ISSN 1725-3209

EUROPEAN ECONOMY

Occasional Papers 158 | July 2013

2013 Economic and Fiscal Programmes of Albania and Bosnia and Herzegovina: EU Commission's overview and country assessments

Economic and Financial Affairs

Occasional Papers are written by the Staff of the Directorate-General for Economic and Financial Affairs, or by experts working in association with them. The "Papers" are intended to increase awareness of the technical work being done by the staff and cover a wide spectrum of subjects. Views expressed do not necessarily reflect the official views of the European Commission. Comments and enquiries should be addressed to:

European Commission
Directorate-General for Economic and Financial Affairs
Publications
B-1049 Brussels
Belgium
E-mail: mailto:Ecfin-Info@ec.europa.eu

Legal notice

Neither the European Commission nor any person acting on its behalf may be held responsible for the use which may be made of the information contained in this publication, or for any errors which, despite careful preparation and checking, may appear.

This paper exists in English only and can be downloaded from the website
ec.europa.eu/economy_finance/publications

A great deal of additional information is available on the Internet. It can be accessed through the Europa server (ec.europa.eu)

KC-AH-13-158-EN-N
ISBN 978-92-79-29367-2
doi: 10.2765/49518

© European Union, 2013

European Commission
Directorate-General for Economic and Financial Affairs

2013 Economic and Fiscal Programmes of Albania and Bosnia and Herzegovina: EU Commission's overview and country assessments

EUROPEAN ECONOMY Occasional Papers 157

CONTENTS

Introduction 1

Part I: Overview 3

1. Overview of the 2013 Progammes 5

Part II: Country analysis 9

1. Albania 10
   - 1.1. Executive Summary 10
   - 1.2. Economic Outlook and Risks 11
   - 1.3. Public Finance 14
   - 1.4. Structural Reforms 17
   - 1.5. Annex: Overall Assessment of Programme Requirements 19
2. Bosnia and Herzegovina 20
   - 2.1. Executive Summary 20
   - 2.2. Economic Outlook and Risks 21
   - 2.3. Public Finance 23
   - 2.4. Structural Reforms 26
   - 2.5. Annex: Overall Assessment of Programme Requirements 28

LIST OF TABLES

II.1.1. Macroeconomic developments and forecasts 10
II.1.2. Financial sector indicators 11
II.1.3. Composition of the budgetary adjustment 13
II.1.4. Composition of changes in the debt ratio 15
II.2.1. Macroeconomic developments and forecasts 20
II.2.2. Financial sector indicators 22
II.2.3. Composition of the budgetary adjustment 24

INTRODUCTION

In this Occasional Paper the Directorate General for Economic and Financial Affairs publishes its overview and assessments of the 2013 Economic and Fiscal Programmes (EFP) of the potential candidate countries (Albania and Bosnia and Herzegovina).

In 2001, a regular economic fiscal surveillance procedure was established for the candidate countries. It aims at preparing these 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) of candidate countries are part of this procedure. The PEPs have evolved, since their start in 2001, into increasingly important platforms for the authorities to develop and communicate appropriate economic, fiscal and structural policies over the medium term, consistent with their EU membership aspirations.

For this reason a similar, though reduced, exercise was started in 2007 with the potential candidate countries, with the submission and assessment of annual EFPs as an important element. The EFPs have two objectives: first, to outline a medium-term policy framework, including public finance objectives and structural reform priorities needed for EU accession; and, second, to offer an opportunity to develop the institutional and analytical capacity necessary to participate in the EMU (with a derogation in regard to the adoption of the euro upon accession), particularly in the areas of multilateral surveillance and co-ordination of economic policies. The development of the institutional capacity to co-ordinate between the various ministries, government agencies and the central bank is a particularly important aspect of the exercise.

The most recent EFP, covering the period 2013-2015, was submitted by Albania on 31 January 2013 and has been made public under the following internet address:
http://www.minfin.gov.al/minfin/pub/economic_and_fiscal_programme_2013_2015_albania_en_4409_1.pdf.

The EFP of Bosnia and Herzegovina was received on 28 January 2013. At the time of finalising the present paper, the Bosnian EFP has not yet been published on the website of the Directorate for Economic Planning (http://www.dep.gov.ba).

The assessments were prepared in the Directorate-General for Economic and Financial Affairs under the guidance and coordination of Carole Garnier and Uwe Stamm. The principal authors were Hans Berend Feddersen and András Tari (Albania) and Anton Gladnishki (Bosnia and Herzegovina).

The programmes and their assessments by the Commission staff were discussed during an experts meeting on 24 May in Brussels, with experts from the potential candidate countries, EU Member States, the European Central Bank and Commission staff.

Comments would be gratefully received and should be sent to:

Directorate-General for Economic and Financial Affairs
Economies of candidate and pre-candidate countries
Carole Garnier
European Commission
B-1049 Brussels

or by e-mail to: carole.garnier@ec.europa.eu

Part I

Overview

1. OVERVIEW OF THE 2013 PROGRAMMES(1)

In 2012 both countries experienced a substantial economic slowdown, while immediate prospects remain uncertain. Albania managed to avoid recession but output growth halved compared to previous years (to 1.6%), while Bosnia and Herzegovina's economy slightly contracted[2]. Uncertainties in the external environment and exceptionally bad weather conditions at the beginning of the year undoubtedly played their part in this outcome, but domestic demand was also plagued by a loss of confidence among consumers and investors. Looking forward, the two EFPs expect a marked improvement with an especially strong rebound projected in Albania, underpinned by revived final consumption and investments as well as a continuation of the recent favourable dynamics of net exports. However, such assumptions are subject to significant downside risks, including enduring weaknesses in the main trading partner countries (which might weigh, apart from exports, also on the inflow of remittances and FDI) and the increasingly subdued growth in credit extension to businesses and households. The Bosnian programme is somewhat less sanguine, but still projects a gradual, mostly domestic demand-driven recovery which also faces the challenges of a potentially sluggish external environment coupled with a weak business climate and the possibility of emerging inflationary pressures at home.

Table I.1.1:

Economic and Fiscal Programmes 2013
Key indicators

	2009	2010	2011	2012	2013	2014	2015
Growth (GDP, real, annual % change)							
Albania	3,3	3,8	3,1	1,5	3,1	3,9	4,1
Bosnia and Herzegovina	-2,9	0,7	1,4	0,2	1,3	3,6	3,9
Unemployment rate (%, LFS)							
Albania	13,0	13,7	13,3	13,5	13,1	12,2	10,9
Bosnia and Herzegovina	24,1	27,2	27,6	28,0	28,2	27,5	26,6
Current account balance (% of GDP)							
Albania	-15,3	-11,5	-12,1	-10,3	-9,5	-8,2	-7,1
Bosnia and Herzegovina	-6,6	-5,6	-7,8	-6,8	-5,9	-5,8	-5,8
Inflation (CPI, annual % change)							
Albania	2,3	3,6	3,5	2,0	3,0	3,0	3,0
Bosnia and Herzegovina	-0,4	2,1	3,7	2,2	2,1	1,9	2,1

Source: Economic and Fiscal Programmes (EFP) 2013 for 2011-2015, CCEQ for 2009 and 2010.

Weak economic growth led to shrinking external imbalances, but vulnerabilities remain. Albania's merchandise exports held up especially well in 2012, but the value of services export fell and overall, it was the decline in imports in the wake of feeble domestic demand that contributed most to a noticeable reduction in the current account deficit[3]. In Bosnia and Herzegovina, the current account deficit improved slightly in the course of 2012, but this was to a large extent due to higher net current transfers, while the foreign trade deficit expanded further to 32.4% of GDP. The programmes do not expect a reversal, but the current account deficits remain large. Moreover, in the absence of any significant improvement in price competitiveness[4], the projected robust export growths depend to a large extent on the expected recovery in the EU, whereas imports might surge if and when domestic demand strengthens. While FDI inflows are projected to cover a sizeable part of the current account deficit (virtually all of it in

(1) Data quoted for 2012 in this section refer to the most recent figures available which may thus differ from EFP data reported in the tables.

(2) According to recent estimates by the Directorate for Economic Planning, real GDP in Bosnia and Herzegovina fell by 0.2% in 2012.

