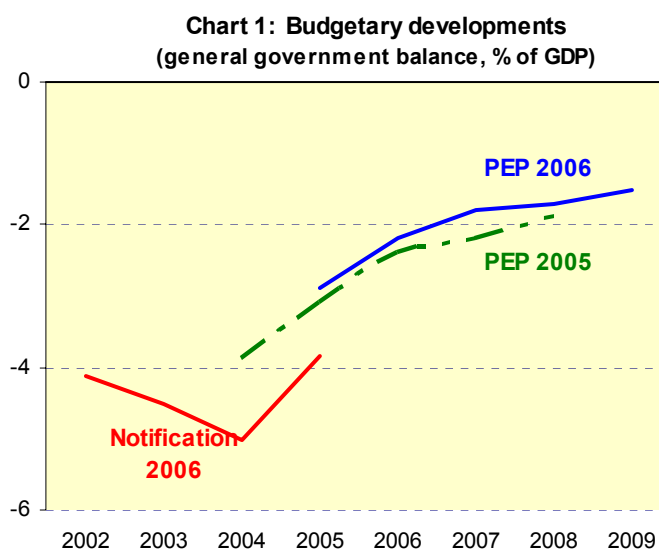
The 2006 PEP presents a short description of the monetary and exchange rate policy framework, the main features of which have been in place for the past ten years. The primary policy objective is price stability and the exchange rate has traditionally and successfully been used as a stabilisation anchor. The PEP reconfirms that the tightly managed float remains an appropriate policy framework to sustain low inflation and forestall exchange speculations. Moreover, widespread euroisation of the financial system limits the scope for monetary policy discretion. Larger exchange rate flexibility would imply significant credit risks due to un-hedged non-financial sector balances. According to the PEP, an "aggressive credit policy" of banks has led to a widening of the current account and an increase in external indebtedness, as foreign owned banks refinanced their domestic lending by credits from their mother companies. The PEP explains measures taken by the central bank to discourage banks' foreign borrowing (e.g. subsequent increases in marginal reserve requirements on banks' foreign liabilities) and to curb domestic credit growth. The document mentions the possibility of additional measures should credit growth continue to accelerate, foreshadowing the introduction of credit controls in late 2006. The programme would have benefited from a more in-depth discussion on the effectiveness of administrative instruments, based on recent experience, as well as on possible policy alternatives for a small open economy exposed to strong and persistent capital inflows.

The PEP projects a gradual reduction of inflation from 3.5% (expected) in 2006 to 2.6% in 2009. Lower inflation is expected to be supported by a slowdown in administrative prices, lower commodity price increases as well as strengthened competition in the Croatian retail sector. Consistent with the outlined exchange rate policy framework, the exchange rate of the Kuna vis-à-vis the euro is expected to remain constant at around HRK 7.35 over the programme period, thus supporting a lowering of annual inflation. Overall, inflation projections appear plausible and broadly concur with the Commission's views expressed in its recent forecast. The risk for higher than projected inflation could result from stronger domestic demand and continued real appreciation pressures as a result of strong capital inflows. As the stabilisation of the nominal exchange rate is an explicit policy objective under the programme, a stronger real appreciation of the Kuna would be reflected in higher domestic inflation.

4. BUDGETARY TARGETS AND THE MEDIUM-TERM PATH OF THE PUBLIC FINANCES

The 2006 PEP presents a rather coherent medium-term public finance framework with fiscal projections for the main categories on the revenue and expenditure side of the consolidated general government budget. As in the previous year's submission, the main objective of fiscal policy remains a continuous and moderate reduction of the general government deficit to facilitate a lowering of external imbalances. The strategy envisages a rationalisation and improved targeting of spending which leads to a reduction of subsidies and transfers as a share of GDP. Also, a simplification of the tax system and improvements in tax collection procedures are mentioned as the key elements of the fiscal strategy. The programme contains only limited information on concrete fiscal policy measures and their likely budgetary effects. Expenditure and revenue ratios as well as fiscal balances are for the first time reported on the basis of ESA 95 which is a significant technical improvement. Moreover, the document provides additional information allowing for a comparison with fiscal data of the previous years' PEP which used GFS standards. The PEP contains an analysis of fiscal risks, which is a valuable complement to the presentation of the fiscal strategy.

The fiscal programme envisages a gradual reduction of the consolidated general government deficit from an expected 2.4% of GDP in 2006 to 1.5% of GDP in 2009. The primary balance will gradually improve from a close to zero balance in 2006 to a small surplus of 0.4% of GDP in 2009. Fiscal consolidation is based on a reduction of the public spending ratio (including net acquisition of non-financial assets) by around two and a half percentage points of GDP in the three-year period (from 49.3% of GDP in 2005 to 46.1% of GDP in 2008). In particular, spending for wages, subsidies, social transfers and investments as a share of GDP is programmed to be reduced. At the same time, the revenue to GDP ratio is planned to decline by 1.7 percentage points over 2006 to 2009. The public debt ratio is projected to fall from an expected 42.1% of GDP in 2006 to 38.1% of GDP in 2009, mainly driven by an improvement of primary balances and an acceleration of GDP growth. The programme provides estimates on the output gap, which remains negligible over period, as well as on budgetary sensitivity indicators. According to these estimates, the cyclically adjusted primary balance follows a similar pattern of a gradual deficit reduction, which suggests a very low risk that fiscal policies could turn pro-cyclical over the reference period.



4.1. Targets and adjustment

As for the year 2006, the original budget framework adopted in November 2005 foresaw a deficit target for the consolidated general government sector of 3.2% of GDP in GFS terms (equivalent to 2.3% in ESA 95 terms), significantly lower than the 2005 deficit of 4.1% of GDP. According to the last year's PEP, this deficit reduction was expected to be driven by a marked reduction of current spending in percent of GDP, in particular on wages, subsidies and social transfers. However, budget developments in the first half of 2006 were primarily marked by better than expected revenue collection resulting from stronger growth and cautious budgeting. This, together with some spending overruns, led to the adoption of a supplementary budget in July with higher revenues and expenditures as a share of GDP. Excess revenues were partly used to finance higher current spending. The marginal reduction of the revised budget deficit (to 3% of GDP in GFS or 2.2% in ESA 95 terms) resulted mainly from lower than initially planned capital spending. Preliminary data on budget execution of the consolidated general government in 2006 suggest that budget implementation has been broadly in line with the revised plan. However, official data are largely cash based, and do not contain changes in general government arrears, debt

assumptions and other factors that in past years have had a significant impact on net lending/borrowing as defined under ESA 95. According to the fiscal notification submitted by Croatia in April 2006, these factors have accounted for one percentage point of GDP in fiscal year 2005. Preliminary information suggests that general government arrears continued to increase through 2006, by 0.2% of GDP. Also, there is some uncertainty as to what extent payments on the basis of government guarantees have added to overall spending. Therefore, the general government deficit on ESA 95 may turn out to be higher than projected, thus necessitating stronger fiscal adjustment in 2007 and beyond.

For the year 2007, the programme envisages a further reduction of the general government deficit. The deficit is set to fall by 0.4 percentage points to 1.8% of GDP in ESA 95 terms. This target seems consistent with the budget framework adopted in November 2006. The programme projects consolidated general government expenditure, including net acquisition of non-financial assets, to be reduced by 0.6 percentage points, and total revenues to decline by 0.2 percentage points. The lower expenditure-to-GDP ratio is largely driven by a reduction in social spending (by 0.5 percentage points), but it remains unclear how the described reforms in the area of social security will generate the necessary savings. In general terms, the PEP mentions the importance of a continuation of structural reforms in the area of pension and health care, but emphasises at the same time that "all current rights" will be maintained. A comprehensive reform of social benefit spending reportedly aims at a better targeting of social transfers, but the programme does not quantify the fiscal savings. Moreover, it remains open whether the reform would include a wide range of social benefits currently provided to different groups of war veterans. For 2007, the PEP's policy matrix suggests a net increase in social spending by 0.2% of GDP rather than a decline. This is due to active employment policy measures as well as a number of additional benefits planned to be provided in the framework of what is called a new "population policy". This encompasses an increase of children's allowances, maternity benefits and other family support measures. Reductions are foreseen in spending on wages (0.2 percentage points), but the programme does not provide details on envisaged wage and employment policies in the broader context of the public administration reform. Recent evidence suggests that the authorities are planning to increase the level of employment significantly due to EU accession related tasks. Moreover, experience in recent years shows that the public sector wage bill has repeatedly been higher than initially foreseen. Against this background, the intended wage reduction may turn out to be a challenge. Subsidies are programmed to be reduced only marginally (by 0.1 percentage points), on the back of further restructuring of the railway system. It is worth noting that the otherwise ambitious notion of a continuation and acceleration of enterprise restructuring in other parts of the PEP does not yield a more substantive subsidy reduction. Capital spending is projected to slightly increase, but the document does not elaborate on public investment plans foreseen over the medium term. Overall, it is difficult to comprehend a spending reduction of 0.6% of GDP on the basis of information about policy measures provided in the document.

Moreover, considerable risks to fiscal policy implementation may result from strong and mounting pressures to raise budgetary wages and boost pension payments for certain pensioners groups, especially in the context of elections scheduled for late 2007. Recently issued guarantees for large borrowing by shipyards, a planned increase of the deficit of the Croatian Bank for Development and Reconstruction (HBOR), as well as significant off-budget operations and the non-coverage of some local governments in the general government accounts add uncertainties to the fiscal stance and its effect on domestic demand in 2007.

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

	2005	2006	2007	2008	2009	Change: 2006-09
Revenues	45.0	45.0	44.8	44.0	43.3	-1.7
<i>of which:</i>						
- Taxes and social security contributions	40.2	40.2	39.8	39.4	38.9	-1.3
- Other (residual)	4.8	4.8	5.0	4.6	4.4	-0.4
Expenditure	47.9	47.2	46.6	45.7	44.7	-2.5
<i>of which:</i>						
- Primary expenditure	45.7	45.0	44.5	43.7	42.8	-2.2
<i>of which:</i>						
Gross fixed capital formation	3.9	3.4	3.5	3.2	3.0	-0.4
Consumption	16.6	16.9	16.8	16.6	16.2	-0.7
Transfers & subsidies	21.2	20.7	20.1	19.7	19.3	-1.4
Other (residual)	4.0	4.0	4.1	4.2	4.3	0.3
- Interest payments	2.2	2.2	2.1	2.0	1.9	-0.3
Budget balance	-2.9	-2.2	-1.8	-1.7	-1.5	0.7
- Cyclically adjusted						
Primary balance	-0.7	0.0	0.3	0.3	0.4	0.4
Gross debt level	44.2	42.1	40.5	39.3	38.1	-4.0

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

In 2008 and 2009, the general government deficit is projected to decline further to 1.7% and 1.5% of GDP, respectively. A major part of adjustment over these two years is planned to be realised through a reduction of primary spending, in particular of government consumption (by 0.6 percentage points) and spending on social benefits and subsidies (by 0.4 percentage points). Also, public investment as a share of GDP is programmed to be reduced from 3.5% of GDP in 2007 to 3% in 2009. Only limited information is provided on specific budget and structural measures to support fiscal adjustment over the latter part of the PEP period. An assessment of the quality of fiscal adjustment is therefore rather difficult. New tax policy measures are not envisaged for 2007 and 2008. The revenue-to-GDP ratio is projected to significantly decline, by 1.5 percentage points of GDP, over the two years 2008 and 2009. The reduction comes mostly on account of indirect taxes, but this is not explained and appears questionable. Even under the assumption of unchanged tax rates, the projected growth path as well as the need to adjust excises could actually imply a stronger growth of indirect taxes as a percent of GDP.

Box 1: The PEP 2006 and the Accession Partnership economic priorities

Following the opening of accession negotiations with Croatia on 3 October 2005, the Council adopted an Accession Partnership on 20 February 2006, which updates the previous European Partnership.

Short-term economic priorities, which are expected to be accomplished within one to two years, include the continuation of stability-oriented macroeconomic policies, further fiscal consolidation, in particular in the area of social welfare spending and subsidies to enterprises.

They also encompass a strengthening of expenditure control and public debt management, an acceleration of privatisation and enterprise restructuring, in particular in the agriculture, steel and shipbuilding industry, further improvements of the business environment and the development of macroeconomic statistics.

The short-term priorities, which have already been partly addressed through policies in 2006, are to large extent reflected in the policy framework of the PEP 2006.

The medium-term economic priorities are expected to be implemented within three or four years. They include the completion of privatisation of assets held by the State Privatisation Fund, the implementation of comprehensive health care and pension reforms and the continuation of labour market and education reforms. The 2006 PEP addresses these medium-term priorities to a varying degree. In particular, future reform plans with respect to health care financing and pension receive relatively little coverage in the programme. Overall, while broadly supportive of the relevant Partnership priorities, the 2006 PEP would fall short of fully delivering all of its medium-term priority objectives.

The 2006 PEP includes – as the previous submission - a sensitivity analysis with three different scenarios and identifies relevant risks that are either rooted in lower growth or weaker fiscal and structural policy implementation. In the first scenario, real growth rates are reduced by 50% over the PEP period, caused by either a less favourable external environment or structural reform delays, leading to significantly higher fiscal deficits in each year over the reference period, by 1.6 percent of GDP on annual average. The second scenario assumes a 50% lower revenue growth in 2007- 2009, while real GDP growth rates are left unchanged, which would lead to significant deviations from baseline fiscal deficits, by around 2.8 percentage points in both 2008 and 2009. Finally, the third scenario assumes a one-off increase in spending on social transfers or subsidies in 2007 (of HRK 1 billion), leading to higher fiscal deficits by around 0.3 percentage points on average over the reference period. The risk analysis is similar to the one presented in the PEP 2005 and demonstrates the rather significant sensitivity of changes in real growth, revenues and spending to the fiscal balance. It should prepare the ground for the design of possible counterbalancing and contingency measures in the case risks actually occur. The document itself does not elaborate on possible counter-measures in the event of risk occurrence and it thus remains unclear how precisely the fiscal strategy would respond in case the deficit needs to be reduced on short notice.

In conclusion, as last years' submission, the 2006 PEP again demonstrates the authorities' commitment to continued and moderate fiscal consolidation over the medium term, to be brought about by a reduction of the spending-to-GDP ratio. The direction of this strategy remains appropriate against the background of relatively high spending ratios and significant state intervention in the economy. It rightly recognizes the specific role of fiscal consolidation in reducing external imbalances, given the limited scope for monetary policy discretion. However, the recent widening of the current account and further rise in foreign indebtedness may suggest that efforts at fiscal adjustment might need to be stepped up in order to effectively address external vulnerabilities. Interestingly, the programme mentions

the possibility of a stronger fiscal adjustment, namely a reduction of the general government deficit to 0.6% of GDP by 2009, in case of a realisation of stronger revenue collection, better spending control and faster progress in structural reforms. Overall, the document would have benefited from more detailed information on specific fiscal and other economic policy measures that would support the process of fiscal adjustment. On the basis of information provided in the PEP, it remains rather difficult to assess to what extent fiscal objectives are backed by concrete policies. At the same time, considerable risks of overspending, some of which are elaborated in the programme, could result from weaker policy implementation. Therefore, the fiscal scenario may eventually turn out to be less comfortable than projected in the programme.

4.2. Debt developments

Over the period 2002 - 2005, public debt has grown from 48.6% to 49.6% of GDP, while general government debt, defined as public debt minus outstanding guarantees, has risen stronger from 40% of GDP to 44.2%. A key feature is a large share of foreign debt (around 55%) and of foreign currency denominated debt. The PEP 2006 projects a gradual reduction of the general government debt from 42.1% of GDP in 2006 to 38.1% of GDP in 2009. Over this period, nominal GDP growth in itself will reduce the debt ratio by around 3 percentage points per year. This effect is partially offset by interest payments which are projected to increase the ratio by 2 percentage points on average per year. The impact of the exchange rate over the reference period is negligible, which is in line with the programme's assumption of a stable exchange rate. The lowering of the debt ratio is markedly effected by an increase of the primary balance to a surplus of 0.3% of GDP on average over the PEP period. The privatisation process is also expected to impact favourably on the debt ratio. Revenues are projected to reduce the gross debt-to-GDP ratio by around 0.6 percentage points on average over the PEP period. Given the still sizeable remaining portfolio of the State Privatisation Fund, this seems realistic, provided a smooth continuation of the privatisation process. The debt sensitivity analysis, which is somewhat less detailed as compared to the previous years' submission, confirms that public debt dynamics are particularly sensitive to changes in the Kuna/euro exchange rate and in primary balances. While a marked devaluation of the Kuna does not appear likely under the current policy framework, a fiscal loosening and higher primary deficits would significantly impact on public debt developments.

With respect to the debt management strategy, the PEP foresees a continuation of borrowing primarily on domestic markets and in Kuna-denominated securities, also with a view to developing a domestic capital market. The latter however also requires that the issuance policy of the Ministry of Finance becomes more predictable and transparent. Stronger domestic borrowing will eventually help reducing foreign exchange risk exposure of the government sector. The mentioned impact on the country's overall external indebtedness however remains uncertain, as recent experience suggests. Depending on market and liquidity conditions, more intense domestic government borrowing could lead to stronger foreign borrowing by the private sector. The PEP paints a rather rosy picture of recent institutional improvements of debt management capacity in the Ministry of Finance. While a reorganisation of the debt management into a front, back and middle office has been initiated, the reform seems far from being fully accomplished. The PEP would benefit from addressing existing shortcomings and outlining measures to be taken with a view to bring the legal and institutional framework in line with EU best practice. While it is indirectly mentioned that risks may arise from independent borrowing activities of extra-budgetary funds and local governments, the strategy does apparently not foresee a centralisation of borrowing activities in the Ministry of Finance.

5. STRUCTURAL REFORMS

The 2006 PEP covers a broad range of structural reforms related to the enterprise and financial sector, labour market and social welfare system, agricultural sector, public administration, education, health care, judiciary, environment and public procurement. The presentation is largely descriptive, providing information on past and ongoing reforms with a strong emphasis on legislative harmonisation with EU rules and institution building activities. The structural reform agenda aims to foster economic restructuring, enhance competition, stimulate employment and rationalise social spending, which remains appropriate.

Table 4: **Net direct budgetary impact of key reform commitments** (in EUR million)

Description of the Policy	2006	2007	2008	2009
Enterprise restructuring and state aid	-10.5	-93.8	-92.1	-104.8
Labour market reforms	-48.0	-5.6	-6.9	-6.8
Social Welfare and family support	0.0	-59.3	-103.8	-12.6
Agriculture sector reform	-26.7	-18.4	-15.5	-8.4
Health reforms	56.1	40.0	0.0	0.0
Other reforms	-15.3	-56.4	-37.0	-24.5
Total impact on the budget	-44.4	-193.4	-255.2	-156.9
Total impact on the budget (% of GDP)	-0.1%	-0.5%	-0.7%	-0.4%

Source: 2006 Pre-accession Economic Programme, own calculations

More emphasis could have been given to measures to improve the overall business environment and attract strategic foreign investors, given the pertaining administrative obstacles still in place. The relation between the structural reform agenda and the fiscal strategy is elaborated in only a few cases. It is therefore difficult to see to what extent and in which particular areas the structural reform agenda could underpin the implementation of the fiscal strategy. Fiscal estimates of structural reforms are not entirely consistent with the medium term budgetary scenario and do not appear to be comprehensive. An overview about the implementation of structural reform measures included in the previous PEP 2005 shows that delays have particularly occurred in the area of privatisation and enterprise restructuring. The full implementation of the PEP's structural reform agenda would require intensified efforts to accelerate reforms in a number of areas.

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Other reforms	-15.3	-56.4	-37.0	-24.5
Total impact on the budget	-44.4	-193.4	-255.2	-156.9
Total impact on the budget (% of GDP)	-0.1%	-0.5%	-0.7%	-0.4%

Source: 2006 Pre-accession Economic Programme, own calculations

5.1. Product and capital markets

The 2006 PEP touches upon the following main reform areas related to the functioning of product markets: strengthening of competition policy and state aid control, continuation of privatisation and enterprise restructuring (railways, shipbuilding, steel), and SME development. The programme's stated objective is to speed up the privatisation of company assets held by the Privatisation Fund. The sale of a steel and aluminium company is explicitly envisaged to be finalised in the first quarter of 2007. The programme suggests that this may imply significant fiscal costs due to necessary debt write-offs, but those are not quantified. Otherwise, the PEP does not provide an explicit time frame for the implementation of the privatisation process and appears less ambitious than the previous years' programme. It remains unclear on which basis estimates on privatisation revenues provided in the fiscal part of the document were made.

The further liberalisation of rail transport and the restructuring of the large railway company remain a policy priority, following the unbundling of the railway system and registration of independent railway companies for different operations that started in 2006. The PEP provides for an estimate of maintenance and new investment costs envisaged as well as on savings resulting from lower subsidies to the railways. With respect to the shipyards sector, a National Restructuring Programme is expected to be adopted in the first half of 2007 at the latest, on the basis of which individual restructuring plans for each loss-making shipyard will be established. The PEP targets the privatisation of the shipyard sector to be finalised by 2010. No information is provided on the fiscal impact of shipyard restructuring.

As in the previous submission, the programme presents a large number of support schemes to foster the development of the SME sector which appear to partly overlap, suggesting a duplication of initiatives. Some streamlining of initiatives may still be warranted to ensure efficient, effective and well targeted SME support. The programme does not provide detailed information on the reform of network industries, e.g. on the state of advancement of wide ranging reforms required under provisions of the South East Europe Energy Treaty which was signed by Croatia in October 2005 and came into force as of July 2006.

5.2. Financial sector

The Croatian financial sector is dominated by commercial banks, accounting for 77.6% of assets in mid-2006, which are to a large extent foreign-owned and generally very liquid, well capitalised, and highly profitable. Banking supervision lies within the responsibility of the Croatian National Bank and appears to be broadly in line with EU best practice. The PEP 2006 comprehensively describes recent and planned initiatives to align financial sector legislation with EU directives. The document could have been more pronounced on financial sector related challenges and possible policy responses. One of the key challenges over the medium term will be to manage robust credit growth, while simultaneously fully liberalising the capital account (foreseen by 2008), which will most likely imply the removal of some administrative measures, such as marginal reserve requirement for foreign borrowing as well as recently re-introduced credit controls. Another challenge will be to implement a comprehensive overhaul of the regulatory framework for banking supervision and payment services which could have been given more prominence in the document. Finally, the credit risk associated with the high level of euroisation as well as a generally weak legal framework for the enforcement of creditor rights remain potential vulnerabilities to the banking system. In the non-banking sector, the key challenge will be the development of the securities market in order to sustain the growth of domestic institutional investors (pension and investment funds, insurance companies).

5.3. Labour market

Despite a recent decline in unemployment and moderate employment growth, the Croatian labour market continues to face significant challenges, such as low employment and participation rates, a high youth unemployment rate and a significant share of job seekers being long-term unemployed. According to the PEP, a new set of active labour market measures were implemented in the context of the 2006 Annual Plan for Stimulating Employment. These comprised more focused support to particularly sensitive groups, including employment subsidies for young persons without work experience, the long-term unemployed, the elderly population and other vulnerable groups. The programme envisages to expanding active labour market policies, particularly in the form of employment subsidies, over the PEP period and estimates the fiscal impact to amount to around HRK 50 million per year. As last years, the PEP does apparently not foresee any policy measures related to the reform of the tax/benefit system, employment protection or wage bargaining system which would potentially be conducive to increasing the flexibility of labour markets. The assessment would have benefited from analysis of the mentioned policy areas as they are to be an important part of the on-going discussions between the European Commission and Croatia on the Joint Assessment of the Employment Policy Priorities (JAP). Especially, the flexicurity which is high on the EU political agenda would need to be addressed. Additionally, while respecting the respective PEP and JAP purposes, the assessment would benefit from emphasizing the need to ensure appropriate links between macroeconomic and employment policies in line with the Lisbon agenda.

5.4. Other reform areas

The reform of the social security system remains one of the key priorities of the structural reform agenda. The stated reform objective is to improve the efficiency of social benefit spending through a better targeting of the neediest parts of the population. To this end, the strategy focuses – in general terms - on a better coordination of social welfare spending to avoid multiple exclusions of potential beneficiaries or unjustified accumulation of benefits under various support schemes. The reform would institutionally be backed by the establishment of one-stop shops. The PEP lacks more details about future reforms of social benefit spending and its fiscal implications over the medium term and does not refer to progress being made under recent government initiatives to overhaul the social welfare system by a consolidation and rationalisation of numerous benefit schemes. On the reform of health care financing, the PEP elaborates on structural measures taken in 2006 and their fiscal impact over the PEP period, but does not seem to envisage further measures to restore the financial discipline of the sector. Stronger financial support to families in the context of a new National Population Policy has become an explicit target in the PEP 2006 and is meant to help addressing the problem of an ageing population. The 2006 PEP includes various measures in the area of agriculture that aim to increase the competitiveness of the sector through restructuring and modernisation. More detailed information would have been useful on the development of state aid to agriculture over the programme period. The continuation of education reform on the basis of an Educational System Development Plan (2005-2010) should generally be supportive of the development of a knowledge-based economy. The provision of free school text books for a large number of pupils, which has significant fiscal effects, may be primarily motivated by re-distribution considerations. As in the previous PEP, emphasis on judicial reform is appropriate and the successful implementation of envisaged measures could be conducive to improving the overall business environment.

6. THE QUALITY AND SUSTAINABILITY OF PUBLIC FINANCES

6.1. The quality of public finance

The 2006 PEP reports on a number of measures that should improve the quality of public finances over the medium term. The continued implementation of fiscal impact assessments on the basis of a harmonised methodology as of 2007 across all bodies of state administration should enhance fiscal transparency and budget management. Moreover, the ongoing reform of the single treasury system and the inclusion of all social security funds should foster a more effective expenditure control. In addition, internal audit units have already been established in all line ministries and the process of strengthening financial management and control is expected to continue through harmonised procedures. The PEP sets out a comprehensive reform agenda to establish a coherent, effective and fully functioning public procurement system in line with EU practice. It remains the declared objective of the programme to simplify the tax system and reduce the relatively high tax burden of the economy. However, the document does hardly provide any details on concrete tax policy measures, such as taxation or tax rates changes. Structural reforms focus on the continuation of measures to raise the efficiency of tax administration, following up on earlier measures, such as the establishment of large tax-payers offices and a Financial Police. The fiscal strategy of the programme does not explicitly mention details about re-orientation of spending that would increase the quality of public finances over the reference period. In a general way, the programme attaches significant importance to the reform of education and science over the medium term. No explicit medium targets are set for spending on education, infrastructure development or research and development.

6.2. The sustainability of public finances

The 2006 PEP contains a separate section on the long-term sustainability of public finances, which is an improvement compared to previous submissions. Long-term projections differ markedly from those provided last years' PEP, due to a different set of assumptions. Projections for the period 2005 - 2050 (table 9 of the PEP's Annex) are for the first time based on explicit population projections. Moreover, assumptions on labour productivity and unemployment are based on projections undertaken for the ten new Member States in the context of a recent study of the Economic and Policy Committee (EPC). While the previous PEP assumed an average labour productivity growth of 5% in the period 2005-2050, the 2006 PEP projects labour productivity to drop accordingly from a peak of 3.8% in 2010 to 1.7% in 2050. The unemployment rate (ILO definition) is projected to be reduced from 12.7% to 7% by 2050, which is similar to previous years' projections. Participation rates for male and female are expected to remain unchanged over the long term horizon. Finally, the programme assumes a no policy change scenario. Total expenditures are projected to gradually decline from 47.9% of GDP in 2005 to 43% of GDP in 2050, while total revenues are set to go down from 45 to 43.1% of GDP during the same period. The previous years' submission foresaw significantly lower spending and revenue ratios of 32.8% and 36.4% of GDP, respectively, by 2050. Spending on old age pensions is expected to be more than halved from 10% to 7.1% of GDP (the PEP 2005 projected a decline to 4.9% of GDP), as a larger share of pensions is expected to be paid by the second pillar. Pension contributions would only slightly decline from 6.9% to 6.5% of GDP in 2050. Health care spending is set to increase from 6.3% to 7.9% of GDP, mainly as a result of an ageing population. The previous PEP projected a decline by 2 percentage points over the same period.

The 2006 PEP does not explicitly report on reform measures envisaged to improve the long term sustainability of public finance. Pension reforms are apparently not foreseen over the PEP horizon. Measures envisaged to boost employment may alleviate long term pressures provided they are successful in increasing participation rates. At the same time, ensuring the sustainability of the pension system will certainly require from the authorities to withhold occasional claims from strong pensioners' constituencies for higher pensions. A National Health Care Development Strategy (2006-2011) was adopted in mid-2006 which according to the PEP sets out a comprehensive restructuring of health care services. With respect the reform of health care financing, the programme describes the various measures undertaken in 2006 to improve the fiscal discipline of this sector (reduction of spending on drugs, introduction of administrative fee for medical services). The programme falls; however; short in assessing the effects of health reforms on the long term sustainability of public finance.