(3) In 2012 the export of goods increased by a robust 8.5%, but, due to the weak performance of services export, the value of overall exports was up by only 0.9%. By contrast, imports of goods and services decreased by 5.2%, resulting in an overall reduction by 14.4% in the trade deficit. The improved trade balance was in turn the main contributor to the narrowing current account deficit.

(4) According to the EFP, the real effective exchange rate has been largely stable in both Albania and Bosnia and Herzegovina.

Albania and more than 40% in Bosnia and Herzegovina), a continuing stable inflow of such direct investments is dependent, among others, on both countries' efforts to further improve the business environment.

The financial sector appears resilient, but the rising share of non-performing loans is a cause for concern. Banks remain well capitalised and liquid in both countries, but their asset side has been deteriorating due to the rising share of non-performing loans (to around 23 % in Albania and about 13% in Bosnia and Herzegovina). This leads to tight credit conditions which, along with demand factors, currently constrain the growth of lending. In line with the expected economic recovery, the Bosnian programme projects a gradual acceleration of credit growth, based mainly on foreign financing by parent banks. Albania's EFP, on the other hand, expects banks to maintain relatively tight credit standards, resulting in credit expansion rates below historical values over the programme horizon.

Table I.1.1:

**Economic and Fiscal Programmes 2013
Fiscal indicators**

	2009	2010	2011	2012	2013	2014	2015
Total revenue (% of GDP)**							
Albania	26,1	26,2	25,5	24,7	25,6	25,6	25,4
Bosnia and Herzegovina	39,3	37,3	40,0	39,9	39,1	37,9	36,9
Total expenditure (% of GDP)**							
Albania	33,2	29,3	29,0	28,4	29,1	28,0	27,6
Bosnia and Herzegovina	42,9	39,4	40,7	41,4	39,9	37,9	35,9
Government balance (% of GDP) *							
Albania	-7,0	-3,1	-3,5	-3,7	-3,5	-2,4	-2,2
Bosnia and Herzegovina	-4,4	-2,5	-0,7	-1,5	-0,8	0,0	1,0
Government gross debt (% of GDP) *							
Albania	59,5	58,5	59,5	61,9	63,8	63,8	63,4
Bosnia and Herzegovina	21,8	25,6	35,5	37,0	36,6	34,4	30,9

* General government, national acc. standards

Source: Economic and Fiscal Programmes (EFP) 2013 for 2011-2015
** 2010 data from EFP 2012, 2009 data from EFP 2011.

Fiscal planning and predictability leave ample room for improvement. Weak economic growth has taken its toll on the budget, with public revenues substantially underperforming in Albania and to a lesser extent in Bosnia and Herzegovina. Albania had to resort to a mid-year readjustment which still left the budget deficit higher than initially planned, while Bosnia and Herzegovina's budget shortfall doubled in 2012, albeit from a lower base. Fiscal policy in Albania is explicitly expansionary in 2013, which might be linked to the election cycle, but by the end of the programming period both countries project an expenditure-led consolidation of public finances. The risks to these adjustment paths are clearly on the downside, given the optimistic macroeconomic assumptions and, in the case of Albania, the high implicit tax elasticities. In both countries, overoptimistic revenue projections often carry the risk of triggering ad hoc adjustments on the expenditure side, usually leaving growth-enhancing capital outlays to bear the burden of any rebalancing. Bosnia and Herzegovina's recent fiscal reform strategy aims to counteract this tendency by putting more emphasis on cuts in current spending; however, its implementation faces non-negligible risks given the country's track record in implementing unpopular reforms. In Albania, fiscal predictability suffered a blow when public debt exceeded the statutory ceiling of 60% of GDP in 2012, leading to the abolishment of the ceiling. Public debt is expected to further increase in 2013 before stabilising in the following years and it remains a source of vulnerability, given its important short-term component and the resulting rollover risks. In Bosnia and Herzegovina, on the other hand, the structure and maturity profile of public debt do not pose an immediate concern.

Structural reforms are indispensable to remove bottlenecks to growth. Common challenges faced by both transition economies include weaknesses in the business environment, skills mismatches and persistently high unemployment, low production capacity and a limited export base, as well as the need to complete the privatisation process. Furthermore, Bosnia and Herzegovina's economy is characterised by a large government sector with limited efficiency, while Albania needs to substantially improve the functioning of its energy sector. The programmes broadly succeed in identifying the main challenges, but still lack a strategic and comprehensive approach outlining specific and targeted policy measures to address them.

Part II

Country analysis

1.1. EXECUTIVE SUMMARY

Albania's economic growth slowed down sharply in 2012. Following an average real GDP growth rate of 3.4% in the preceding three years, the Albanian authorities estimate that annual real GDP growth was 1.6% in 2012. The slowdown reflects low consumption growth and declining investment in the wake of weakening confidence and continued recession in Albania's main economic partner countries. While some pick-up of growth can be expected over the medium term, the quick re-acceleration of economic activity projected in the programme, driven by strong export growth and an upturn in private consumption, is likely to face several headwinds such as subdued external demand and tight credit conditions as the ratio of non-performing loans to total loans has risen sharply to 23%.

The economic slowdown has only led to a marginal reduction of external imbalances. The current account deficit has narrowed slightly but remains above 10% of GDP, adding to a substantial accumulation of external liabilities over the years as reflected by a gross external debt amounting to some 52.5% of GDP. Looking forward, the heavy exposure in terms of exports and remittances to recession-hit Italy and Greece poses some risks to a sustained narrowing of the current account deficit, even if exports in 2012 held up rather well. External imbalances will remain a source of vulnerability, which has in recent years been mitigated by a relatively stable inflow of foreign direct investments financing most of the deficit. It will be a key challenge for the government to increase or even maintain the past level of FDI inflows.

FDI inflows are not only crucial in terms of balance of payments but also essential for transferring knowledge, boosting productivity and diversifying the rather narrow production and export base that leaves the economy vulnerable to external shocks. Decisive and urgent action is required to increase the country's attractiveness as an investment destination by improving the business environment, the perception of which has recently deteriorated further due to the accumulation of arrears and the de-facto renationalisation of the energy distribution company. Beyond the limited on-going privatisation attempts, economy-wide competitiveness would benefit from further improving the regulatory framework, accelerating the resolution of the long standing issue of property rights, and pushing ahead with product market reforms notably in the energy sector so as to ensure a reliable supply of electricity. Together with raising the quality of the education system and up-skilling the labour force, such reforms could contribute to alleviating the persistently high unemployment rate as well as supporting economic diversification.

Public finances are characterised by pernicious imbalances. The general government deficit is stable at 3.5% of GDP which is too high to achieve debt sustainability and the statutory ceiling for public debt (60% of GDP) was breached in 2012. While the explicit aim of the 2013 budget is to stimulate economic growth which lifts the debt-to-GDP ratio to 63.8%, the stated priority for 2014-2015 is fiscal consolidation. This implies a narrowing of budget deficits that would initiate a reduction of public debt to 63.4% of GDP at the end of 2015. Fiscal predictability, which has been a recurrent issue due to the overestimation of revenues as well as weak and uncertain tax collection in the past, is further threatened by the repeal of the statutory debt ceiling last year. Ensuring the credibility of the sustained but gradual effort of fiscal adjustment needed to embark on a path towards debt sustainability calls for the rapid adoption of an efficient anchor, such as a clear and transparent fiscal rule, which would also lower financing costs for both the public and the private sector. The composition of expenditures should also be guided by a pro-growth vision, avoiding the recent practice of compensating the downward trend in the revenue-to-GDP ratio with capital spending cuts and that the projected consolidation in 2014-2015 will be based exclusively on lower capital expenditure. Privatisation receipts should also be used to reduce debt, repay accumulated arrears and create fiscal space to allow more growth-enhancing capital spending. Yet, the privatisation process

has recently slowed down, making future estimations of revenues uncertain. While the high public debt hampers macroeconomic stability and sustainable growth, it is also associated with high rollover risks since more than half of it is short term. Its management should be further oriented towards lengthening the outstanding debt profile and lowering the re-financing risks.