Annex table 1: Structural indicators

	CROATIA					EU 25				
	2002	2003	2004	2005	2006	2002	2003	2004	2005	2006
General economic background										
Real GDP ¹	5.6	5.3	3.8	4.3	4.8	1.2	1.3	2.4	1.7	2.9
Labour productivity ²	55.3	57.5	58.4	60.1	60.8	100	100	100	100	100
Real unit labour cost ³	1.5	2.4	n.a.	n.a.	n.a.	-0.4	-0.4	-1.0	-0.6	-0.8
Real effective exchange rate ⁴	n.a.	n.a.	n.a.	n.a.	n.a.	89.1	100.2	106.2	104.7	105.4
Inflation rate ⁵	1.7	1.8	2.1	3.3	3.2	2.1	1.9	2.1	2.2	2.2
Unemployment rate ⁶	14.7	14.1	13.6	12.6	11.5	8.7	9.0	9.0	8.7	7.9
Employment										
Employment rate ⁷	53.4	53.4	54.7	55.0	n.a.	62.8	62.9	63.3	63.8	64.7
Employment rate - females ⁸	46.7	46.7	47.8	48.6	n.a.	54.7	55.0	55.7	56.3	57.3
Employment rate of older workers ⁹	24.8	28.4	30.1	32.6	n.a.	38.7	40.2	41.0	42.5	43.6
Long term unemployment ¹⁰	8.9	8.4	7.3	7.4	n.a.	3.9	4.0	4.1	3.9	3.6
Product market reforms										
Relative price levels ¹¹	55.3	64.3	65.3	66.6	n.a.	100	100	100	100	n.a.
Total trade-to-GDP ratio ¹²	n.a.	n.a.	n.a.	52.9	n.a.	12.4	12.0	12.6	13.6	n.a.
Net FDI ¹³	3.7	3.6	2.2	2.6	7.8	1.3	1.3	0.9	1.2	n.a.
Market share electricity ¹⁴	n.a.	82.0	86.0	87.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Sectoral and ad-hoc state aids ¹⁵	n.a.	n.a.	n.a.	n.a.	n.a.	0.4	0.3	0.3	0.3	n.a.
Business investment ¹⁶	24.3	28.6	29.1	29.0	30.8	17.2	16.9	17.1	17.4	n.a.
Knowledge based economy										
Tertiary graduates ¹⁷	n.a.	5.6	5.4	n.a.	n.a.	11.4	12.3	12.6	n.a.	n.a.
Spending on human resources ¹⁸	4.3	4.5	n.a.	n.a.	n.a.	5.1	5.2	n.a.	n.a.	n.a.
Educational attainment ¹⁹	90.6	91.0	93.5	93.8	n.a.	76.7	76.9	77.2	77.5	n.a.
R&D expenditure ²⁰	1.1	1.1	1.2	n.a.	n.a.	1.9	1.9	1.9	1.9	n.a.
Internet access ²¹	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	42.0	48.0	51.0

1. Growth rate of real GDP in %. 2. Labour productivity per person employed - GDP in PPS per person employed relative to EU-25 (EU-25=100). 3. Growth rate of the ratio: compensation per employee in current prices divided by GDP (in current prices) per total employment. 4. Vs IC24 (1995 = 100), current year's values are based on Commission's forecast deflator figures, nominal unit labour cost deflator. 5. Annual average rate of change in Interim Harmonized Indices of Consumer Prices (HICPs), Croatia = CPI. 6. Unemployed persons as a share of the total active population. 7. Employed persons aged 15-64 in % of total population of the same age group. 8. Employed women aged 15-64 in % of total female population of the same age group. 9. Employed persons aged 55-64 (EU25) or 50-64 (Croatia) in % of total population of the same age group. 10. Long-term unemployed (over 12 months) in % of total active population aged 15-64. 11. comparative price levels of final consumption by private households including indirect taxes (EU-25=100). 12. Trade integration - Average value of imports and exports of goods&services divided by GDP. 13. Average value of inward and outward FDI flows in % of GDP. 14. Market share of the largest generator (% of total net generation). 15. In % of GDP. 16. Gross fixed capital formation by the private sector in % of GDP. 17. Total tertiary graduates in science and technology per 1000 of population aged 20-29. 18. Public expenditure on education in % of GDP. 19. Percentage of the population aged 20 to 24 having completed at least upper secondary education. 20. GERD (Gross domestic expenditure on R&D) - in % of GDP. 21. Percentage of households who have Internet access at home.

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

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

THE FORMER YUGOSLAV REPUBLIC OF MACEDONIA

1. SUMMARY AND CONCLUSIONS

The ECOFIN Council of 26/27 November 2000 considered: ...*“that a regular in-depth dialogue with accession countries on a large spectrum of macro-economic policy and financial stability issues will assist the accession process. It could be used both as a means to identify risks and vulnerabilities in these countries and as a way to help them define their strategy for economic integration into the EU. Such a dialogue would further enhance the cooperation and the exchange of information between existing and future Member States ahead of their accession. ... The Commission is invited to report each year to the Council (Ecofin) on its assessment of the fiscal notification and the Pre-accession Economic Programmes.”*

The former Yugoslav Republic of Macedonia submitted its first Pre-Accession Economic Programme (the “2006 PEP”) on 1 December 2006. The document covers the period 2007-2009 and presents an optimistic, but generally coherent, macroeconomic framework, including medium-term fiscal targets and projections for key macroeconomic variables. The programme partly complies with the content, form and data requested. It is largely consistent with earlier policy documents, such as the government’s Economic Programme, presented in August 2006, and takes into account commitment towards the International Financial Institutions. However, the structural reform part of the programme would have benefited from a closer reference to the analysis in the Commission’s Progress Report and to the economic priorities spelled out in the European Partnership for the country.

The key objectives of the 2006 PEP are to foster economic growth by reducing the share of the public sector in the economy while maintaining public sector accounts close to balance. Monetary policy targets the continuation of price stability and of the de-facto currency peg towards the euro.

The macroeconomic scenario envisages a marked acceleration of economic growth from an average growth of 4% during the last years towards 6% and 6½% during 2007-2009. This scenario appears optimistic in view of the country’s track record of relatively low growth but is not implausible when comparing with the experience of other candidate countries. Growth acceleration is mainly driven by domestic components, such as private consumption and in particular investment. This scenario is broadly in line the Commission’s recent forecast, although the Commission’s forecast expects a more moderate pace of growth acceleration. The document also provides an alternative scenario in case of a slower pace of structural reforms, which results in lower growth and higher fiscal and external deficits.

The document expects a rather stable performance of the external balances, with a slightly narrowing trade account deficit (reaching some 18% of GDP in 2009) and a minor widening of the current account deficit (from 1.3% of GDP in 2006 to 2% in 2009), reflecting a gradual decline in private transfers. FDI is expected to play an important role in 2008 only. The most important source for financing the substantial trade deficit remains private transfers, consisting of workers' remittances or cash exchanges at the country’s exchange offices. The document also contains a commitment towards further liberalisation of capital movements, in line with undertakings ensuing from the Stabilisation and Association Agreement (SAA) with the European Union.

The monetary and exchange rate policies continue to be oriented towards price stability and the maintenance of the de-facto peg towards to euro, which is in place since 1995. Inflation

is expected to remain under control, reaching some 2½% in 2009. The long-term interest rate differential with euro-zone rates is still substantial, but has started to decline over the last few years. Given the country's good track record of low inflation and exchange rate stability, the programme's approach appears plausible and credible in this respect. In particular in view of the high degree of euroisation in the country, a change in the exchange rate policy, abandoning the current anchor to the euro, appears unlikely.

The overall budgetary strategy of the 2006 PEP consists in reducing the country's tax burden while maintaining public sector accounts close to balance. Key elements in this strategy are the introduction of a flat tax on corporate profits and income, and maintaining the growth of government expenditures below nominal GDP growth, among others by limiting discretionary spending in the areas of public consumption and investment. As a result, public sector revenue and expenditure ratios are expected to significantly decline by more than 5 percentage points of GDP, each. The programme's adjustment is frontloaded, with a decline in the public sector share of GDP by more than 3 percentage points in the first year of the programme. The general government balance is expected to remain close to -1% of GDP. Interest payments are expected to remain slightly below 1% of GDP, resulting in a close to zero primary balance. However, when correcting for the contribution of business cycle, the cyclically adjusted deficit performance indicates deterioration in the fiscal position, with an increase in the deficit to 2.7% of GDP in 2009.

Table 1: **Comparison of key macroeconomic and budgetary projections**

		2005	2006	2007	2008	2009
Real GDP growth	COM	4.0	3.8	4.5	5.5	n. a.
(% change)	PEP 2006	4.0	4.0	6.0	6.0	6.5
Consumer price inflation (%)	COM	0.5	3.3	2.7	2.3	n. a.
	PEP 2006	0.5	3.3	3.0	2.5	2.5
General government balance (% of GDP)	COM	0.3	-0.6	-1.2	-1.0	n. a.
	PEP 2006	n. a.	-0.8	-1.0	-1.2	-0.8
Primary balance (% of GDP)	COM	-	-	-	-	n. a.
	PEP 2006	1.2	0.3	-0.1	-0.3	0.0
Government gross debt (% of GDP)	COM	40.9	35.6	34.6	34.0	n. a.
	PEP 2006	40.9	35.6	34.0	31.7	28.7

The general government debt ratio is foreseen to continue declining, from 35.6% of GDP to 28.7% in 2009. The main factor for this continued decline will be strong nominal GDP growth, amounting to around 9% during the programme period. Overall, the fiscal scenario with low deficits and a low and declining debt ratio is plausible and well based on a sound track record with a usually better than expected budgetary performance. However, the planned reduction of the share of revenues and expenditures appears rather ambitious and unprecedented. In particular the planned freeze of investment expenditures seems to be in conflict with the country's need to modernise its economy and to improve its human capital. Fiscal risks appear to be evenly distributed. On the revenue side the assumed tax elasticities are on the cautious side and actually in line with a significantly lower growth performance at around 4% annually. On the expenditure side, the assumptions on lowering the growth of expenditures could be seen as being optimistic. However, in recent years, the tax administration has demonstrated its ability to contain expenditures according to targets.

The programme contains a comprehensive description of a vast area of reform efforts. In terms of financial commitments the 2006 PEP focuses on infrastructure and agriculture,

while in terms of regulatory activities, the range of reforms is more widespread. Important areas appear to be the improvement of the business environment, the liberalisation and privatisation of network industries (telecommunication, electricity, railways), judiciary reform, fiscal decentralisation, health care, education, etc. Unfortunately, the link of the various reform projects with accession related priorities spelled out in the Progress Report and the European Partnership is not explicitly mentioned. Furthermore, there are no concrete references to the Lisbon agenda. Especially, the prominent role of support for the agricultural sector is not fully and convincingly motivated.

Overall, the intended reforms of the tax system and of public administration should improve the quality of public finances, benefiting from a simpler tax system, a lower tax burden in combination with a broader tax base and more efficient institutions. However, particular attention should be devoted to also improve the quality of public expenditures, channelling public resource to areas of strategic importance, such as human capital. In view of the relatively favourable situation of the country's public finances, with a low deficit and a low and declining debt ratio, long-term sustainability of the financial system appears not to be at risk. Recently, the pension system has been transformed into a three-pillar system, which should over time help to improve the sustainability of this branch of the social security system. The current risks with respect to the sustainability of the health system are higher. However, reforms of this system are under way.

It can thus be concluded:

- The first Pre-Accession Economic Programme for 2007 – 2009 of the former Yugoslav Republic of Macedonia is a comprehensive economic policy document, containing an optimistic but sound and coherent economic scenario, an ambitious fiscal strategy and a description of a wide area of structural reforms. Concerning content, form and data, the programme largely complies with the requested standard. The document should help to align the country's policy mix with the economic conditions and the country's orientation towards meeting the economic Copenhagen criteria for EU membership.
- The recent economic performance has shown solid but relatively subdued economic growth, low inflation, a favourable performance of the external account and sound public finances, with largely balanced public sector accounts and a low and declining debt ratio. The programme's scenario of a strong growth acceleration appears optimistic in view of the country's track record of below potential growth. However, when taking into account the experience of other candidate countries, the scenario is not implausible. The programme's expectations concerning inflation, the stability of the exchange rate regime and the maintenance of sound public finances are more in line with the country's track record and the Commission's forecast. Overall, the document suffers from a lack of reliable statistical data, impeding the analysis of the country's position in the growth cycle and also rendering difficult the decisions on effective structural reform measures.
- The PEP's public finance agenda presents an ambitious project of substantially reducing the tax burden while maintaining the general government deficit at a level of some 1% of GDP. This measure intends to stimulate investment and to strengthen disposal income, which should have a positive impact on economic growth and employment. The estimates of expected public revenues are based on cautious assumptions, leaving substantial room in case of limited success in reducing expenditures. However, the fiscal part would have benefited from a more detailed and concrete presentation of the development of the various expenditure and revenue elements. Furthermore, more information on measures to improve the quality of public finances would have been welcome.

- The country's structural reform programme intends to support the establishment of a functioning market economy, such as liberalising network industries, privatising the last remaining state property, strengthening the rule of law, improving the business climate and strengthening the competitiveness of the country's enterprises. The programme's reform agenda is in line with the fiscal scenario, but would have benefited from a closer alignment with the reform requirements in view of the country's EU accession perspectives, as spelled out in the latest Progress Report and the European Partnership.

2. INTRODUCTION

On 1 December 2006, the Minister of Finance of the former Yugoslav Republic of Macedonia, Mr. Slavevski submitted the country's first Pre-Accession Economic Programme (the "2006 PEP") to the Commission. The programme covers the period 2007-2009 and contains a presentation of the macroeconomic framework, a discussion of public finances and debt dynamics and a chapter on structural reforms. The programme has been endorsed by the Ministry of Finance and is currently in the process of being adopted by the government. It is the result of contributions from various line ministries and the Central Bank. Social partners have not yet been involved in the programme's formulation process. The overall coordination took place at the Ministry of Finance. The document is broadly in line with the country's National Development Plan, the fiscal strategy for 2007-2009, the National Plan for the Adoption of the Acquis (NPAA) and the Economic priorities of the country's European Partnership. It also takes into account the country's obligations towards IMF and World Bank. The document was drafted by the outgoing government and substantially revised by the new administration, entering office in mid-August.

The document partly complies with the content, form and data required. It contains a general overview over recent economic developments and presents a parsimonious macroeconomic framework. The document describes key medium-term fiscal and other policy objectives and provides an overall presentation of structural reforms of product and capital markets in the light of EU-integration. Concerning the form, the 2006 PEP follows the structure of the outline and represents a stand-alone document, providing required information on structural reforms, on the underlying assumptions. The document also includes the quantitative information required for the data appendix. The data presented appears to be complete and correctly compiled. However, the majority of the data is not yet in line with ESA 95 requirements.

The programme is designed to foster economic growth, while maintaining overall macroeconomic stability. Key objectives are to maintain - in line with Maastricht requirements - a sound fiscal position, to address labour market imbalances and to support the private sector development. Membership to the EU and NATO are further key policy objectives. Preparing for the eventual participation in ERM II is seen as an important challenge. The main instruments to achieve those objectives are fiscal discipline, a reduction of the tax burden, improving the efficiency of the public sector, proceeding with administrative decentralisation and privatisation. Public debt is envisaged to sharply decline from 36% of GDP in 2006 to 29% of GDP by 2009. The structural reform agenda covers a wide range of areas. While the programme's priorities are not very clearly spelled out, in terms of intended expenditures, a clear emphasis is de facto put on infrastructure and agriculture, amounting to more than two thirds of additional spending.

3. MACROECONOMIC DEVELOPMENTS

3.1. Recent macroeconomic developments

Annual economic growth was at around 4% in 2005 and is estimated to have reached a similar level in 2006. During the first three quarters of 2006, officially registered output growth was 3%. However, leading indicators point to stronger growth than indicated by official data. Consumer price inflation remained low at 0.5% in 2005, but accelerated to 3.2% in 2006, largely as a result of the alignment of excise duties with EU levels and higher energy prices. Core inflation remained very low.

Public finances remained close to balance in recent years, with a slight surplus in the general government balances of 0.3% of GDP in 2005 and a deficit of 0.6% in 2006. The main factor for this better than expected performance was lower than planned public investment expenditures. The current account improved markedly during the last years, with a sharp reduction in the deficit from -7.7% in 2004 to a deficit of 1.4% of GDP in 2005. Provisional data points to even a slight surplus in 2006. Important factors for this development were improving exports and a strong increase in private transfers in the form of workers remittances and cash exchanges at exchange offices. The situation in the labour markets has improved, with a decline in unemployment in 2005 and 2006. However, the official level of unemployment is still very high, at some 36% of the labour force.

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

Macroeconomic scenario

The macroeconomic scenario presents a medium-term outlook on key variables, such as output growth, inflation, public finances, external balances, the labour market etc. The document also contains a short description of an alternative scenario and presents a sensitivity analysis of various factors influencing debt dynamics. The scenario is presented in a coherent and consistent way, although more information on the underlying economic factors would have been helpful. When looking at the historic growth performance of the country, the scenario takes an optimistic approach, but does not appear implausible in view of the experience of other candidate countries. The key objective is to unleash the country's growth potential which should have a positive effect on the labour market. The fiscal policy is geared towards reducing the tax burden while keeping public finances close to balance. Monetary policy is focussed on maintaining price stability. To this end, the exchange rate policy is geared towards keeping the exchange rate stable towards the euro. This policy mix appears appropriate for a small open economy with a high degree of currency substitution and a foreign debt structure dominated by euro-denominated debt titles, implying a limited degree of discretion as regards monetary and exchange rate policies.

The external outlook is based a decelerating growth of trade of goods and services. However, due to the high import content of exports, the net contribution of foreign trade is expected to remain negative in 2007 - 2009. This profile reflects the overall expectation of decelerating global trade and is largely in line with Commission forecasts for this sector.

Real sector

The macroeconomic scenario envisages a marked acceleration of economic activity, with real output growth improving from expected 4% in 2006 to 6.5% annually in 2009. The main driving forces for this favourable development are private consumption, supported by increased real disposable income and strong investment, improving labour productivity. On the supply side, the service sector will be the main contributor to growth. The country's de facto fixed exchange rate regime is expected to keep inflationary pressures close to EU levels, with consumer price inflation coming down to 2.5% in 2009. The general government deficit is expected to remain close to balance, while the level of public debt is seen to continue declining gradually towards 35% of GDP. The current account deficit is expected to improve, from more than -3% of GDP in 2007 to -2% of GDP in 2009. However, as a result of the important role of private transfers in recent years, the current account balance has been difficult to predict. Overall, the programme's growth projections appear to be on the optimistic side, while most other aggregates are seen in a similar way as in the Commission's latest forecast from autumn 2006.

Table 2: Comparison of macroeconomic developments and forecasts

	2005		2006		2007		2008		2009	
	COM	PEP	COM	PEP	COM	PEP	COM	PEP	COM	PEP
Real GDP (% change)	4.0	4.0	3.8	4.0	4.5	6.0	5.5	6.0	n.a.	6.5
<i>Contributions:</i>										
- Final domestic demand	2.1	2.3	3.5	6.0	5.0	7.0	6.6	5.9	n.a.	7.2
- Change in inventories	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-	0.0
- External balance of goods and services	1.9	1.7	0.4	-2.0	-0.4	-1.0	-1.2	0.1	n.a.	-0.7
Employment (% change)	4.3	4.3	3.1	4.0	3.4	4.0	3.6	4.0	n.a.	4.0
Unemployment rate (%)	37.3	37.3	37.1	36.3	36.2	35.3	35.1	34.3	n.a.	33.2
GDP deflator (% change)	0.5	0.5	3.7	3.3	3.6	3.0	2.5	2.5	n.a.	2.5
CPI inflation (%)	0.5	0.5	3.3	3.3	2.7	3.0	2.3	2.5	n.a.	2.5
Current account balance (% of GDP)	-1.4	-1.3	-2.8	-1.2	-3.4	-3.3	-4.0	-2.5	n.a.	-2.0

Sources: Pre-Accession Economic Programme (PEP); Commission services Autumn 2006 forecasts (COM)

The alternative scenario assumes a lower speed of structural reforms, which would result in achieving output growth of 2-3% only, which would lead to an increase in the general government deficit by about a quarter percentage point. At the same time, stronger import growth would lead to an increase in the current account deficit to 5% - 7% of GDP.

When looking at the growth performance, the programme expects a significant acceleration of growth, resulting from the government's growth stimulating measures. Econometric estimates based on historic data point to a potential growth rate of 3.7%, which in view of the currently low labour force participation rate might however underestimate the country's actual growth potential.

External sector

Overall, the external side of the 2006 PEP is based on the expectation of a largely unchanged situation with respect to merchandise trade, while inflows of private transfers are seen to decelerate from the historically high levels of recent years. Concerning FDI, the

programme expects a substantial inflow in 2008, while in the remaining years the expected level of FDI inflows is rather cautious.

With respect to the current account, the 2006 PEP expects a slight deterioration during the programme period, with an increase in the deficit from -1.3% of GDP in 2005 to -2.0% in 2009. This deterioration is mainly a result of declining inflows of private transfers, while the imbalance in the trade account is supposed to improve only marginally, after a short-term expected deterioration in 2006. While latest data for 2006 suggests a more favourable performance of the external accounts, this picture is largely in line with the general expectations of a slight deceleration of trade on a global level and the assumption of decelerating transfers from abroad. As a result of lower growth of merchandise imports, the trade balance is expected to improve marginally, from a deficit of -21.4% of GDP in 2006 to 18.1% in 2009. The service balance is expected to remain a marginal factor, with a slight deficit of about 0.1% of GDP during most of the programme years. The most significant impact on external balances is foreseen to come from a decline in inflowing net current transfers, declining from a peak of 20.3% of GDP in 2006 to 17.4% of GDP in 2009.

As far as the financing of the current account deficit is concerned, FDI inflows are expected to play an important role. In 2006, inflows of FDI rose markedly, from 1.7% of GDP in 2005 to 6.3% of GDP. However, a large share of those inflows is exceptional and was due to a single privatisation project. In 2007, FDI inflows are expected to reach only a level of about 2.2% of GDP, which is somewhat higher than FDI inflows in recent years but significantly lower than in comparable countries. In 2008, FDI inflows are expected to increase markedly, reaching nearly 10% of GDP as a result of privatisation projects and improved confidence of international investors while in 2009 those inflows are assumed to decline again to about 3.3%. As a result of substantial capital inflows, foreign exchange reserves are expected to increase, from 24.8% in 2005 to 34.4% of GDP in 2009.

3.2. Monetary and exchange rate policy

The monetary framework is designed to ensure price stability. To this end, the central bank maintains a de-facto fixed peg towards the euro. In view of the high share of euro-denominated imports (some 60% of total imports) this helps to contain price pressures through imports. As a result of the recent strength of the euro and of particularly low domestic inflation rates during the last years, the nominal effective exchange rate slightly appreciated during the last years. So far, no changes to the current exchange rate regime are envisaged. The central bank has initiated early stage preparations in view of an eventual entry to ERM II, once the country has become member to the EU.

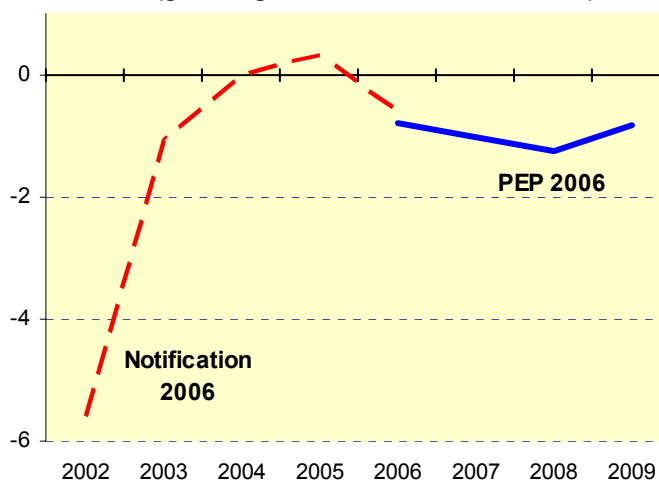
Inflation is expected to remain subdued during the programme period, declining from 3.2% in 2006 towards 2.5% in 2009. In view of the relatively low recent economic growth, no demand driven price pressures took place in the past, with inflation rates close to zero. In 2006, one of the main determinants for the sharp increase in consumer prices (from 0.5% in 2005 to 3.2% in 2006) was the alignment of excise duties with EU requirements, contributing about one percentage point to consumer price inflation. Furthermore, significantly higher energy prices contributed to the relatively strong price increases in 2006.

4. BUDGETARY TARGETS AND THE MEDIUM-TERM PATH OF THE PUBLIC FINANCES

The programme describes the fiscal framework in a coherent and consistent way, although the presentation would have benefited from a more detailed exposition of the expected development of various elements of the country's public finances. The envisaged deficit targets are slightly higher than those targets in the previous years. However, in the past, the authorities tended to realise better than planned fiscal targets, based on cautious revenue estimates and lower than anticipated government spending for investment. The programme also contains an assessment of the cyclical position of the economy, indicating that while in the past few years the economy tended to grow below potential, over the programme period it is now expected to perform above potential. As a result, the cyclically adjusted fiscal position would show higher deficits in 2007-2009. Unfortunately the programme does not present estimates on the quantitative impact of the various revenue and expenditure measures. Furthermore, the presented data are not yet in line with ESA 95.

The overall fiscal strategy targets a substantial reduction in the tax burden by more than 5 percentage points of GDP during the programme period, while maintaining the deficit at a level of some 1% of GDP. The programme is frontloaded with a substantial adjustment in the first year of the programme period intending to reduce the share of revenues by 3.9 percentage points of GDP as well as to lower the share of expenditures by 3.7 percentage points of GDP. The reductions are being mainly achieved by keeping nominal growth of revenues and expenditures below nominal growth of GDP. A key measure on the revenue side is the introduction of a "flat tax" on corporate profits and personal income. Another important factor is the expected loss of dividends resulting from the planned sale of the state minority stake in the telecommunication company. Both factors are expected to reduce revenues by more than 1% of GDP each. Furthermore, the fiscal framework assumes a decline in foreign donations. Overall, the share of public revenues in GDP is expected to decline by more than 5 percentage points during the programme period, from 39.5% of GDP in 2006 to 34.1% in 2009. Total expenditures are expected to decline from 40.3% of GDP in 2006 to 34.9% in 2009. The share of public debt interest payments is expected to decline slightly, from 1.1% of GDP in 2006 to 0.9% in the remaining years. As a result, the primary balance will be close zero, reaching its highest deficit in 2008 with -0.3% of GDP and a marginal primary surplus of 0.1% of GDP in 2009.

Chart 1: Budgetary developments
(general government balance, % of GDP)



4.1. Targets and adjustment

The 2006 budget target of the PEP envisages a general government deficit of 0.8% of GDP (GFS 1986), which is 0.2 percentage points higher than the original budget target of 0.6% of GDP. However, latest fiscal data suggest that the final outcome for the year 2006 will probably be close to the original budget target of 0.6% of GDP. Main factors for this better than expected performance have been higher than expected tax revenues towards the end of the year and a more disciplined than expected budget execution during the election months in spring and summer 2006. This pattern of a better than expected budgetary performance has been a recurring feature in recent years. Unfortunately the document does not present more details on the fiscal development during the year of submission.

The PEP targets for 2007 a general government deficit of 1.0% of GDP, which is in line with the government's budget proposal for this year. Due to general elections in summer, the budgetary process experienced a slight delay, but remained in line with the budget targets specified in the PEP. Thus, the government budget for 2007 adopted on 29 December 2006 envisages the same budget target as indicated in the PEP, submitted on 1 December 2006. The deficit target of -1.0% of GDP is about ¼ percentage point of GDP higher than originally agreed with the IMF. However, in view of the use of those additional funds for improving the quality of public finances, this target is considered to be broadly in line with the IMF standby agreement.

The main budgetary measures for 2007 are the introduction of a "flat tax", reducing the corporate profit tax from 15% to 12% and lowering and simplifying the personal income tax from the previous 3 brackets (24%, 18% and 15%) to a unique 12% rate. Furthermore, the changes to the corporate profit and income tax laws will also affect the tax base for calculating social security contributions. As a result, the nominal growth of this revenue item will also be lower than in recent years. This will lead to a decline in the share of revenues from social contributions from 10.3% of GDP in 2006 to 9.6% in 2007. The overall impact of the introduction of the flat tax on total revenues has been estimated to be at around 1¼ % of GDP. For 2008, a further reduction of both tax rates to 10% is included in the programme. The envisaged planned sale of the remaining state minority shares in the highly profitable land-line telecommunication company, in spite of a very sizeable one-off exceptional income, is likely, owing to the loss of regular dividends, to have a negative impact on total current revenue. This is expected to reduce public revenues from 2007 onwards by another percentage point of GDP. Furthermore, the 2007 budget does no longer contain provisions for donations from external sources, which had played a significant role in previous years. Overall, nominal revenues are expected to decline by 1.5% in 2007, compared to a planned increase in the nominal GDP by 9.3%. The main factor for the decline in absolute terms is the category "other revenues", which will shrink by 23% in 2007. As a share in GDP, the decline will amount 2.3 percentage points of GDP. Nominal tax revenues are expected to increase by 4.7% in 2007, while social contributions are expected to rise by 1.7% in nominal terms.

The share of total expenditures is expected to decline by 3.7% of GDP, a trend which appears to be rather evenly distributed among most expenditure categories. The share of collective consumption and expenditures for social contributions is planned to decrease by 0.9 % of GDP each. The main instrument for decelerating the growth of collective consumption will be an expenditure freeze for discretionary purchases, such as ministerial cars or furniture. Furthermore, a better targeting of social security spending should allow for containing the growth in that area. Improving the structure of the debt portfolio by early repayment of high-interest debt titles will allow reducing the costs of government debt servicing from 1.1% of GDP in 2006 to 0.9% of GDP in 2007. Gross investment of the

public sector is expected to decline by 6.6% compared to the previous year, which will reduce its share in GDP from 5.6% in 2006 to 4.8% in 2007. The main factor seems to be planned privatisations in the energy sector, thus reducing the public sector investment in this area. Furthermore, subsidies are intended to be reduced by about one third, which will reduce the share of this expenditure category from 2.1% of GDP in 2006 to 1.2% in 2007.