Macroeconomic stability has continued to be enhanced by the monetary policy. Headline inflation has been low and relatively stable within the central bank's 2-4% target range for most of the period since 2006. Such performance was maintained last year when it benefited from the negative output gap, relatively low inflationary pressures from the external side, and well-anchored inflation expectations. In this context, the central bank has had room to support the slowing economy. By July 2012 it had cut the policy interest rate by a total of 125 basis points to 4%, which was further reduced to a historic low of 3.75% on 30 January 2013. This monetary easing has been transmitted effectively to short-term interbank rates. However, monetary flexibility is constrained by the relatively high degree of euroisation of the financial system. Unhedged borrowers also pose an indirect market risk to the banking system in the event of currency depreciation.

It is important that stability-oriented fiscal and monetary policies are complemented by well-designed and properly implemented structural reforms in order to boost growth prospects in the future. Efforts need to be stepped up to reinforce the legal system, strengthen the rule of law, fight corruption and enhance human capital as well as transport and energy infrastructure.

1.2. ECONOMIC OUTLOOK AND RISKS

The EFP's macroeconomic scenario projects, somewhat optimistically, that economic activity will re-accelerate quickly after the slowdown in 2012. Already this year, growth is expected to return to the same rate as in 2011 (3.1%). In the subsequent two years, GDP growth is expected to reach 4%. This GDP profile is based on strong export growth, particularly in 2013 when exports are seen to surge by 8.5% similarly to their increase recorded in 2012. This seems somewhat optimistic as the immediate international environment is not conducive to export-led growth, at least not in the short term. The Commission forecasts continuing declines in Italian and Greek imports in 2013 and the EFP itself projects that Albania's relevant foreign markets will contract by 0.5% in the same year. The programme alleges that Albania's international competitiveness has improved "in terms of quality, cost and better geographic distribution". However, the real effective exchange rate has been stable which suggests that price competitiveness has remained roughly unchanged. The other main alleged driver of GDP growth in the programme period is consumer spending which is seen to accelerate from 0.4% growth in 2012-2013 to around 3% in 2014-2015. The magnitude of this acceleration seems to be on the high side because consumption will also be affected by the downside risks to projected export growth. Furthermore, the emerging surplus on the government's primary fiscal balance (see below) suggests that consumption growth will receive little support from the public sector. A reversal of the declining trend for remittances could support consumer spending, but will require a significant upturn in the economies of the main economic partner countries. Overall, the programme's growth projection appears optimistic. Certainly, the recent monetary easing and a modest recovery in confidence in the latter half of 2012 is providing some support to economic activity and should allow for a modest pick-up of growth in the programme years. On the other hand, it is likely that economic activity will be held back by subdued external demand and relatively tight credit conditions against the background of the high and rising ratio of non-performing loans.

Table II.1.1:

Macroeconomic developments and forecasts

	2011	2012	2013	2014	2015
Real GDP (% change)	3.1	1.5	3.1	3.9	4.1
Contributions:					
- Final domestic demand	2.8	-1.7	1.3	2.8	2.9
- Change in inventories	0.0	0.0	0.0	0.0	0.0
- External balance of goods and services	0.3	3.2	1.8	1.1	1.2
Employment (% change)	n.a.	n.a.	n.a.	n.a.	n.a.
Unemployment rate (%)	n.a.	n.a.	n.a.	n.a.	n.a.
GDP deflator (% change)	3.0	2.2	1.4	0.5	0.5
CPI inflation (%)	3.5	2.0	3.0	3.0	3.0
Current account balance (% of GDP)	-12.1	-10.3	-9.5	-8.2	-7.1

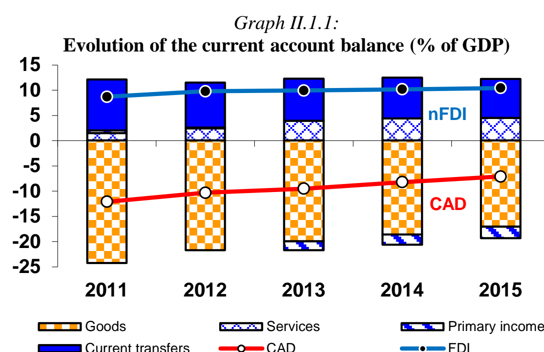
Sources: Economic and Fiscal Programme (EFP) 2013

Inflation is expected to remain in the middle of the central bank's target range. It is reasonable to assume that the domestic economy will generate only low inflationary pressures in view of a substantial negative output gap which is expected to close gradually after 2015. Although the authorities may overestimate potential growth and the size of the current output gap, this is counterbalanced, in terms of inflationary pressures, by the optimistic growth projection. The exchange rate vis-à-vis euro and dollar is assumed to remain stable and the oil price to be declining slightly. On balance, the projection of 3% average annual consumer price inflation in the programme years appears realistic also in view of the central bank's recent track record of keeping inflation within its 2-4% target range.

Albania's long-standing current account deficit is seen to narrow by about 1 percentage point of GDP per year. The deficit has been above 10% of GDP since 2007, reaching a peak of 15% in 2008. The authorities estimate the deficit to have declined to 10.3% of GDP in the context of the 2012 growth slowdown and project a further gradual narrowing to 7.1% in 2015. It is mainly seen to be brought about by a smaller deficit in the balance for goods and services. Export values are projected to increase at an annual average of 8.3% whereas the corresponding increase of import values has been set at 4.2%. This projection may not appear implausible against the background of Albania's international trade performance over the past ten years. However, it does not seem to have been fully taken into account that the outlook for exports to Albania's most important trading partner (Italy) has deteriorated which makes the current account projection look somewhat optimistic.

Graph II.1.1:

Evolution of the current account balance (% of GDP)



Source: Economic and Fiscal Programme (EFP) 2013, ECFIN calculations

Remittances provide an important source of financing the trade deficit. The large structural deficit on the balance for goods and services has traditionally been coupled with a substantial net inflow of transfers, particularly of remittances by Albanians working abroad. Net transfers are estimated to have amounted to 9.0% of GDP in 2012. They are projected to remain relatively stable in absolute terms, but to decline to 7.7% as a share of GDP by 2015. However, just like for exports, the

adverse economic conditions in Italy and Greece may harm remittances more than projected. This may make them decline not only as a ratio of GDP, but also in absolute terms, as they have done in 2008-2012.

A steady inflow of foreign direct investments is crucial for Albania in terms of balance of payments and economic development. The EFP expects FDI inflows to remain relatively dynamic. Their share of GDP is projected to increase gradually from 9.9% in 2012 to 10.4% in 2015. The downside risks associated with this projection appear to be relatively high. One risk is the difficult economic situation of the main trading partners which are also the main sources of FDI. A second risk, as pointed out by the EFP itself, is the dependence of FDI inflows on a continuation of the privatisation process. Third, Albania's attractiveness as a destination for FDI will suffer further if the investment climate deteriorates relative to alternative destinations in the region. Recently, the accumulation of arrears and the de-facto renationalisation of the energy distribution company CEZ have hurt Albania's reputation as an investment destination. Finally, renewed turmoil in international financial markets could impinge negatively on FDI inflows. If such inflows should decline, it could result in a significant reduction of foreign exchange reserves given that FDI inflows are financing the whole current account deficit in the programme period according to the EFP. In view of these downside risks to FDI inflows, the authorities are encouraged to implement reforms which can improve Albania's attractiveness to foreign investors, including by strengthening the rule of law and solving the long-standing issues of property rights and VAT reimbursement.

Table II.1.2:
Financial sector indicators

	2008	2009	2010	2011	2012
Total assets of the banking system, mEUR	1,917	2,287	2,301	2,287	2,471
Foreign ownership of banking system					
Credit growth	43.8	20.5	8.6	11.7	7.4
Bank loans to the private sector %	100.0	100.0	100.0	100.0	100.0
Deposit growth	14.8	-0.1	15.5	14.5	9.4
Loan to deposit ratio	0.56	0.67	0.63	0.62	0.61
Financial soundness indicators					
- non-performing loans	4.7	9.1	12.6	17.0	21.7
- core capital to risk weighted assets	16.3	15.3	14.5	14.3	-
- liquid to total assets	43.0	28.0	27.0	27.5	-
- return on equity	14.8	2.4	7.3	2.0	5.2
- forex loans to total loans %	73.0	70.3	68.6	67.5	64.6

Sources: National Central Bank, Ecowin/Reuters

The banking sector is clearly marked by the economic slowdown and is tightening credit standards. Private sector credit growth slowed to 5.5% year-on-year in September 2012 and bank lending to households was actually declining. The currency composition of bank lending continued to shift towards the domestic currency, but the foreign exchange component still represented 64% of total bank loans in September 2012. The shift is explained by banks' growing reluctance to extend foreign exchange loans to the private sector and by declining demand for such loans, particularly from the corporate sector. On the deposit side, the share of foreign-exchange-denominated deposits is

trending upwards and represented 52% of total deposits in September 2012. This trend is allegedly driven by repatriations of euro-deposits by Albanian emigrants in Greece.