In the years 2008-2009, the share of the public sector in the economy –as measured by the share of government revenue and expenditure on GDP- is envisaged to decline at a slower pace, with the share of total revenues declining by 0.6 and 0.9 percentage points in 2008 and 2009 respectively. In contrast to 2007, the largest contribution to this decline will come from tax revenues and social contributions (-1 percentage point in 2008 and -0.5 percentage points in 2009), whereas the share of other revenues will increase by 0.4 percentage points in 2008 and decline again by the same amount in 2009.

The main risks of this approach are probably linked to the ambitious expenditure reduction targets, in particular in the area of public consumption and social transfers. Unfortunately the document does not contain sufficiently concrete details on expenditure reducing measures. In this context, the absolute reduction of gross fixed capital formation in 2007 and 2008 is particularly noteworthy. The assumptions on the revenue side appear to be in general on the cautious side, in particular when taking into the rather optimistic growth scenario. The Commission forecast envisages a similar level and profile of the public sector deficit, but is more conservative with respect to the decline in the public sector's share in GDP.

Overall, the risk of realising a deficit beyond -3% of GDP appears to be relatively low, given the cautious revenue assumptions incorporated into the fiscal framework and taking into account the country's track record of over-performing fiscal targets. However, in view of the assumed strong output growth, the cyclically adjusted fiscal balance clearly deteriorates towards the end of the programme period, reaching a cyclically adjusted deficit of 2.7% of GDP in 2009. As a result, the fiscal stance can be seen as being pro-cyclical. However, in view of still very high unemployment and increasing investment, the risk of overheating appears to be limited.

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

	2005	2006	2007	2008	2009	Change: 2006-09
Revenues	n.a.	39.5	35.6	35.0	34.1	-5.5
<i>of which:</i>						
- Taxes and social security contributions	n.a.	31.8	30.2	29.2	28.6	-3.2
- Other (residual)	n.a.	7.7	5.4	5.8	5.4	-2.3
Expenditure	n.a.	40.3	36.7	36.2	34.9	-5.5
<i>of which:</i>						
- Primary expenditure	n.a.	39.2	35.8	35.3	34.0	-5.2
<i>of which:</i>						
Gross fixed capital formation	n.a.	5.6	4.8	5.7	5.7	0.1
Consumption	n.a.	14.9	14.1	13.6	12.8	-2.1
Transfers & subsidies	n.a.	18.7	16.9	16.0	15.5	-3.2
Other (residual)	n.a.	0.0	0.0	0.0	0.0	0.0
- Interest payments	n.a.	1.1	0.9	0.9	0.9	-0.3
Budget balance	0.3	-0.8	-1.0	-1.2	-0.8	0.0
- Cyclically adjusted	-0.1	-1.3	-1.9	-2.5	-2.7	-1.4
Primary balance	n.a.	0.3	-0.1	-0.3	0.0	-0.3
Gross debt level	40.9	35.6	34.0	31.7	28.7	-6.8

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

4.2. Debt developments

Overall, the current debt level is relatively low, amounting at the end of 2006 to some 35.6% of the estimated GDP. Over the programme period, the debt ratio is expected to decline further, reaching a level of 28.7% of GDP end of 2009. The main driving force for this decline will be strong nominal GDP growth of around 9% annually. This factor will reduce the debt ratio by 3 percentage points in 2007 and 2.7 percentage points in 2008 and 2009. Stock-flow adjustments will increase the debt ratio by 0.9 percentage points in 2007, but contribute 0.8 and 1.2 percentage points to the reduction of the ratio in 2008 and 2009.

The country's debt strategy consists of maintaining the debt-to-GDP ratio on a declining trend by supporting strong GDP growth and improving the structure of public debt, by replacing external debt through domestic debt and by increasing the share of the euro-denominated debt in the foreign exchange-denominated debt. In order to improve debt management, the Ministry of Finance established a central public debt management department in 2005 and adopted a medium-term public debt strategy, currently covering the years 2006-2008. In September 2006, the share of foreign debt was 61% of total debt, while debt denominated in foreign currency amounted to 84% of total debt. The currency composition of the debt is dominated by the euro, amounting to some 55% of total denominated debt, followed by SDR (18%) and USD (10%). The interest rate structure is characterised by a relatively high share in debt titles with variable rates, amounting to 56% of total debt. The average time of maturity of external public debt has been about 9 years end of 2006, while domestic debt has an average maturity of some 3 years only. Debt servicing costs are expected to remain during the programme period between 1-1½% of GDP. The programme is very cautious with respect to expected privatisation revenues. Thus, the decline in the debt ratio might be faster than anticipated, taking into account those potential additional funds, which might be used for early debt redemption.

5. STRUCTURAL REFORMS

The 2006 PEP provides a broad and comprehensive overview over the country's structural reform agenda. The document also contains a detailed and comprehensive matrix of policy commitments, with quantitative information on impact of the various reform measures on budgetary expenditures and revenues. The presentation also contains information on the time schedule of the various measures.

Table 4: Net direct budgetary impact of key reform commitments (in EUR million)

Description of the Policy	2006	2007	2008	2009
Agriculture sector reform	0.0	-32.0	-44.2	-50.5
Transport and communication	-20.9	-24.7	-25.1	-9.9
Education and Science	0.0	-8.8	-14.9	-12.6
Enterprise reform	-0.5	-4.4	-1.9	-2.5
Health reform	-1.6	-3.0	-2.9	-3.0
Labour market reform	0.0	-2.5	-1.6	-1.5
Other reforms (public administration, knowledge-based society, judiciary, environment, public procurement etc)	-1.9	-9.8	-8.6	-7.6
Total impact on the budget	-24.9	-82.7	-97.8	-86.2
Total impact on the budget (in % of GDP)	-0.5%	-1.6%	-1.7%	-1.4%

Source: 2006 Pre-accession Economic Programme (PEP), own calculations

However, the presentation would have benefited from a more explicit description of the government's policy priorities and the policy mix which results from its priorities. The policy mix contains measures, which are in line with the Lisbon agenda and the priorities derived from the Commission's Progress Report and spelled out as economic priorities in the European Partnership. However, when looking at the fiscal commitments, the policy mix is highly focussed on a few areas, such as strengthening infrastructure and supporting the agricultural sector, while the financial commitments related to other policy objectives, such as education and improving the efficiency of public administration, are very limited. Furthermore, the overall level of reform oriented spending appears to be relatively low, amounting to less than 2% of GDP.

5.1. Product and capital markets

The 2006 PEP contains a long and comprehensive description of a large number of structural reform areas targeted to improve the efficiency of product and capital markets. The main reform areas mentioned in the document are supporting the agricultural sector, strengthening infrastructure, proceeding with privatisation, strengthening the competitiveness of the industrial sector, strengthening competition policy and state aid control, promoting industrial clusters, improving business environment, supporting SMEs and liberalising network industries (energy, telecommunication, transport). With respect to financial commitments, the focus appears to be on agriculture and infrastructure.

The pace of structural reforms appears to be relatively moderate in the programme. It also allocates only a limited amount of budgetary resources to promote structural reforms. Furthermore, a considerable share of the available funds seems to be devoted to areas, which in view of meeting the Copenhagen criteria might not be the most effective ones. With respect to the timing of reforms, the programme presents a front-loaded approach with respect to improving infrastructure, while the support for agriculture appears to remain a constant feature of the programme.

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

5.2. Labour market

The document describes important developments and features of the country's labour market and refers to the country's commitments towards labour market reform spelled out in various policy documents, such as the National Plan for the Adoption of the Acquis (NPAA), the National Plan for Employment (NPA) and the National Strategy for Employment (NSE). However, the document does not provide information on the concrete implementation of the number of the mentioned measures. With respect to the financial implications of labour market reforms, the matrix of policy commitments points to a budgetary net impact of EUR 2.5 million in 2007 (3% of net fiscal implications in 2007), which will decline to EUR 1.5 million by 2009 (1.7% of net fiscal implication in 2009).

5.3. Other reform areas

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

6. THE QUALITY AND SUSTAINABILITY OF PUBLIC FINANCES

6.1. The quality of public finances

The country enrolled in May 2000 in a major reform of public administration, which - with support from the IFIs - intended to reduce the public sector to its core activities and to improve the transparency and efficiency of public administration in general. Another impulse for public sector reform is based on the Ohrid framework agreement from 2001. In line with this agreement, the authorities endorsed a major programme of administrative decentralisation, which envisages transferring the competence and the financial means in a number of communal areas (such as education, health, local cultural institutions, urban planning and construction, fire brigades, etc.) to the local communities. So far, mainly the responsibilities have been transferred, while the transfer of the financial competences is done in a gradual way. However, in some cases the transfer of public debt obligations appears to have created an important burden for the public finances of some communities. Overall, the institutional and legal changes during the last years appear to lead to a strengthening of the country's capacities to administrate public finances. Unfortunately the PEP is not very concrete with respect to a time schedule on how to proceed with further improving the administration of public finances.

The government's objective to introduce a flat tax on corporate profits and income will have an important impact on the level and composition of public revenues, leading to a significant reduction in the tax burden and a further increase in the share of indirect taxes in

total revenues. The lowering of direct taxes might help to stimulate consumption and investment. But at the same time, it might shift the tax burden to lower income households. Furthermore, the tax wedge on labour will remain high, impeding efforts to reduce unemployment.

6.2. The sustainability of public finances

The programme contains a medium-term (1999-2009) and a long-term (2000-2050) analysis of the sustainability of public finances, based on historic averages of its key factors, such as real GDP growth and interest rates. In the current policy scenario, the debt-to-GDP ratio is expected to decline from 35% of GDP in 2006 to 29% of GDP in 2009. The alternative scenario presents estimates for deviating assumptions concerning interest rates, GDP growth, the primary balance and the exchange rate. The two biggest risks associated to the debt ratio appear to be lower than expected GDP growth and a substantial exchange rate depreciation. The demographic situation appears to be stable and no major risk to the country's sustainability of public finances. However, continuous and substantial deficits in the health system could represent in the medium-term an important burden to public finances.

Overall, there appear to be no major and immediate threats to the long-term sustainability of the country's public finances, given the country's relatively low level of indebtedness. The expected acceleration of GDP growth and the completion of privatisation should contribute to a continuous decline in the debt ratio. Demographic pressures seem to pose no major threats, although a continued reform of the social security system appears to be necessary to keep public sector health spending under control. Provided the full implementation of the current public sector reform agenda, the former Yugoslav Republic of Macedonia is relatively well placed to meet the costs of an aging population. Nevertheless, costs in relation to the reform of the pension and health-care systems should be monitored carefully.

Annex table 1: Structural indicators

	The former Yugoslav Republic of Macedonia					EU 25				
	2002	2003	2004	2005	2006	2002	2003	2004	2005	2006
General economic background										
Real GDP ¹	0.9	2.8	4.1	3.8	3.1	1.2	1.3	2.4	1.7	2.9
Labour productivity ²	n.a.	n.a.	n.a.	n.a.	n.a.	100	100	100	100	100
Real unit labour cost ³	n.a.	n.a.	n.a.	n.a.	n.a.	-0.4	-0.4	-1.0	-0.6	-0.8
Real effective exchange rate ⁴	n.a.	n.a.	n.a.	n.a.	n.a.	89.1	100.2	106.2	104.7	105.4
Inflation rate ⁵	2.3	1.1	-0.4	0.5	3.2	2.1	1.9	2.1	2.2	2.2
Unemployment rate ⁶	34.8	39.6	39.3	39.9	36.0	8.7	9.0	9.0	8.7	7.9
Employment										
Employment rate ⁷	35.7	34.3	33.8	34.1	n.a.	62.8	62.9	63.3	63.8	64.7
Employment rate - females ⁸	26.2	26.0	25.7	25.4	n.a.	54.7	55.0	55.7	56.3	57.3
Employment rate of older workers ⁹	22.5	24.4	21.9	23.2	n.a.	38.7	40.2	41.0	42.5	43.6
Long term unemployment ¹⁰	n.a.	n.a.	n.a.	n.a.	n.a.	3.9	4.0	4.1	3.9	3.6
Product market reforms										
Relative price levels ¹¹	39.6	43.8	43.8	43.5	n.a.	100	100	100	100	n.a.
Total trade-to-GDP ratio ¹²	n.a.	n.a.	n.a.	n.a.	n.a.	12.4	12.0	12.6	13.6	n.a.
Net FDI ¹³	2.1	2.0	2.9	1.6	5.8	1.3	1.3	0.9	1.2	n.a.
Market share electricity ¹⁴	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Sectoral and ad-hoc state aids ¹⁵	n.a.	n.a.	n.a.	n.a.	n.a.	0.4	0.3	0.3	0.3	n.a.
Business investment ¹⁶	16.6	16.7	17.8	n.a.	n.a.	17.2	16.9	17.1	17.4	n.a.
Knowledge based economy										
Tertiary graduates ¹⁷	3.1	3.3	3.7	n.a.	n.a.	11.4	12.3	12.6	n.a.	n.a.
Spending on human resources ¹⁸	3.4	3.4	n.a.	n.a.	n.a.	5.1	5.2	n.a.	n.a.	n.a.
Educational attainment ¹⁹	65.4	n.a.	n.a.	n.a.	n.a.	76.7	76.9	77.2	77.5	n.a.
R&D expenditure ²⁰	0.3	0.2	n.a.	n.a.	n.a.	1.9	1.9	1.9	1.9	n.a.
Internet access ²¹	n.a.	n.a.	11.0	11.2	14.0	n.a.	n.a.	42.0	48.0	51.0

1. Growth rate of real GDP in %. 2. Labour productivity per person employed - GDP in PPS per person employed relative to EU-25 (EU-25=100). 3. Growth rate of the ratio: compensation per employee in current prices divided by GDP (in current prices) per total employment. 4. Vs IC24 (1995 = 100), current year's values are based on Commission's forecast deflator figures, nominal unit labour cost deflator. 5. Annual average rate of change in Interim Harmonized Indices of Consumer Prices (HICPs), tFYRoM = CPI. 6. Unemployed persons as a share of the total active population. 7. Employed persons aged 15-64 in % of total population of the same age group. 8. Employed women aged 15-64 in % of total female population of the same age group. 9. Employed persons aged 55-64 (EU25) or 50-64 (tFYRoM) in % of total population of the same age group. 10. Long-term unemployed (over 12 months) in % of total active population aged 15-64. 11. comparative price levels of final consumption by private households including indirect taxes (EU-25=100). 12. Trade integration - Average value of imports and exports of goods&services divided by GDP.

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

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

Source: Commission services, national sources

TURKEY

1. SUMMARY AND CONCLUSIONS

The ECOFIN Council of 26/27 November 2000 considered: *“...that a regular in-depth dialogue with accession countries on a large spectrum of macro-economic policy and financial stability issues will assist the accession process. It could be used both as a means to identify risks and vulnerabilities in these countries and as a way to help them define their strategy for economic integration into the EU. Such a dialogue would further enhance the cooperation and the exchange of information between existing and future Member States ahead of their accession. (...) The Commission is invited to report each year to the Council (Ecofin) on its assessment of the fiscal notification and the Pre-accession Economic Programmes”.*

On 1 December 2006, Turkey submitted the 2006 Pre-Accession Economic Programme (PEP) to the European Commission, covering the 2007-2009 period. It is Turkey's sixth PEP after the ECOFIN Council of 26/27 November 2000 expressed its wish for a regular in-depth dialogue with accession countries. The programme largely complies with the requirements of the consolidated outline in terms of content, form and data.

The PEP is consistent with other economic policy documents, such as the ninth National Development Plan (2007-2013), the Memoranda related to the Stand-By Arrangement with the International Monetary Fund and the World Bank's Country Economic Memorandum. The medium-term budget framework is largely in line with what is indicated in the PEP. The PEP has been formally approved by the High Planning Board, which is chaired by the Prime Minister and comprises representatives of all relevant line ministries. The structure and content of the PEP demonstrates a high and improving degree of familiarity with the technical tools and analytical requirements of this exercise, in particular on the macroeconomic issues. Yet, many of the methodological issues raised in the assessment of the 2005 PEP have not yet been taken into account. Moreover, some valuable analysis, including on the impact of oil prices volatility on the external accounts is no longer included.

The programme's key objectives are to ensure sustainable growth, in tandem with a rapid convergence of the per capita income towards EU-averages. The monetary and fiscal policy mix aims at price stability and continued fiscal prudence. The monetary policy framework has been adjusted in 2006, when the inflation targeting regime has been introduced. These objectives are very similar to the last year's PEP. In the area of structural reforms, key objectives include (i) enhancing the role of the private sector; (ii) improving financial sector intermediation and (iii) increasing the value of human capital. Besides, administrative reforms and raising productivity in the agricultural sector aim at enhancing overall competitiveness and a more efficient allocation of resources throughout the Turkish economy. The strengthening of competition and further legislative alignment with EU rules in a broad range of policy areas remain important PEP priorities. However, policy objectives in these areas are sometimes not very precisely defined.

The programme estimates that the Turkish economy will grow at rates around potential, which will be close to 5.5% in 2007-2009. Economic expansion would be increasingly balanced amongst demand components. Gross fixed capital formation would be mainly driven by the private sector and increase by an average of 6.7% over the programme period. Exports are projected to increase by 11.2% annually, compared with 9.9% for imports. Private consumption would grow by an average 4.8% annually. These projections are more

or less in line with the Commission's forecasts. However, the Commission is slightly more optimistic on private consumption growth and assumes that export growth will be more moderate than the PEP assumes.

Turkey's current account deficit has risen significantly in 2006 to 8.2% of GDP from 6.4% in 2005. The PEP projects that the current account deficit will gradually decline to 5.7% of GDP by 2009. The maturity of capital inflows would lengthen gradually. FDI would decrease from about 3% in GDP in 2006 to an average of 2% in 2007-2009. Net portfolio investments are expected to decline from about 6% of GDP in 2005 to less than 2% of GDP in 2006-2009. The likelihood of this scenario crucially depends on the attractiveness the investment climate, declining real interest rates and continued market and consumer confidence. Continued access to external sources of finance appears to be of high importance for achieving the described financing pattern, since a significant part of these flows consists of potentially volatile short-term capital. Therefore external deficits need to be monitored closely. A further widening of the trade deficit may pose a potential challenge to stability in 2007-2009. But overall, macroeconomic projections appear realistic. They are broadly in line with the stability-oriented policy mix presented in the programme, and do largely concur with the European Commission's autumn 2006 forecast.

The overall objective of Turkey's fiscal policy is to contribute to establishing a sustainable growth environment and at the same time to support disinflation. Achieving substantial primary surpluses is the main fiscal tool in this respect, contributing not only to disinflation but also to debt sustainability. As in previous years, the document does not describe in great detail how those targets to be achieved and therefore lacks some transparency. The 2006 PEP states, like in previous years, that the free float in combination with the newly adopted inflation targeting regime remains an appropriate policy framework to sustain price stability.

Table 1: **Comparison of key macroeconomic and budgetary projections**

		2005	2006	2007	2008	2009
Real GDP growth	COM	7.4	6.0	6.4	6.3	n. a.
(% change)	PEP	7.4	6.0	5.0	5.6	5.9
Consumer price	COM	8.1	10.2	8.6	6.1	n. a.
inflation (%)	PEP	8.2	9.5	7.1	4.0	4.0
General government	COM	-1.2	-3.6	-4.0	-3.3	n. a.
balance (% of GDP) (*)	PEP	-0.2	2.7	-0.6	0.0	-0.3
Primary balance	COM	n. a.	n. a.	n. a.	n. a.	n. a.
(% of GDP) (*)	PEP	9.8	11.1	7.9	7.2	6.5
Government gross	COM	69.6	69.4	66.1	63.3	n. a.
debt (% of GDP) (*)	PEP	69.2	63.4	57.7	53.1	48.4

(*) COM data for public finances use fiscal notification 2006

The structural reform agenda sets out a continuation of the plans put in place over the last years. The general aim remains to be increasing the efficiency in the private sector and the public administration and to support the strengthening of market forces. The agenda covers a broad range of issues. The outlined reforms are at different stages of implementation in several important areas, such as privatisation and social security reform.

The Turkish government has, at several occasions, turned to ad-hoc measures to achieve its fiscal targets. The programme states that, in order to reduce the need for such practices in

the future, efforts to widen the tax base, better capture the unregistered economy, and decrease the number of tax exemptions will be intensified. Turkey has accomplished a remarkable effort of fiscal consolidation but ensuring a high-quality fiscal adjustment will be a key challenge on the way to the EU.

The 2006 PEP does not contain a separate section on the long-term sustainability of public finances. It would greatly benefit from some medium-term analysis, which should be predominantly based on demographic and macroeconomic scenarios. Turkey's situation differs dramatically from the EU-Member States. With its very young population (the average age is just 27), falling birth rates, and significant in- and outward migration, some more in-depth analysis appears a crucial section in a the context of a PEP, in particular since the Turkish authorities are moving to new health and pension systems, whereby key indicators, like for example retirement age, dependency ratio and overall labour market participation might significantly change.

It can thus be concluded:

- Turkey's sixth Pre-Accession Economic Programme for 2007-2009 is a comprehensive economic policy document, which presents a sound and coherent medium-term framework in macroeconomic, fiscal and structural reform areas. The programme largely complies with content, form and data requested, even if it contains very limited methodological improvements over previous years' submissions. In particular some deficiencies persist concerning the use of the European System of Accounts (ESA 95). To some extent, the definition of core objectives and some policies appears generally less detailed compared to the previous submission. Overall, the programme can provide important guidance for economic policy making, in particular towards fully meeting the economic Copenhagen criteria for accession.
- In spring 2006, the Turkish economy was faced with financial market turbulences. This brought about increased exchange rate volatility and some further inflationary pressures. The authorities reacted appropriately and firmly in form of monetary tightening and continuous fiscal consolidation efforts and the economy continued to stay on a robust growth path. The programme's macroeconomic projections seem plausible in the context of the announced policy mix and given the assumption of a stable and benign external environment.
- The programme's continued fiscal consolidation and stability-oriented monetary policies remain appropriate to address challenges arising from considerable external imbalances. While the envisaged reduction of public spending over the medium term is welcome, the programme remains rather vague on the underlying fiscal and structural measures and their respective budgetary effects, which are not always presented in a comprehensive and systematic way. The PEP would benefit from a better monitoring of long-term fiscal sustainability. The introduction of a new social security system, and more generally, the medium and long-term cost of the pension and health care systems should therefore be monitored very carefully. In addition, infrastructure investment may need to increase in less developed regions, given the size of regional disparities in Turkey.
- The PEP's structural reform agenda covers a broad range of issues, including in the areas of labour market and social security reforms and privatisation. The programme broadly supports Turkey's efforts to enhance its capacity to cope with competitive pressures and market forces in the context of EU accession. However, strong focus on timely implementation of the outlined plans will be essential. In addition, more emphasis might be put on labour market reforms, in particular to support job creation during the economic transformation process, and to improving state aid monitoring. The PEP

might have also benefited from more clarity concerning reform plans in the areas of R&D and innovation. The programme's reform agenda is largely consistent with the fiscal scenario and partly aligned with the reform requirements in view of the country's EU accession perspective, as spelled out in the latest Progress Report and the Accession Partnership.

2. INTRODUCTION

The Turkish authorities submitted the 2006 Pre-Accession Economic Programme (PEP) covering the period 2007 to 2009 to the European Commission on 1 December 2006. It is Turkey's sixth PEP since the ECOFIN Council of 26/27 November 2000. Like in previous years, the Pre-accession Economic Programme was prepared under the lead of the State Planning Organisation and benefited from contributions by and consultations with all relevant institutions, in particular the Treasury, the Ministry of Finance, the Ministry of Agriculture, the Central Bank, the Privatisation Agency, the Banking Regulation and Supervision Agency, etc. The document has been formally approved by the "High Planning Board", which comprises the Prime Minister and representatives of key ministries. The programme's overall objectives are to maintain macroeconomic stability, to ensure sustainable growth, and to improve the income of living of Turkish citizens. It presents a rather coherent macroeconomic framework and a fiscal consolidation programme which aims at gradual reduction of the general government deficit over the PEP period, also with a view to reducing public and external indebtedness. The structural reform agenda puts emphasis on increasing the efficiency both in the private sector and the public administration and to support the strengthening of market forces. The agenda covers a broad range of issues, with reforms being at different stages of implementation in several important areas, such as privatisation and social security reform.

3. MACROECONOMIC DEVELOPMENTS

3.1. Recent macroeconomic developments

The report presents a succinct and clear overview of economic developments in 2005 and 2006. Concerning 2006, the document covers all relevant data available by late November. Compared to last year, the presented data are slightly more detailed.

Annual real GDP growth fell significantly from 7.4% in 2005 to 6.1% in 2006, chiefly due to weaker private consumption, which was partly driven by the tighter monetary stance, higher interest rates and less lending. Public consumption and investment increased by 9.6% and 5.2% respectively. Contributions by the external sector changed substantially. Imports grew at 1.0% in the final quarter of 2006, down significantly from rates over 10% in the first six months of 2006. Export growth remained largely constant at 8.5% in both 2005 and 2006. Data from the labour force survey reported a decline in the unemployment rate to 10.5% in December 2006, down from 11.2% a year earlier. Average annual consumer price inflation stood at 9.6% in 2006, significantly higher than in 2005 (8.2%). The current account deficit has widened further. In 2006, it increased markedly to 7.9% of GDP as compared to 6.3% of GDP in 2005, due a rise in the merchandise trade deficit and lower tourism receipts. In 2006, net FDI inflows increased to about 4.8% of GDP, up from 2.4% in 2005, providing for coverage of about 60% of the current account deficit.

The programme is largely compliant with the requirements in terms of content, form and data. It provides evidence of the Turkish administration's strong institutional and analytical

capacity, although it might have benefited from more closely addressing the specific issues raised in last year's assessment. The underpinning macroeconomic framework appears broadly coherent and consistent. As in previous years, a medium-term fiscal framework is presented. The PEP is also largely consistent with other policy documents, although the World Bank's Country Economic Memorandum is providing much more detail on economic policy priorities, namely in the area structural reforms. Moreover, developments of some economic variables in 2006 are not always systematically compared to estimates for the relevant period in 2005, and more references to the attached tables would have been useful.

Table 2: Comparison of macroeconomic developments and forecasts

	2005		2006		2007		2008		2009	
	COM	PEP	COM	PEP	COM	PEP	COM	PEP	COM	PEP
Real GDP (% change)	7.4	7.4	6.0	6.0	6.4	5.0	6.3	5.6	n. a.	5.9
<i>Contributions:</i>										
- Final domestic demand	10.9	11.6	8.9	8.9	8.0	4.3	6.4	5.6	n. a.	6.5
- Change in inventories	-2.0	-2.5	-2.0	-1.6	-1.3	0.0	-0.1	0.0	n. a.	0.0
- External balance of goods and services	-1.6	-1.7	-0.9	-1.6	-0.3	0.9	0.0	0.1	n. a.	-0.6
Employment (% change)	1.4	1.2	1.6	0.3	1.9	1.5	1.4	1.7	n. a.	1.9
Unemployment rate (%)	10.3	10.3	9.8	10.1	9.1	9.8	8.9	9.8	n. a.	9.7
GDP deflator (% change)	5.4	5.4	8.5	8.6	8.0	7.0	5.0	4.0	n. a.	4.0
CPI inflation (%)	8.1	8.2	10.2	9.5	8.6	7.1	6.1	4.0	n. a.	4.0
Current account balance (% of GDP)	-6.7	-6.4	-6.5	-7.9	-7.2	-7.4	-7.2	-6.5	n. a.	-5.7

Sources: Pre-Accession Economic Programme (PEP); Commission services Autumn 2006 forecasts (COM)

3.2. Macroeconomic scenario

As in previous years, the quantitative framework for the period 2007-2009 is well presented and contains detailed information on key variables. The link between the macroeconomic framework and the impact of structural reforms described in sections 3 and 4 still deserves more attention in particular in a medium-term perspective. The programme's external assumptions are largely in line with international forecasts, including the EU Commission's autumn 2006 forecast. Compared to these forecasts, the Turkish programme is somewhat more optimistic with respect to the pace of the country's disinflation and the widening of the external deficits. The assumption on the EUR/USD exchange rate is based on the one in the Commission's autumn 2006 forecast. Alternative scenarios are not developed. The document provides some reasons for divergences from the previous submission. The key macroeconomic challenges and objectives of the programme could have been specified more explicitly from the start. Projections for key macroeconomic variables seem overall plausible, in particular since the policy mix has been very adequately adapted (i. a. by monetary tightening) for the changes compared with the previous submission.

Real sector

The real sector scenario used in the programme is close to market consensus and broadly in line with the Commission autumn 2006 forecast. Both sources assume that the Turkish economy will grow at rates - close to potential - of around 5.5% per annum through the programme period, driven by continuous rapid productivity growth. However, while the

Commission believes that growth will mainly come from private consumption and investment, with a negative contribution from the external balance, the PEP assumes that net exports will increase substantially over previous years. Job creation is expected to be modest in both scenarios. The disinflation process is set to continue, but the Commission projects that the pace will slow down more rapidly. The already mentioned different views on exports translate in the projection by the PEP assumes that the current account deficit will fall from a peak in 2006, while the Commission forecasts that the gap will rather stabilize around 7% of GDP.