The financial system appears to be relatively resilient, but is under pressure from a rising number of non-performing loans (NPLs). Generally, banks remain well-capitalised and highly liquid. The predominantly foreign-owned sector had a capital adequacy ratio of 15.9% in September 2012, i.e. well above the required minimum and slightly higher on a year-on-year basis. The main concern regarding financial stability is the deteriorating quality of bank loans. NPLs as a share of total loans increased by 4.3 percentage points year-on-year to 22.7% at the end of September 2012. A stress test carried out by the central bank has shown that adverse events, like a drop in GDP growth or a depreciation of the national currency, may require the recapitalisation of individual banks or of the banking sector as a whole. While the risk of contagion from Greek parent banks to Albanian subsidiaries has declined, the exposure to Italian banks continues to be "relevant" in the words of the EFP. Overall it seems fair to assess that, even though the financial system appears resilient, the risks to financial stability have not entirely disappeared.

1.3. PUBLIC FINANCE

The general government deficit in 2012 has turned out to be higher than planned in the original budget. The fiscal deficit amounted to 3.4% of GDP which is slightly below the 3.5% deficit in 2011, but higher than the 3.0% target in the budget from December 2011 which had still been maintained in the government's "Macroeconomic and Fiscal Framework 2013-2015" from July 2012. However, following a significant shortfall in collected revenues, a budget revision in December 2012 increased the deficit target to 3.7% of GDP. Total revenues fell by 0.2% year-on-year and by 1 percentage point as a share of GDP (to 24.5%) and they were 7.3% lower than in the original budget. Total expenditures fell by 0.3% year-on-year and by 1.1 percentage point as a share of GDP (to 27.9%). The overall decline of expenditures was solely achieved by lowering capital spending by 14.2% compared to 2011 (24.6% compared to the original 2012 budget) to 4.5% of GDP. Current expenditures actually increased by 2.9% compared to 2011. Overall, the budget implementation in 2012 was characterised by cutting public investment sharply to provide at least a partial offset to disappointing tax revenues which otherwise would have lifted the fiscal deficit to about 5% of GDP, *ceteris paribus*. Nevertheless, capital spending as a share of GDP remained above the size of the overall fiscal deficit. Overall, it seems fair to say that the budget implementation in 2012 suggests that budget preparation and execution provide room for improvement.

Going forward, consolidation of public finances focuses on the deficit while it has abandoned debt targeting. The EFP presents the fiscal target for the programme period simply as the projected deficits for 2013 (3.5% of GDP), 2014 (2.4% of GDP) and 2015 (2.2% of GDP). In addition, the fiscal framework maintains the principle that the budget balance net of capital expenditures should not be negative ("golden rule"). However, the fiscal strategy has abandoned the statutory ceiling for public debt which had been introduced in 2008 and had capped the permitted level of public debt at 60% of GDP. The ceiling was repealed by parliament in December 2012 when the debt ratio had started to exceed 60% of GDP.

The explicit aim of the 2013 budget is to stimulate economic growth and to offset negative effects from the external environment. The 2013 Annual Budget Law, adopted on 17 December 2012, is based on the assumption of 3.1% real GDP growth and 4.5% nominal GDP growth. Compared to the fiscal outturn in 2012, revenues are projected to increase by 9.3% and by 1.1 percentage point of GDP (to 25.6%). Expenditures are projected to increase by 9.2% and by 1.2 percentage point of GDP (to 29.1%). This means, that the fiscal deficit is budgeted to increase slightly from 3.4% of GDP in 2012 to 3.5% of GDP in 2013 which lifts the debt-to-GDP ratio to 63.8% at the end of the year. The deficit

on the primary balance of general government in 2012 (-0.5% of GDP) is projected to turn into a small surplus in 2013 (0.1% of GDP).

Like in previous years, revenue growth is again seriously over-estimated. Firstly, the optimistic growth rate for real GDP in 2013 is unlikely to materialise. Lower GDP growth would automatically translate into lower-than-projected tax revenues. Secondly, even if the EFP's macroeconomic projection should materialise, it is unlikely that revenues will increase by 9.3% without higher tax rates and/or significant improvements in tax collection. VAT revenues, for instance, are projected to increase by 10.0% year-on-year which is clearly inconsistent with a projected 0.9% increase in nominal private consumption expenditure and a 2.6% increase in the value of imports. A new VAT law is currently in the drafting stage and is foreseen to enter into force "not earlier than mid-2013", but increased revenues are not among its objectives. The trend in the past two years was for overall revenues to decline by about 1 percentage point of GDP per year. There is no ground to expect a sudden reversal of this trend to an increase of the same magnitude.

Table II.1.3:

Composition of the budgetary adjustment (% of GDP)

	2011	2012	2013	2014	2015	Change: 2012-15
Revenue	25.5	24.7	25.6	25.6	25.4	0.7
- Taxes and social security contributions	20.7	19.5	20.1	19.9	19.9	0.4
- Other (residual)	4.8	5.2	5.5	5.7	5.5	0.3
Expenditure	29.0	28.4	29.1	28.0	27.6	-0.8
- Primary expenditure	25.8	25.3	25.5	24.4	24.0	-1.3
of which:						
Gross fixed capital formation	6.2	5.5	5.8	4.7	4.2	-1.3
Consumption	8.9	8.5	8.6	8.4	8.3	-0.2
Transfers & subsidies	10.5	10.6	10.7	10.6	10.6	0.0
Other (residual)	0.2	0.7	0.4	0.7	0.9	0.2
- Interest payments	3.2	3.1	3.6	3.6	3.6	0.5
Budget balance	-3.5	-3.7	-3.5	-2.4	-2.2	1.5
- Cyclically adjusted	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Primary balance	-0.3	-0.6	0.1	1.2	1.4	2.0
Gross debt level	59.5	61.9	63.8	63.8	63.4	1.5

Sources: Economic and Fiscal Programme (EFP) 2013, ECFIN calculations

The counter-cyclical orientation of the 2013 budget is reflected on the expenditure side. The budgeted increase of expenditures by 9.2% would represent a significant fiscal expansion if revenues should continue their recent trend and, thereby, fall far short of budget. In 2013 there is again a high risk that a revenue shortfall and the need to contain the budget deficit will force a downward adjustment of expenditures, particularly of capital spending. This implies also a risk that the deficit target of 3.5% of GDP and the minimum target for capital spending ("golden rule") may conflict with each other. Capital expenditures are budgeted to increase by 17.0% year-on-year which would raise their share of GDP from 4.5% in 2012 to 5.0%. But if the government again cuts capital expenditure sharply in order to contain the overall budget deficit, there is a risk that capital spending as a ratio of GDP will fall below the fiscal deficit expressed as ratio of GDP, i.e. the "golden rule" of fiscal policy would be breached.

Beyond the current year, the stated priority of fiscal policy is to consolidate public finances in order to ensure their sustainability. The projected narrowing of the budget deficit (to 2.4% of GDP in 2014 and

2.2% in 2015) is based on a macroeconomic scenario in which real GDP increases by around 4% and nominal GDP by around 4.5% in each of the two years. Since interest payments are projected to remain stable at 3.6%, the surplus of the primary balance of general government would increase to the range of 1–1½ % of GDP. The debt-to-GDP ratio would decline by 0.4 percentage points over the two years to 63.4% at the end of 2015. Overall, this scenario can be characterised as a stabilisation of the fiscal situation.

Fiscal stabilisation in 2014-2015 is projected to be achieved through reductions in capital expenditures. Revenues are projected to remain stable as a ratio of GDP in 2014 and to fall marginally by 0.2 percentage points in 2015. Expenditures, on the other hand, are projected to be cut by 1.1 percentage points in 2014 and by 0.4 percentage points in 2015. The decline in total expenditures corresponds almost exactly to the projected cuts in capital expenditures. There are some minor shifts in the projections for the other expenditure items, but they roughly cancel each other out.