Based on two of the three different methods used to calculate potential output, the programme considers that the economy has reached potential output in 2006 and will remain close to potential in 2007-2009. The main reasons for the favourable growth performance are the effects of structural reforms. Compared to the 2005 PEP, the current programme is somewhat more optimistic concerning the GDP growth profile for 2007-2009. Concerning the demand components of growth, the 2006 programme shows a weakening reliance on investment and private consumption, while the expectations concerning public consumption and exports are more optimistic. This growth pattern is largely plausible, given a diminishing negative impact of the strict fiscal policy on public consumption and disposable income and the elections foreseen in 2007. No major rising inflationary pressures are expected from this growth pattern. Furthermore, the programme appears to be reasonable in assuming a positive effect of decreasing interest rates, declining economic volatility and the diminishing crowding out of private investment through public sector borrowing on private investment. However, the high growth rates of imports observed in 2006 would have deserved a more detailed explanation.

Regarding the contribution of the various production factors to growth, Turkey's output appears to have been mainly driven by capital deepening, contributing 73% to total growth during 1990 - 2000 and by 65% in 2001-2005. The share of labour was 24% in 1990-2000 and fell dramatically to a contribution of 5% in 2001-2005 following the 2001 financial crisis. The increase in total factor productivity was 3% and 30% in 1990-2000 and 2001-2004 respectively. During the programme period, this distribution is expected to become more even, with the share of capital accumulation in growth generation reaching 35% on average during 2006-2009, the share of employment 18% and that of total factor productivity 47%. The investment ratio would remain stable around 25% of GDP and would be increasingly financed by private domestic savings, reflecting increased confidence in economic stability.

The programme is more pessimistic regarding employment generation than in 2005, and therefore largely in line with the Commission, expecting an average employment increase of about 1¾% each year. However, an increase in the labour force will limit the decline in unemployment.

External sector

Turkey's current account balance has continuously deteriorated since the 2001 financial crisis. For the programme period, a decrease in the current account deficit is expected. The underpinning scenario seems somewhat optimistic about growth of merchandise exports and - albeit to a lesser extent- on tourism revenues. The expected volume of workers remittances is forecasted to stabilize around USD 1 billion⁵. As a result, the current account deficit is expected to decline from 8.2% of GDP in 2005 to 5.7% in 2009. The programme

⁵ The choice of this specific currency denomination is that of the programme.

does not anticipate any difficulties in financing the current account deficit, despite a very constrained capital account outlook with considerable repayment obligations towards the IMF, amounting to about EUR 8 billion during 2006-2009.

In contrast to the 2005 PEP, no alternative scenarios are included on energy imports. Given the high sensitivity of the Turkish current account to oil prices, the programme would have benefited from an in-depth analysis of the effect of a shift in oil demand combined with energy price volatility. In addition, and again unlike last year, the programme does not include a scenario whereby the TRY real exchange rate shows significant instability relative to the baseline scenario and its effect on the current account.

3.3. Monetary and exchange rate policy

The 2006 PEP presents a short description of the framework of monetary and exchange rate policy. Its main features have been put in place in the last three years. The key objective of monetary policy is to ensure price stability, or – in other words - to support the disinflation process. As from January 2006, an explicit inflation targeting policy has been implemented. By this shift, the anchor of base money and net domestic assets has been replaced by headline inflation. In the preparatory phase, administrative and statistical capacity had been increased. The publication of quarterly inflation reports and decisions of the Monetary Policy Committee, which decides by voting on changes in key interest rates, has substantially enhanced transparency.

Due to improved fiscal discipline and structural reforms in the financial sector, the effectiveness of monetary transmission mechanisms has already significantly increased. Besides enhancing the overall transparency and predictability, a more credible management of expectations and more confidence are seen as key factors aiming at further improving monetary transmission. In the PEP2006, the Central Bank explicitly announced a closer monitoring of consumer loans. This development is clearly inspired by recent increases in private sector lending, due to a falling fiscal dominance, in a context of a widening current account deficit.

The free floating exchange rate regime remains in place. The interventions made so far aimed at smoothening excessive exchange rate volatility and to build reserves. Apart from a small appreciation in 2007, the programme implies a constant real exchange rate during 2006-2009.

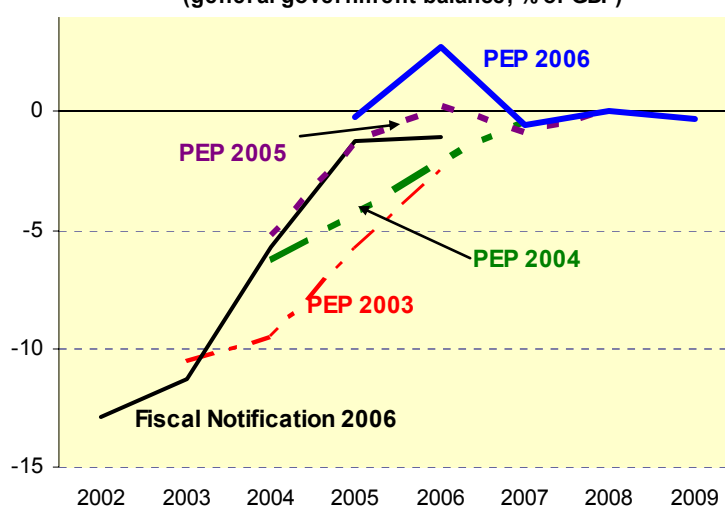
Inflation increased from 8% in the first months of 2006 to over 11% by August 2006, mainly due to the depreciation of the currency, rises in international commodity prices and remaining rigidities in services prices. In the second part of the year, CPI inflation came down again, to 9.7% in December 2006, in particular as a result of falling energy prices. The most important factors that have contributed to this reduction in inflation are the increased confidence in the economy as a result of the tighter monetary policies that were implemented following financial turbulences in May-June 2006. The incomes policy implemented under the programme is another factor which contributed to the decline. The envisaged permanent reduction in chronic inflation aims at converging towards EU averages by the time of accession.

4. BUDGETARY TARGETS AND THE MEDIUM-TERM PATH OF THE PUBLIC FINANCES

The overall objective of Turkey's fiscal policy is to contribute to establishing a sustainable growth environment and at the same time to support disinflation. Achieving substantial

primary surpluses is the main fiscal tool in this respect, contributing not only to disinflation but also to debt sustainability. As in previous years, the document does not describe in great detail how those targets to be achieved and therefore lacks some transparency. The presentation of the public finances would have gained significantly from a more in-depth discussion of the various measures, in particular the social security reform, and their impact on the presented objectives. Main revenue-related measures are an improvement of efficiency in tax collection and a broadening of the tax base. These should neutralise the fiscal effects of the reductions in private and corporate income taxes. On the expenditure side, emphasis is put on reducing the social security deficits. Unfortunately, like in previous years, no quantitative estimates of the budgetary effects of the individually described measures are given. Budgetary objectives appear broadly realistic, in particular since real interest rates are falling faster than anticipated in a context of high growth.

Chart 1: Budgetary developments
(general government balance, % of GDP)



The 2006 programme comprises for the third time cyclically adjusted budgetary balances. The results point at a relatively low weight of the cyclical component in Turkish fiscal balances. It appears that the importance of structural determinants has started coming down due to lower interest rates in combination with high primary budget surpluses. The calculations also indicate that the growth of the Turkish economy during most of the programme period is very close to potential. Given the strong volatility in the last decade the present cyclical position of the Turkish economy remains very difficult to ascertain. The programme would benefit from some clarifications on the methodology used in the individual sections. Indeed, it is not always clearly stated when and why non-ESA 95 compatible data are used.

4.1. Targets and adjustment

According to the PEP2006, the public sector borrowing requirement (general government surplus) amounted to 2.7% of GDP in 2006, which compared very favourably with the 2006 projection of 0.2% of GDP in the 2005 PEP. Stronger than anticipated economic growth led to higher revenues, real interest rates fell faster than expected, and in particular higher privatisation receipts explain the large difference. In 2007, a general government budget deficit of 0.6% of GDP is targeted. This appears optimistic compared with the medium term

fiscal framework, which underpins the new IMF Stand-By Agreement, and which is based on deficits averaging 1% of GDP.

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

	2005	2006	2007	2008	2009	Change: 2006-09
Revenues	43.9	46.3	46.5	45.9	44.9	-1.4
<i>of which:</i>						
- Taxes and social security contributions	31.8	32.7	36.0	36.1	35.7	3.0
- Other (residual)	12.1	13.6	10.5	9.8	9.2	-4.4
Expenditure	43.6	43.6	47.1	45.9	45.1	1.5
<i>of which:</i>						
- Primary expenditure	34.1	35.2	38.6	38.7	38.4	3.2
<i>of which:</i>						
Gross fixed capital	3.8	3.9	4.0	3.9	4.0	0.1
Consumption	17.5	18.7	19.7	19.7	19.5	0.8
Transfers & subsidies	9.0	9.1	9.3	9.2	9.3	0.2
Other (residual)	3.7	3.6	5.6	5.8	5.7	2.1
- Interest payments	9.5	8.4	8.5	7.2	6.7	-1.7
Budget balance	-0.2	2.7	-0.6	0.0	-0.3	-3.0
- Cyclically adjusted	-2.3	-1.3	-2.9	-1.9	-1.8	-0.5
Primary balance	9.8	11.1	7.9	7.2	6.5	-4.6
Gross debt level	69.2	63.4	57.7	53.1	48.4	-15.0

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

The key objective of the medium-term fiscal framework is to achieve primary surpluses of around 7% of GDP in 2007-2009. The ratio of general government revenues to GDP is expected to decline over the programme period from 46.5% in 2006 to 44.9% in 2009, reflecting changes to the health system, the phasing out of a number of temporary revenue measures and the effect of the reduction in income taxes. To some extent, these revenue-reducing measures will be compensated by the intended widening of the tax base and the improved efficiency of tax collection. In contrast with previous years, no straightforward reduction in the tax burden is foreseen. Following an increase of 2.5% of GDP in 2007, mainly due to the introduction of a universal healthcare system, a fall in general government expenditure is programmed in the remainder of the period, from 47.1% of GDP in 2005 to 45.1% in 2008. One of the main driving forces for this foreseen decline is the effect of efficiency increasing measures. The largest contribution to the decline in total general government expenditures, however, is stemming from a decline in interest payments, decreasing by nearly 2 percentage points of GDP, from 8.4% of GDP in 2006 to 6.7% in 2008.

As observed in spring 2006, the projected fall in interest rates is plausible, but remains highly dependent on exogenous factors, such as overall sentiment vis-à-vis emerging markets and global interest rates. However, the sensitivity analysis made in the programme suggests that the overall picture is rather realistic, in particular regarding 2007.

Up to 2006, fiscal consolidation was largely based on revenue-increasing measures, in particular from higher indirect taxes. Indirect tax revenues increased from 11.7% of GDP

in 1999 to 17.2 percent of GDP in 2006. In contrast to primary revenues, non-interest expenditures reflect no major changes during the period, with expenditures for personnel, goods and services and current transfers largely unaffected by fiscal consolidation. Primary expenditures hovered at around 35% of GDP. Therefore, despite recently high growth primary expenditure, on aggregate, were not used as a policy tool to achieve fiscal consolidation. In order to prepare for EU accession and contribute to the catching up of income levels, Turkey would need to achieve efficiency gains in public expenditures in order to make appropriate room in the budget for growth public expenditures and lower taxes, for example on public investment in education or infrastructure.

For 2007 to 2009, projections differ significantly from the 2006 numbers. The main changes on the income side are in Social Funds (+2.8%) and in the area of privatisation. Privatisation receipts fall back from 2.2% of GDP in 2006 to relative low levels of 0.5-0.8% in 2007-2009. On the expenditure side, additional spending in 2007 in social security and wages explain in large part the increase by 3.4% in non-interest expenditures. However, given that general elections are scheduled in 2007, risks of fiscal slippages are significant. According to the programme's calculations of the cyclically adjusted budget, fiscal policy will remain neutral.

The reform of the social security system is of paramount importance to further improve Turkey's fiscal situation. The social security deficit increased from 1.9% of GDP in 2000 to 4.8% of GDP in 2005. Given the currently favourable demographic profile of Turkey, the currently high deficits pose a bigger challenge in the long run considering that the number of elderly will start to increase as the demographic shift starts to kick in. The proportion of Turkey's population aged 65 and above to the labour force will increase by 10% between 2000 and 2020, according to OECD projections. The projected deficit of the system is expected to reach 6.7% of GDP in the long term, under a no-reform scenario. The section on public finances would have benefited from greater detail on the reform of the health and pensions systems, including on the effect of incurred delays in the implementation.

Box 1: The PEP 2006 and the Accession Partnership economic priorities

Following the opening of accession negotiations with Turkey (on 3 October 2005), the Council adopted an Accession Partnership on 20 February 2006, which updates the previous Accession Partnerships (1999, 2003).

Short-term economic priorities include pre-accession fiscal surveillance - with an emphasis on appropriate measures to achieve macroeconomic stability and predictability, structural reforms, thereby ensuring the control of public expenditure, financial sector reform, safeguarding the independence of market regulatory authorities, accelerating privatisation - in particular of state-owned banks, addressing the problem of the informal economy, correcting labour market imbalances, improving the business climate, reform of the agricultural sector, education, health and the facilitation and promotion of FDI. The short-term priorities, which have already been partly addressed by specific

measures in 2006, continue to be priorities in the policy framework of the PEP 2006.

The medium-term economic priorities are expected to be implemented within three or four years. They include the completion of the privatisation programme, as well as the reform of the agricultural sector. The sustainability of the pension and social security system needs to be ensured and the general level of education and health needs to improve. The 2006 PEP addresses these areas to a varying degree. In particular, future reform plans with respect to the informal economy, labour market and education reforms receive relatively little coverage in the programme.

Overall, the 2006 PEP is broadly in support of the relevant parts of the Accession Partnership and its full implementation should therefore facilitate the accomplishment of the economic priorities.

Given that some profitable previously state-owned enterprises (SOE), like Turk Telekom and Tupras, have now been totally privatised, the contribution of SOEs to the public sector revenues surplus will decrease. In previous years, SOEs transferred about 0.4% of GDP to the budget. The PEP is unclear on how these revenue losses for the consolidated budget will be mitigated.

Although, relative to GDP, education does not seem underfunded in international comparison, efficiency and effectiveness is low. Turkey will need to better concentrate the sector's significant financial, human, and material resources on ensuring the enrolment, attendance and completion of basic education for all students, upgrading the quality of learning, increasing secondary school enrolment and completion rates, and improving students' transition from schooling to employment if it wants to be successful in its income convergence towards EU levels and in its eventual integration in EU-labour markets.