The risks associated with the fiscal projection are mainly on the side of higher deficits and debt. These risks relate primarily to the revenue side of the budget. A stable revenue-to-GDP ratio is normally a plausible projection in the absence of major changes in tax rates and the tax regime. However, in view of Albania's underperforming tax revenues in recent years, a stabilisation of the revenue-to-GDP ratio is likely to require an enhanced effort by the administration to collect due taxes. If this is not forthcoming, there is a risk that the trend decline of the revenue-to-GDP ratio will continue. Another risk concerns the macroeconomic scenario. Whereas nominal GDP growth is projected relatively plausibly at 4.5% for 2014 and 2015, the projection of 4% real annual GDP growth is on the optimistic side. If real growth turns out to be lower than projected, employment and profits will be lower than assumed which would impact negatively on government revenues. Disappointing real growth would also tend to raise government expenditures as a ratio of GDP due to higher social spending.

The budgetary risks are likely to hurt growth-enhancing capital spending. The structure of Albania's public expenditure has a relatively high proportion of non-discretionary spending. Therefore potential saving measures are likely to fall on traditionally flexible spending items, particularly capital investment. This would hamper the growth-enhancing aspect of the public finance strategy and be detrimental to the country's medium- and long-term development needs.

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

	2011	2012	2013	2014	2015
Gross debt ratio [1]	**59,5**	**61,9**	**63,8**	**63,8**	**63,4**
Change in the ratio	1,0	2,4	1,9	0,0	-0,4
Contributions [2]:					
1. Primary balance	**0,3**	**0,6**	**-0,1**	**-1,2**	**-1,4**
2. "Snow-ball" effect	**-0,2**	**1,0**	**0,5**	**0,4**	**0,3**
Of which:					
Interest expenditure	3,2	3,1	3,1	3,1	3,1
Growth effect	-1,7	-0,9	-1,8	-2,4	-2,5
Inflation effect	-1,7	-1,2	-0,8	-0,3	-0,3
3. Stock-flow	**10,2**	**8,5**	**7,8**	**4,6**	**3,4**

Notes:

[1] End of period.

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

Source: Economic and Fiscal Programme (EFP) 2013, ECFIN calculations

Public debt is associated with elevated re-financing risks. Almost all of the public debt (61.9% of GDP at the end of 2012) relates to the central government. More than half it, viz. 56.8%, constitutes domestic debt. The foreign debt is predominantly denominated in euro (57.8%) and relates mainly to development projects. More than half of total public debt is short-term which implies significant rollover risks. The average maturity of domestic debt was 386 days in 2012 which the government plans to extend to 445 days in 2013. Domestic debt was predominantly held by commercial banks (66.6% at the end of September 2012). The associated rollover risk may currently be mitigated by the ample liquidity of commercial banks and their limited lending opportunities.

1.4. STRUCTURAL REFORMS

Reforms need to be accelerated to realise medium-term growth potential. In particular, further measures are needed to improve the business environment by strengthening the legal system and the enforceability of contracts, developing administration and addressing the issue of property rights. The informal economy and weak tax collection remain a challenge. It is imperative to improve infrastructure, especially in energy and transport, while persistently high unemployment and skills mismatches call for upgrading the skills of the labour force and enhancing the functioning of the labour market. The lack of diversification of the production base in terms of sectors and export markets leaves the economy vulnerable to external shocks. The EFP correctly identifies the broad objectives, but concrete measures remain piecemeal and mostly backward looking; as such they fail to provide a comprehensive answer to the challenges facing the country.

Measures to enhance the business climate are unambitious. They include a further reduction of the administrative burden to start a business and the implementation of the European Charter for SMEs. A recently enacted law on administrative courts aims to ensure for citizens and businesses a due legal process within a reasonable timeframe, but its implementation is still pending. The fight against economic crime and corruption is seen as a strategic priority; however, no wide-ranging measures are proposed in the EFP to address the problem. The reform of public administration will involve,

similarly to the proposal already made last year but not yet implemented, a link between civil servants' salary and their evaluation and training.

Energy is in the focus of several initiatives. This is welcome given the country's extensive reliance on hydropower whose output often fails to meet domestic demand. Steps are being taken to further liberalise the electricity market for consumers, scheduled to be completed by 2015. The electricity production market is also opening up, with concessions being granted to private operators and four hydro power plants being privatised. The planned construction of interconnection networks with neighbouring countries, especially the former Yugoslav Republic of Macedonia and Kosovo(5) would enhance energy exchange capacities and security of supply, but the EFP does not contain a clear timing or budget allocations in this respect. The recent forced nationalisation of the electricity distributor risks undermining efforts to provide adequate electricity supplies deteriorates the investment climate and might constitute a drain on public resources. In order to ensure the long-term stability of the sector, the regulatory and legal framework governing the relations between key players needs to be reviewed.

Attracting FDI is crucial but gets limited attention. Promoting foreign direct investments would help finance the sizeable current account deficit and support technology transfer and innovation. Apart from mentioning limited on-going privatisation attempts (of, among others, Albpetrol(6) and Albtelecom), recalling the relatively favourable framework conditions thanks to broad macroeconomic stability and the development of economic zones, the EFP gives relatively little consideration to this area. Against this background, the projected increase in FDI flows might turn out to be optimistic and is in any event not further explained.

Banking system regulatory framework is set to strengthen. One of the most important projects still in course is the implementation of the Basel II requirements for risk assessment and management. Once the new capital adequacy regulation is approved, banks will be given the necessary time to adapt their internal system to the new requirements and build the indispensable human capacity.

Furthering employment and improving the labour market remains a significant challenge. The unemployment rate has been stubbornly high in recent years (exceeding 13 %), despite economic growth. The proportion of long term unemployed remains high, while the informal economy is still an important provider of jobs. Shortcomings in education and training are significant. The EFP falls short of addressing these challenges as it recalls to a large extent existing labour market services but fails to put forward major new initiatives, with the exception of plans to step up labour inspections to combat informal employment.

(5) This designation is without prejudice to positions on status, and is in line with UNSCR 1244 and the ICJ Opinion on the Kosovo Declaration of Independence.
(6) The privatisation has been postponed until after the June 2013 elections

1.5. ANNEX: OVERALL ASSESSMENT OF PROGRAMME REQUIREMENTS

Albania's Council of Ministers approved the programme on 30 January 2013 and submitted it to the European Commission on 31 January. The programme is in line with the annual budget for 2013, the Macroeconomic and Fiscal Framework 2013-2015, the Medium Term Budget Programme 2013-2015 as well as the National Strategy for Development and Integration. The programme would have benefited from establishing a closer link to the country's accession process, such as the assessments in the European Commission's Progress Reports.

Macro framework

The programme presents a reasonably comprehensive picture of past developments which could, however, have been drafted clearer. Almost all the relevant data are covered, but weaknesses remain, not least regarding the labour market and wage statistics. The macroeconomic framework, albeit optimistic, is sufficiently comprehensive. Links between the macroeconomic scenario and the structural reform measures could have been made more explicit. In light of the many risks and the heightened uncertainty, the authorities could have considered complementing the macroeconomic projections with alternative scenarios.

Fiscal framework

The fiscal framework is not fully consistent with the presented macroeconomic scenario and seems rather optimistic. The plausibility of revenue and, to a lesser extent, expenditure projections would have benefited from more details and explanations on how they have been derived. More concrete information on envisaged fiscal policy measures and their budgetary impact would also have been desirable. Fiscal data are not in full compliance with ESA95 standards.

Structural reforms

The structural reform framework could have been made more coherent and comprehensive. The programme would have benefited from better focusing on the major structural reforms and providing more details and a clear timeline for them, along with estimates of their budgetary impact.

2. BOSNIA AND HERZEGOVINA

2.1. EXECUTIVE SUMMARY

After a mild recovery, the economy has re-entered into negative territory in 2012. Following a 1% real growth in 2010 and 2011, output growth is estimated to have turned negative in 2012, partly due to the deterioration of the external environment and partly to severe climatic conditions in both winter and summer. Tight lending conditions, falling employment and the implementation of fiscal consolidation measures had negative repercussions on domestic demand. At the same time, the worsened external environment – due to the EU sovereign debt crisis – resulted in falling exports, which, albeit accompanied by shrinking imports, led to a negative contribution of net exports to growth. The gradual recovery targeted by the programme over the medium-term horizon, is based on progressively strengthening domestic demand, while the negative contribution of net exports is set to increase.

After a sharp crisis-led adjustment in 2009-2010, external imbalances have been rising. The current account deficit narrowed significantly in the peak of the crisis, initially driven by shrinking imports, due to falling domestic demand, and thereafter by the favourable evolution of metal prices, fuelling nominal export growth. However, the narrowing of the current account deficit has been reversed since mid-2010 and external imbalances have started to grow again. This deterioration was mainly driven by the expansion of the trade deficit, reaching 32.4% of GDP in 2012, as export growth slowed in 2011 and even turned negative in 2012, influenced by the worsened external environment. The narrowing in 2013 and then stabilisation of the current account deficit foreseen in the programme might be difficult to achieve. The trade balance could deteriorate more than foreseen due to structural problems related to weak private sector productivity which limits export growth potential while imports will grow alongside the expected domestic demand recovery.

Fiscal sustainability needs to be anchored in a credible medium-term strategy. After the gradual fiscal consolidation in 2010-2011, which followed the sharp deterioration in 2009, budgetary imbalances increased in the course of 2012. The downturn in economic activity reduced the tax base and the budget revenue-to-GDP ratio fell to 39.9%, while expenditures expanded further. Thus the budget deficit increased to 1.5% of GDP, from 0.7% of GDP a year earlier, according to the EFP. The country had to resort to the IMF and a new Stand-By Arrangement was agreed. The authorities' ambitious fiscal strategy over the medium term aims at an expenditure-led fiscal consolidation of 2.5 percentage points of GDP by 2015, but it is subject to significant risks. The foreseen cuts in current spending require the adoption and implementation of structural fiscal reforms which cannot be taken for granted, given the country's track record, while spending pressures may increase in the run-up to the general elections scheduled in 2014.

The main fiscal challenge stems from the composition of expenditure. Consolidated general government expenditures have been increasingly dominated by current spending even before the crisis, while their share rose even further -at close to 90%- during the economic downturn at the expense of capital outlays, which served as a fiscal buffer. The public sector wage bill of about 13% of GDP exceeds by a wide margin the region average, partly due to the complex constitutional set-up of the country and as a result of unsustainable wage hikes in the pre-crisis period. Social spending - accounting for over 17% of GDP- also exceeds the regional standards, with a significant part related to the 1992-1995 war. The authorities recognise the need for decisive actions to reduce the large government size and to improve the expenditure composition and claim to have put these goals at the centre of their fiscal strategy.

A dysfunctional labour market, combined with low quality of the human capital, is an impediment to medium-term growth. Unemployment, which already reached 40% in the pre-crisis period, has further deteriorated since mid-2009 -with the officially registered unemployment rate climbing up to 44.5% at end-2012-, while participation in the labour market is extremely low, with an activity rate of 44%. The crisis has had a particularly strong incidence on low-skilled workers and has raised youth unemployment to over 60%. Major shortcomings that hamper the functioning of the labour market include a high labour taxation, poorly targeted social transfers and benefits that discourage active job-seeking and skills-mismatch vis-à-vis the needs of the labour market. In addition, slow progress in structural reforms (privatisation, business environment, etc.) is not conducive to job creation. The programme recognises the need for labour market reforms but focuses on some active labour market policies while decisive actions are required to address structural rigidities.

Private sector development is hampered by an unfavourable business environment. Bosnia and Herzegovina lags behind its peers as seen by its ranking in various international surveys. Starting a business, enforcing contracts, access to financing, and political instability are considered to be among the most problematic factors for doing business in the country. The authorities acknowledge the importance of creating a more favourable business environment and foresee a number of adequate measures in this regard, such as the planned establishment of one-stop-shop business registration system. Still, decisive actions for improvement of the weak business environment are needed for a more dynamic private sector development.

2.2. ECONOMIC OUTLOOK AND RISKS

The authorities expect a gradual recovery over the medium-term. GDP growth is projected to reach 1.3% in 2013 and to accelerate to 3.6% in 2014 and 3.9% in 2015. The recovery will be mainly domestic demand-driven. The gradually accelerating private consumption and surging investment demand will be accompanied by rising imports, which will cause a negative net contribution of the external sector to the economic growth during the whole programming period. The rising external demand is expected to trigger faster expansion of the export-oriented branches of the processing industry, in particular the metal, chemical, and wood processing sectors. The labour market will be positively influenced by the higher economic activity and employment will rise from 2014.

Table II.2.1:

Macroeconomic developments and forecasts

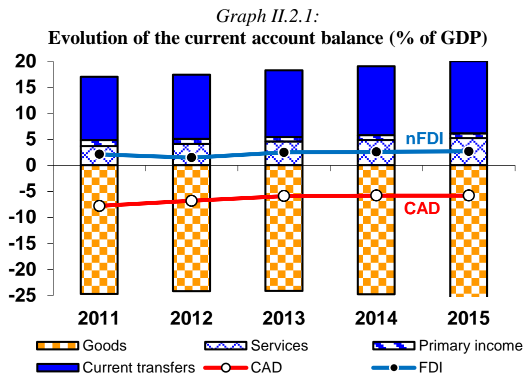
	2011	2012	2013	2014	2015
Real GDP (% change)	1.4	0.2	1.3	3.6	3.9
Contributions:					
- Final domestic demand	1.7	-0.6	1.5	4.4	5.1
- Change in inventories	0.0	0.0	-0.1	0.0	0.0
- External balance of goods and services	-0.3	0.7	-0.2	-0.8	-1.2
Employment (% change)	-3.2	-0.3	-0.3	1.6	2.2
Unemployment rate (%) LFS	27.6	28.0	28.2	27.5	26.6
GDP deflator (% change)	1.2	2.4	2.5	2.0	2.2
CPI inflation (%)	3.7	2.2	2.1	1.9	2.1
Current account balance (% of GDP)	-7.8	-6.8	-5.9	-5.8	-5.8

Sources: Economic and Fiscal Programme (EFP) 2013

Although broadly plausible, the macroeconomic scenario is subject to downside risks. Risks are both external and domestic. External risks stem especially from the potential deterioration (delayed recovery) of the international and EU economic environment and from the evolution of international commodity prices. However, domestic risks should not be underestimated. Political difficulties as experienced in the recent past and delays in structural reforms affect negatively the competitive position of the economy, not least due to the deterioration of the business environment perceived by potential investors. In addition, the inflation scenario might be somewhat benign given the non-negligible increase of domestic demand -alongside the rising employment and wages- projected for 2014-2015.

Strongly surging investments is seen as the engine of growth over the medium-term horizon. Investment-to-GDP ratio has fallen sharply from over 28% in the pre-crisis period to less than 20% in 2012, a relatively low level for a transition economy. Given an expected improvement of the external environment, a gradual loosening of credit conditions, as well as improved investor confidence, private investment is projected to expand at double digit growth rates towards the end of the programming period. Such evolution would be of crucial importance for strengthening private sector's competitiveness and expanding the narrow production capacity after four consecutive years of disinvestment. However, the investment profile is subject to downside risks, as it is strongly dependent on the successful implementation of the authorities' intentions for improvement of the unfavourable business environment.

Graph II.2.1:
Evolution of the current account balance (% of GDP)



Source: Economic and Fiscal Programme (EFP) 2013, ECFIN

External vulnerabilities are set to increase further in the near and medium term. Following a drop in 2012, exports are expected to expand at accelerating rates (to reach 7% in real terms in 2015), based on a strengthened economic growth in the region and in the EU (i.e. the country's main exports markets). However, significant downside risks remain, related to a potential delayed recovery of the EU, as well as weak private sector productivity. The authorities intend to increase further Bosnia and Herzegovina's trade integration with the EU while a geographical diversification of exports towards countries with higher external demand might bring benefits. Moreover, the export growth projection might prove optimistic, given the uncertainties around the future country's exports to Croatia following its entry into the EU[7], even though the recently undertaken measures will undoubtedly reduce the expected adverse impact. As the imports of goods are projected to accelerate steadily -alongside the recovering domestic demand-, the foreign trade gap is expected to expand further in a trajectory far from sustainable. The projected stabilisation of the current account deficit at about 6% of GDP faces significant risks as the expected hike of exports of services and of net current transfers might prove overly optimistic. The expected FDI inflows -due to cover over 40% of the current account deficit- are highly dependent on investors' sentiment, as they are projected to come mainly from several greenfield investment projects in the energy sector. The foreseen decline of foreign exchange reserves, given its magnitude, could potentially impact on macroeconomic and financial stability and thus requires careful attention and the development of policy measures on the part of the authorities.