4.2. Debt developments

The level of gross debt in terms of GDP is expected to fall continuously and rapidly, from 69.2% in 2005 to 48.4% in 2009. Factors behind this decline are declining interest rates and primary surpluses of roughly 7% in 2007-2009. Consequently, interest payments are programmed to fall gradually from 12% in 2005 to less than 7% in 2009. As in previous years, the sustainability of the public debt will be improved by measures to lengthen the debt maturities, to diversify financial market instruments and to provide for liquidity reserves. The Treasury will apply an active risk management strategy to improve the management of contingent liabilities. In order to strengthen the transparency of debt management, a single borrowing authority has been determined and stricter rules of debt management have been introduced. Risk accounting has been established. In view of

improving transparency, public debt management reports are published on a quarterly basis and the responsible minister presents an annual special report to parliament and to the budget commission.

Various sensitivity analyses were presented. One examined the sensitivity of public finances to lower growth and higher interest rates. The growth shock scenario itself is split into two sub-scenarios, one assuming a reduction in public expenditures, while the other assumes public expenditures to remain constant in nominal terms. A separate sensitivity analysis focuses on the debt stock dynamics. According to the PEP 2006 calculations, the debt situation appears to be sustainable. The most critical scenario is the one assuming growth to be one percentage point lower and real interest rates to be 3 percentage points above the baseline scenario, whereby the gross debt level would fall to 53.3% in 2008. While this analysis concludes plausibly that the sensitivity of the debt stock has fallen, this argument could be strengthened by the inclusion of more critical scenarios (for example growth rates and real interest rates respectively 2 percentage points and 5 percentage points above the baseline scenarios). Although such scenarios are not very likely to materialise, they cannot be ruled out yet and remain a source of risk.

5. STRUCTURAL REFORMS

The outlined structural reform agenda represents a continuation of the plans put in place over the last years. The general aim remains to be increasing the efficiency in the private sector and the public administration and to support the strengthening of market forces. The agenda covers a broad range of issues. The outlined reforms are at different stages of implementation in several important areas, such as privatisation and social security reform. The programme is quite clear on what has been achieved and at pointing to delays that have been encountered in relation to the plans outlined in the 2005 PEP. However, in some areas, such as for state aid policy and improvements in the investment climate, it is less clear what is planned to be achieved over the programme period or the expected speed of reforms. In the area of privatisation, the government has modified its plans after the submission of the PEP, delaying privatisations in certain areas. The budgetary effects of reforms to be implemented are outlined for all major reform areas, although cost estimates after 2007 are often lacking. The net costs for agricultural reforms have been drastically reduced compared to the last programme, without clear explanation. Overall, the structural reform agenda should be broadly supportive of further enhancement of Turkey's capacity of cope with competitive pressures and market forces within the EU. More emphasis should be put on labour market reforms, to support job creation during the economic transformation process, and improvements in the monitoring of state aid. The PEP also lacks clear policies and descriptions concerning research and development and innovation, an area which would be important to support a transformation to a knowledge-based economy, as laid out in the Lisbon agenda.

Table 4: **Net direct budgetary impact of key reform commitments** (EUR million)

Description of the Policy	2006	2007	2008	2009
1. Labour market	-846.6	-716.7	-727.0	-640.0
2. Agriculture	-0.2	-2.0	-1.5	-13.6
3. Regional Development	-29.3	-135.3	-292.6	-302.6
4. Health and social security	-17.3	16.2	78.0	96.2
5. Info and Com. Technologies	-432.0	-	-	-
6. Transportation	-2.0	-1.7	-	-
7. Energy	-12.5	-	-	-
Total impact on the budget	-1339.9	-839.4	-943.2	
Total impact on the budget (in % of GDP)	-0.4	-0.3	-0.3	0.0

Source: 2006 Pre-accession Economic Programme (PEP), ECFIN calculations

5.1. Product and capital markets

The PEP highlights the successful continuation of the privatisation process during 2006. Privatisation revenues amounted to USD 12.5 Million⁶ in 2005 and reached USD 8.2 billion in the first ten months in 2006. Such strong continuation of privatisation inflows constitutes a real achievement and is in stark contrast to the low levels attained in earlier years. However, despite strong inflows, delays have been encountered in certain sectors compared to what was envisaged in the 2005 PEP. For several companies the sales procedures have taken longer than expected. The PEP outlines sectors and companies where efforts to privatise are envisaged to continue during the period covered by the PEP. These are for example state-owned banks, games of chance, ports and activities related to the sugar and petrochemical industry.

There is a risk that further delays will be encountered during the programme period compared to the outlined plans. After two years of relatively intensive privatisation, the remaining portfolio of state-owned enterprises is likely to be more challenging to privatise: it is concentrated in areas where privatisation can be seen as more sensitive or other complexities existing, in particular during an election year. This seems to be for example the case for the energy sector, where tenders were launched in August 2006 for privatisation of electricity distribution companies through transfer of operation rights. However, since the submission of the PEP there are signs of the process stalling for the time being. The privatisation process of state-owned Halkbank as outlined in the programme also seems to have been changed, to an IPO sale of a smaller part of the bank. In general, to advance the privatisation agenda during in particular the coming year will take strong commitment from the side of the authorities.

Concerning the area of competition law and policies, no progress has been achieved since the 2005 PEP in putting in place monitoring of state aids. The lack of regulation and monitoring of state aids continue to affect transparency and the overall competitive environment negatively. As regards the business environment, further steps have been taken to improve the conditions. One positive development is the establishment of an investment promotion agency under the Prime Ministry, resolving the previous organisational uncertainty concerning these issues. A well established system, including for example the Investment Advisory Council, is continuing to support the reform process and

⁶ This currency denomination is the choice of the programme itself.

to identify the problematic issues for investors. However, the PEP contains very limited information on what will be focused on over the programme period.

In the field of banking, secondary legislation and regulations related to the new banking law (from 2005) were adopted. This increased the harmonisation with EU and Basel II rules. Over the programme period, supervision of the sector is envisaged to be further strengthened. A time schedule has also been announced for the removal of the privileges of state banks, which is a welcome step. The taken and planned measures are supportive of the overall positive developments in the sector. Despite the improved resilience of the Turkish banking sector to market fluctuation, continued strengthening of supervision will be important to further decrease risks in particular the context of the still rapidly growing banking operations. Concerning capital markets, auditing standards has been upgraded to comply with international auditing standards and a number of (small) steps to align regulations with EU standards were taken. The PEP is also explicit on steps to be taken until 2009 to support the deepening of capital markets.

5.2. Labour market

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

The macroeconomic framework presented in the programme shows that no significant reduction in unemployment is expected over the coming years. The PEP puts only limited focus on the role of labour market regulations and the informal sector in addressing the existing problems. Non-wage labour costs are relatively high and the regulations of the labour market rigid, protecting workers rather than jobs. Tackling these issues in a more systematic way would be supportive of addressing the identified challenges in the labour market and support the creation of jobs in the challenging transformation period ahead. The programme proposes to reduce the cost of employment by introduction of some measures, but these seem rather minor and the timing is not clear.

5.3. Other reform areas

The PEP outlines a wide range of areas where reform efforts have been ongoing and are foreseen to continue over the programme period. Further efforts have been made to improve public financial management, which is yielding positive results in terms of for example the budgeting process and transparency. However, the PEP does not outline any further steps to be taken in this area. Local government reform is important in order to strengthen their role and abilities to perform the needed services. Legal reforms have

proceeded, but the PEP acknowledges that there are deficiencies in the capacity to implement laws at the local level.

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

The PEP highlights the adoption of a social security and health insurance reform package. This is a very important reform package, particularly given that the large deficits in the social security contributions strongly have contributed to Turkey's fiscal problems. In addition, due to demographic change, without reforms the situation would significantly worsen over the coming years. The implementation of the reform package would be an important step forwards. However, in December 2006, key articles of the social security reform package have been blocked by the constitutional court and it is unclear what changes will have to be made to the reforms to get them accepted and when the laws could enter into force. This happened after the submission of the PEP, and the programme still assumes positive budgetary impact from health care and social security reform as of 2007, which given current circumstances seem optimistic. In addition, even with the adoption of the package, there would still urgent issues remain to be addressed in this field. For example, the proposed reform package does not address the issue of the large social security contributions paid by employers. This results in a large tax wedge, weighing on the incentives for employment in the formal sector.

6. THE QUALITY AND SUSTAINABILITY OF PUBLIC FINANCES

6.1. The quality of public finance

The Turkish government has often turned to ad hoc measures to achieve its fiscal targets. The programme states that, in order to reduce the need for such practices in the future, efforts to widen the tax base, better capture the unregistered economy, and decrease the number of tax exemptions will be intensified. Turkey has accomplished a remarkable effort of fiscal consolidation but ensuring a high-quality fiscal adjustment will be a key challenge on the way to the EU. Indeed, fiscal imbalances might emerge over the medium term, either as a result of past policy commitments, for example in education and access to the universal health insurance, or owing to a still pending reform agenda. In addition, infrastructure investment may need to increase in less developed regions, given the persistence of regional disparities in Turkey.

As public expenditures are already relatively high there is little room for Turkey to further increase expenditure in order to meet pressing convergence challenges. Expenditure should also be contained in order to make room for lower taxes in the long run while preserving a

sound fiscal framework. Policy would thus need to focus on trade-offs in expenditure allocations, possibly by reducing spending in functional areas (such as general public services and defence, public order and safety) where it appears to be oversized in comparison with other similar countries. At the same time, reforms should be implemented with the aim of improving the efficiency of expenditure programs in areas where expenditure pressures are being felt, such as health care, education, social protection. Horizontal reforms, focused on the modernization of civil service pay and employment system and the rationalization of the investment program, would also help contain pressures on the wage bill as well as investment spending and thus contribute to better control public expenditure across functional areas. Efficiency considerations are considered to be the main priority in public expenditure policies. Conversely, the Turkish authorities have embarked in an ambitious reform and established an independent revenue administration. Thereby, the intention is to increase the efficiency of tax collection, by means of enhancing automation, training staff and improving all underpinning facilities. In addition, tax laws and regulations will be amended in order to re-assess tax exemptions with the objective of simplification and rationalization of the tax system.

6.2. The sustainability of public finances

The 2006 PEP does not contain a separate section on the long-term sustainability of public finances. It would greatly benefit from some medium-term analysis, which should be predominantly based on demographic and macroeconomic scenarios. Turkey's situation differs dramatically from the EU-Member States. With its very young population (the average age is just 27), falling birth rates, and significant in- and outward migration, some more in-depth analysis appears a crucial section in a the context of a PEP, in particular since the Turkish authorities are moving to new health and pension systems, whereby key indicators, like for example retirement age, dependency ratio and overall labour market participation might significantly change.

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

Annex table 1: Structural indicators

	TURKEY					EU 25				
	2002	2003	2004	2005	2006	2002	2003	2004	2005	2006
General economic background										
Real GDP ¹	7.9	5.8	8.9	7.4	6.1	1.2	1.3	2.4	1.7	2.9
Labour productivity ²	37.1	38.2	38.5	39.4	40.7	100	100	100	100	100
Real unit labour cost ³	n.a.	n.a.	n.a.	n.a.	n.a.	-0.4	-0.4	-1.0	-0.6	-0.8
Real effective exchange rate ⁴	105.9	109.2	115.4	127.1	130.3	89.1	100.2	106.2	104.7	105.4
Inflation rate ⁵	47.0	25.3	10.1	8.1	9.3	2.1	1.9	2.1	2.2	2.2
Unemployment rate ⁶	10.3	10.5	10.3	10.3	9.4	8.7	9.0	9.0	8.7	7.9
Employment										
Employment rate ⁷	46.9	45.8	46.1	46.0	45.9	62.8	62.9	63.3	63.8	64.7
Employment rate - females ⁸	27.0	25.7	24.3	23.8	23.9	54.7	55.0	55.7	56.3	57.3
Employment rate of older workers ⁹	35.7	33.5	33.2	31.0	30.1	38.7	40.2	41.0	42.5	43.6
Long-term unemployment ¹⁰	3.1	2.5	4.0	4.0	3.5	3.9	4.0	4.1	3.9	3.6
Product market reforms										
Relative price levels ¹¹	51.9	57.7	58.5	67.3	n.a.	100	100	100	100	n.a.
Total trade-to-GDP ratio ¹²	29.9	29.7	31.7	31.2	n.a.	12.4	12.0	12.6	13.6	n.a.
Net FDI ¹³	0.3	0.5	0.6	1.5	n.a.	1.3	1.3	0.9	1.2	n.a.
Market share electricity ¹⁴	59.0	45.0	39.0	38.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Sectoral and ad-hoc state aids ¹⁵	n.a.	n.a.	n.a.	n.a.	n.a.	0.4	0.3	0.3	0.3	n.a.
Business investment ¹⁶	16.6	15.5	17.8	19.6	21.0	17.2	16.9	17.1	17.4	n.a.
Knowledge-based economy										
Tertiary graduates ¹⁷	n.a.	5.2	5.6	n.a.	n.a.	11.4	12.3	12.6	n.a.	n.a.
Spending on human resources ¹⁸	3.6	3.7	n.a.	n.a.	n.a.	5.1	5.2	n.a.	n.a.	n.a.
Educational attainment ¹⁹	42.8	44.2	42.0	44.0	n.a.	76.7	76.9	77.2	77.5	n.a.
R&D expenditure ²⁰	0.7	n.a.	n.a.	n.a.	n.a.	1.9	1.9	1.9	1.9	n.a.
Internet access ²¹	n.a.	n.a.	7.0	8.0	n.a.	n.a.	n.a.	42.0	48.0	51.0

1. Growth rate of real GDP in %. 2. Labour productivity per person employed - GDP in PPS per person employed relative to EU-25 (EU-25=100). 3. Ratio of compensation per employee to nominal GDP per person employed, total economy, annual percentage change. 4. Vs IC34 (1995 = 100), current year's values are based on Commission's forecast deflator figures, nominal unit labour cost deflator. 5. Annual average rate of change in Interim Harmonized Indices of Consumer Prices (HICPs). 6. Unemployed persons as a share of the total active population. 7. Employed persons aged 15-64 in % of total population of the same age group. 8. Employed women aged 15-64 in % of total female population of the same age group. 9. Employed persons aged 55-64 in % of total population of the same age group. 10. Long-term unemployed (over 12 months) in % of total active population aged 15-64. 11. Comparative price levels of final consumption by private households including indirect taxes (EU-25=100). 12. Trade integration - Average value of imports and exports of goods&services divided by GDP. 13. In % of GDP, EU-25 = Average value of inward and outward FDI flows in % of GDP. 14. Market share of the largest generator (% of total net generation). 15. In % of GDP. 16. Gross fixed capital formation by the private sector in % of GDP. 17. Tertiary graduates in science and technology per 1000 of population aged 20-29. 18. Public expenditure on education in % of GDP. 19. Percentage of the population aged 20 to 24 having completed at least upper secondary education. 20. GERD (Gross domestic expenditure on R&D) - in % of GDP. 21. Percentage of households who have Internet access at home.

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

Source: Commission services.