Financial sector revival is crucial for stronger economic performance. The financial sector has not been very supportive to growth in recent years. On the one hand, foreign parent banks have decreased their exposure to local subsidiaries during the crisis, while, on the other, the banking system suffered a

(7) Related to the failure of domestic producers to meet the quality standards of the Single Market.

deterioration of the asset quality with the share of non-performing loans to total loans reaching 13.5% at end-2012. Moreover, private sector credit has been negatively affected by the high financing needs of the government, which crowded out private investments. Still, there are no immediate financial stability concerns. Banks are well capitalised, and liquidity and profitability indicators do not signal actual problems. Alongside the gradual economic recovery, the banks are expected to loosen the lending conditions, thus supporting faster economic expansion. The programme projects a gradual acceleration of the credit growth, from around 4% currently to 15% in 2015, while annual deposit growth is estimated to continuously lag behind and the loan-to-deposit ratio – reaching 119.7% at end-2012 – to further increase, thereby implicitly assuming that the banking sector will keep its growth model, based on foreign financing (mainly from the parent banks). In the light of still fragile recovery of the financial system in the EU and still continuing deleveraging pressures in the EU banks, risks are clearly on the downside.

Table II.2.2:
Financial sector indicators

	2008	2009	2010	2011	2012
Total assets of the banking system, mEUR	10,798	10,742	10,828	11,196	11,416
Credit growth	28.4	5.4	-0.9	5.6	4.9
Bank loans to the private sector	57.9	57.5	56.9	57.2	
Deposit growth	15.4	-4	4.7	2.6	2.6
Loan to deposit ratio	1.1	1.2	1.1	1.2	1.2
Financial soundness indicators					
- non-performing loans	3	4.5	9.1	12	12.7
- net capital to risk weighted assets	16.0	16.3	15.6	15.9	17
- liquid to total assets	32.2	30.0	29.6	27.1	24.9
- return on equity	3.0	1.4	-3.0	3.5	4.3
- forex loans to total loans	*72.8*	*73.3*	*72.0*	*67.8*	*63.30*

Sources: National Central Bank, Ecowin/Reuters

2.3. PUBLIC FINANCE

The economic crisis has revealed the weaknesses of Bosnia and Herzegovina public finance. In the pre-crisis period, the consolidated budget has run surpluses positively affected by high economic growth and the introduction of VAT in 2006. However, instead of financing growth-enhancing activities additional fiscal space has been used for unproductive purposes such as high increases of public sector wages, generous social spending and a further expansion of the already large public sector. Following a sharp revenue contraction in the crisis period, the authorities had to implement painful expenditure cuts often facing strong resistance from budget users and beneficiaries. Fiscal consolidation efforts delivered some results and the significant consolidated budget deficit was reduced gradually in 2010-2011. Still, even after several years of fiscal consolidation there remains an ample room for streamlining Bosnia and Herzegovina's public sector. Putting public finances on a more sustainable basis requires a further rationalising of current expenditures, particularly with respect to spending on wages and social transfers which remain high in comparison with the EU and regional peers.

Fiscal imbalances have grown again in 2012, alongside the worsened external environment. The economic downturn led to a slight decline of total revenue-to-GDP ratio, which coupled with growing total spending resulted in a twofold year-on-year expansion of consolidated budget deficit to 1.5% of GDP, according to the EFP. Consequently, total public debt rose by 7%, accounting for 37% of GDP at end-2012. Against the background of rising fiscal and external imbalances and growing concerns

for macroeconomic stability, the authorities elaborated in mid-2012 an economic programme[8] which aimed, inter alia, at safeguarding fiscal sustainability through further fiscal consolidation and structural fiscal reforms.

The main objectives of the medium-term fiscal strategy are the reduction of the government size and improvement of expenditure composition. To this end, the programme foresees an exclusively expenditure-led gradual fiscal consolidation, aiming to improve the general government balance by 2.5 percentage points of GDP – from a budget deficit, accounting for 1.5% of GDP in 2012, to a surplus of 1% of GDP in 2015. The projected adjustment of the overall expenditures -of some 5.5 percentage points of GDP- seems to be overly ambitious, while the projected dynamics of revenues is surprisingly cautious. Total revenue-to-GDP ratio is expected to decline on average by 1 percentage point annually, due to unfavourable developments in all revenue categories, which is not consistent with the macroeconomic scenario and the intended measures for tax base broadening. The improvement of the expenditure composition is planned to be achieved by stronger adjustment of current expenditures and only lower decline of capital outlays. In line with the projected gradual fiscal consolidation, public debt is expected to follow a downward path, from 37% of GDP in 2012 to 30.9% of GDP at the end of the programme horizon.

Box: The budgets for 2013

The State and the Entities adopted their 2013 budgets before the expiration of the previous budget year in a welcome improvement compared with previous practices of late budget laws endorsement and temporary fiscal arrangements, which weakened not only the reliability of public finances but also the planning and decision-making of economic agents.

The main consolidation measures are on the expenditure side. They are based on the continuation and intensification of restrictive fiscal policy (as regards public sector employment, wages and social benefits) implemented in recent years. On the revenue side, the budgets foresee further rise of excise duties on tobacco, as well as some measures aiming to increase revenue efficiency.

Table: Main measures in the budget for 2013

Revenue measures	**Expenditure measures**
Increase of excise rates (tobacco) Tax base broadening	Expenditure cuts (-1.5% of GDP) Restrictive public employment policy Freezing of public sector wages at nominal level in the Federation and State-level institutions 10% wage cut in Republika Srpska Social benefits eligibility audits Optimisation of public sector institutions in Republika Srpska

Sources: EFP 2013

The ambitious fiscal strategy faces non-negligible fiscal risks, especially on the expenditure side. Given the country’s track record in implementing unpopular reforms, there is a risk, recognised by the

(8) The programme was supported by a new Stand-By Arrangement with the IMF of about EUR 400 million.

authorities, that the foreseen restrictive measures targeted at lowering of current spending may not be implemented to the planned extent. Moreover, there is a risk that some unforeseen spending rise might appear in 2014, when next general elections are scheduled to take place. The credibility of the strategy would have gained from a comprehensive description of medium-term measures and policy actions beyond 2013, which would support such an adjustment.

Budget planning and fiscal coordination have improved recently but there is a room for further improvement of the quality of public finance. The adoption of the Global Framework for Fiscal Policies 2013-2015 by the Fiscal Council in June 2012 -after a medium-term fiscal programme at the country level has been lacking in the last couple of years- was a welcome development, which inter alia facilitated the timely preparation of the 2013 budgets. The authorities plan to implement a number of measures regarding fiscal statistics and harmonisation of the different methodologies for budget reporting, which is a basic minimum in order to increase the transparency of fiscal policy and to facilitate the analysis and policy-making. Additionally, a set of measures is targeted at improving revenue efficiency, such as the planned legislative changes in the indirect taxation system and in the customs policy. However, the programme remains silent about the excessive labour taxation (and high social contribution rates, in particular), which is a characteristic of the revenue composition in the country, and thus no measures are foreseen to tackle this issue. The authorities recognise the need for addressing the extremely unfavourable expenditure structure and foresee some measures -such as the reform of war-related social benefits-, which are expected to reduce the share of recurrent spending. The latter is seen to open space for growth-enhancing activities, such as investments in infrastructure. However, in contrast with these intentions, the projected capital expenditure-to-GDP ratio is constantly declining over the programming period.

Table II.2.3:

Composition of the budgetary adjustment (% of GDP)

	2011*	**2012**	**2013**	**2014**	**2015**	**Change: 2012-15**
Revenues	40,0	39,9	39,1	37,9	36,9	-3,0
- Taxes and social security contributions	33,9	33,2	32,5	31,8	31,3	-1,9
- Other (residual)	6,1	6,7	6,6	6,1	5,6	-1,1
Expenditure	40,7	41,4	39,9	37,9	35,9	-5,5
- Primary expenditure	40,1	40,7	39,1	37,1	35,2	-5,5
of which:						
Gross fixed capital formation	1,9	2,3	2,2	1,8	1,7	-0,6
Consumption	18,3	18,2	17,5	16,8	16,0	-2,2
Transfers & subsidies	16,6	16,5	16,2	15,4	14,7	-1,8
Other (residual)	3,3	3,7	3,2	3,1	2,8	-0,9
- Interest payments	0,6	0,7	0,8	0,8	0,7	0,0
Budget balance	-0,7	-1,5	-0,8	0,0	1,0	2,5
- Cyclically adjusted	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Primary balance	-0,1	-0,8	0,0	0,8	1,7	2,5
Gross debt level	35,5	37,0	36,6	34,4	30,9	-6,1

Sources:Economic and Fiscal Programme (EFP) 2013, ECFIN calculations

* The consolidated revenue and expenditure figures for 2011 presented in the 2013 EFP are surprisingly low and significantly differ from official data, published by the Central Bank of Bosnia and Herzegovina and the Macroeconomic Analysis Unit of the Indirect Tax Authority. This discrepancy points to the still low quality of budgetary reporting and

The structure and maturity profile of public debt does not pose an immediate concern. Bosnia and Herzegovina's external debt is projected to drop to an estimated 22.3% of GDP in 2015. Given the country's currency board arrangement, the currency structure of external debt is relatively favourable, since 46% of the outstanding stock is denominated in EUR. A large part of the debt stock has been contracted on concessional terms with the average interest rate of all debt being at less than 2%. The maturity structure is quite favourable with the average repayment period of the existing loan commitments estimated at 17 years. Domestic debt -the bulk of which stems from old foreign currency savings and war claims- is projected to decline to 8.6% of GDP in 2015, although significant potential liabilities could arise in the context of solving the issue of property restitution. Public debt servicing, which soared over twofold in recent years and reached over 3% of GDP in 2012, is projected to surge further by over 50% in 2013-2014, thus posing some risks for its refinancing, given the tight fiscal space and the fact that the country has no access to international capital markets.

2.4. STRUCTURAL REFORMS

The economy of Bosnia and Herzegovina faces serious structural obstacles to growth. The main growth bottlenecks are considered to be: i) the large government sector, characterised by low spending efficiency and sizeable interference in the economy, which distorts market signals; ii) the unfavourable business environment, which hampers private sector development; iii) the low quality of the human capital, combined with a dysfunctional labour market; iv) the low production capacity and export base. The programme rightly refers to these as key challenges for the government's economic policy and lists a number of reform intentions to address them.

Privatisation and enterprise restructuring is a largely unfinished task, particularly in the Federation. The privatisation process has stalled during the crisis period. It is relatively well advanced in Republika Srpska, as about 2/3 of the enterprises intended for privatisation have been already sold, while the bulk of the remaining companies are to be transferred to local governments or likely to be liquidated. The Federation is lagging behind, as slightly over 40% of the initial stock of state-owned capital intended for privatisation had been sold by the end of 2012. Looking for some efficiency gains, the authorities aim to relaunch the privatisation process. The state-owned capital of 35 companies will be offered from sale by the RS government in the course of 2013, while the Federation government intends to denationalise 4 state-owned companies. No privatisation intentions beyond 2013 are presented in the programme. Against the background of a largely unfinished privatisation agenda, the privatisation programme is far from ambitious, while decisive actions need to be taken to allow for more efficient allocation of resources.

Decisive actions for improvement of the weak business environment are needed for a more dynamic private sector development. The EFP foresees a number of appropriate measures aimed at improvement of business environment, such as the planned road infrastructure improvements and the establishment of one-stop-shop business registration system in Republika Srpska, among others. Still, there is an ample room for additional measures for improvement of business environment and fostering private sector development, e.g. in the field of FDI attraction.

Structural rigidities impede sustained labour market improvements. The weak performance of the labour market in the crisis period is due to a combination of cyclical and structural factors. While unemployment has been constantly increasing since mid-2009, it was at very elevated levels even in the pre-crisis period. The very high tax wedge and large informal sector limit the effectiveness of the traditional active labour market policies, planned to be implemented by the authorities. Moreover, the

---

suggests possible simultaneous use of different methodologies by the spending units and/or the consolidating institution. The assessment of the medium-term budgetary strategy is based on the projections as provided in the 2013 EFP.

very low participation rate hints a situation of inactivity trap caused inter alia by generous and poorly targeted rights-based benefits. The intended reform of social benefit system -and the introduction of means-tested benefits in the Federation for disabled persons and for civilian victims of war, in particular- is an adequate measure and a step in the right direction to spur labour demand. Additionally, the situation on the labour market will not improve in the long-term without addressing the bottlenecks of the education and vocational training systems. The persistently high youth unemployment, which climbed up to 63.1% in 2012, calls for government intervention in this field(9). However, the authorities do not seem to recognise the importance of this issue, as no measures are foreseen to address gaps in education.

The pension system reform implemented in Republika Srpska in 2012 is paying off; the Federation intends to follow suit in 2013. The new Pension Law in Republika Srpska, aimed at the improvement of the long-term sustainability of the public finances of the Entity, is estimated to have generated savings worth KM 25 million since its entry into force in January 2012. The law introduced a credit system, which is expected to stimulate longer working careers, established penalties for early retirement, and increased retirement age. This way, apart from the direct budget effects, the pension system reform in Republika Srpska is projected to have a positive impact on the labour market as well. After the failure to address this issue in the last couple of years, the Federation is expected to adopt a strategy for pension system reform in 2013.

(9) Bosnia and Herzegovina ranks 106th out of 144 countries when it comes to quality of the educational system, according to the Global Competitiveness Report 2012-2013.

2.5. ANNEX: OVERALL ASSESSMENT OF PROGRAMME REQUIREMENTS

Bosnia and Herzegovina submitted its 2013 Economic and Fiscal Programme, covering the period 2013-2015, on 28 January 2013. The programme, which has been adopted by the Council of Ministers of Bosnia and Herzegovina, is in line with the government's medium-term fiscal strategy. Like in previous years, the programme would have benefited from establishing a closer link to the country's accession process, such as the assessments in the European Commission's Progress Reports. While it broadly complies with the required content and form, it disposes of several weaknesses, including fiscal inconsistencies and data gaps.

Macro framework

The presented macroeconomic framework in the 2013 EFP is broadly plausible even though the growth scenario is somewhat optimistic and subject to some non-negligible downside risks. The medium-term macroeconomic scenario is based on the assumptions of the Commission's autumn forecast as regards the external environment. The credibility of the presented medium-term programme would have benefited from a more thorough analysis of the downside risks and the elaboration of alternative scenarios, considering there are still prevailing uncertainties. The programme does not comply with the Commission's request to provide an assessment of the medium-term sustainability of the country's external position. The recent macroeconomic performance is adequately described and it includes most relevant information available at the time of drafting.

Fiscal framework

The medium-term fiscal strategy remains fragmented as it is an addition of contributions mirroring the division of competencies between different institutions at entity and state level. The fiscal framework lacks a comprehensive description of medium-term measures beyond 2013, which would support the targeted consolidation. The impact of some briefly mentioned measures could have been quantified to a larger extent. The programme refers to some of the European Partnership priorities but mostly does not translate them into concrete policy action. The compilation and presentation of fiscal data is not yet fully in line with GFS methodology, while there are no roadmaps for the introduction of ESA95. Some data inconsistencies and discrepancies point to the still low quality of budgetary reporting and suggest possible simultaneous use of different methodologies by the spending units and/or the consolidating institution.

Structural reforms

The programme lists the main growth bottlenecks but fails to present a thorough analysis, as requested by the Commission. The EFP is surprisingly silent about the existing plans in the Federation for improvements in the business environment, such as the new Law on Companies, the revision of the Labour Law, etc. The structural reform strategy is vague on medium-term measures beyond 2013. There is an ample room for improvement in terms of supporting the reform intentions with specific measures, quantifying their budgetary impact and presenting a timeframe for their implementation.

KC-AH-13-158-EN-N