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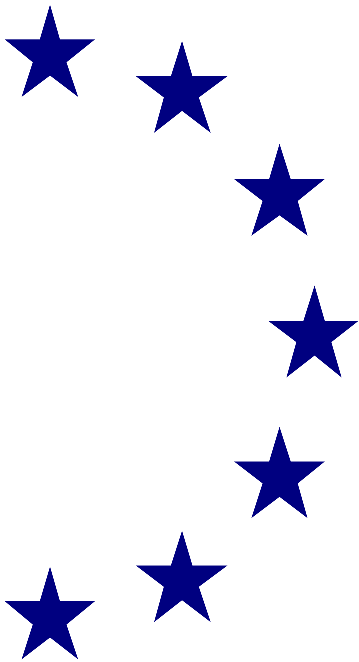

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2003 pre-accession economic programmes of acceding and other candidate countries: overview and assessment

by

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and Financial Affairs

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I. FOREWORD

This Enlargement Paper brings together into a single document the Directorate General for Economic and Financial Affairs evaluations of the third Pre-Accession Economic Programmes (PEPs) of the acceding and candidate countries.

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.

On 4 November 2003, the ministerial meeting between the ECOFIN and their counterparts from acceding and candidate countries adopted (a) for the ten acceding countries “joint opinions” on their respective PEPs and (b) for the three remaining candidate countries within the meeting’s “joint conclusions” conclusions on their PEPs. Excerpts from the documents mentioned under (a) and (b) are contained in this document (Paragraphs 2 of the respective countries’ sections).

For the acceding countries, this PEP is the last one as they will become Member of the EU as of 1 May 2004. From then onwards they will be subject to the EU surveillance mechanisms which are applied to Member States. In that perspective, acceding countries have been invited to intensify their reporting on structural issues, as a preparation of the country-specific recommendations to be addressed by the EU in its 2004 Broad Economic Policy Guidelines.

II. OVERVIEW

1. SUMMARY

All acceding and candidate countries have submitted their third Pre-accession Economic Programme (PEP) in 2003. Like in 2002, governments were invited to submit their PEP at the same time, by 18 August 2003, which was broadly respected. This document gives an overview and assessment of the entire set of 13 programmes.

The international economic environment has weakened since the submission of last year's PEPs. In the EU, the main trading and investment partner for acceding and candidate countries, economic activity stagnated in the first half of 2003. While resisting to some degree, also the acceding and candidate countries felt the consequences of the worldwide economic slowdown. This led in general to more prudent macroeconomic scenarios in the 2003 PEPs.

The objectives of the PEPs are to identify the appropriate economic policies and reforms needed to prepare for EU accession and to develop the institutional and analytical capacity necessary to participate in the multilateral surveillance procedures of EMU upon accession. Overall, the PEPs broadly meet these objectives. While not the focus of the PEPs, the preparations for meeting the conditions for euro adoption became more prominent in the formulation of economic policies in the acceding countries. As far as analytical capacity building is concerned, further improvements can be noted.

The programmes address the main economic challenges faced by these countries on their road to accession. Macroeconomic stability has been attained to sufficient degrees and the functioning of the economy is sufficiently based on market principles in most countries. In consequence, the policy focus shifts to the achievement of conditions for sustainable and strong economic growth, needed to foster substantial real convergence towards the EU. In addition, in particular in acceding countries, euro adoption is an objective and the fulfilment of the Maastricht requirements is already shaping the design of macroeconomic policies.

Partially due to adverse economic conditions, but also because of expansionary policies, budgetary targets for this year are likely to be missed in many countries. Reducing the general government deficit and reforming public finances continue to be important challenges in the PEPs in order to create a stability-oriented and growth-enhancing macroeconomic framework. More attention than previously is paid to the sustainability of public finances, as reflected in the reform efforts dedicated to the pension systems. The reorientation of expenditures remains a priority in the PEPs, while some countries have put tax reform high on the agenda.

Realising strong and durable growth is widely recognised as a major objective and most PEPs foresee relatively high investment to this end, but the level of domestic savings remains low. The ensuing current account deficit needs to be financed requiring access to external capital markets and a sound financial system. Increasing the level of domestic savings would foster sustainable growth and the optimal allocation of resources could be further improved by enhancing the efficiency of financial intermediation.

Structural reform receives much attention as a mean to support growth in the long run. In this context the creation of conditions for a knowledge-based economy became more prominent in the PEPs. Strengthening the supply side of the economy is expected to be achieved through increasing competitiveness, the promotion of research and development, further privatisation, the liberalisation of the utility sector and administrative simplification.

In general, the institutional and analytical capacity of drafting such programmes has further improved. The PEPs are the result of an intensified co-operation between various ministries, and the central banks have also been involved. In particular, co-ordination of structural reforms remains difficult as this domain falls under the responsibility of many government departments. Nevertheless efforts has been made to indicate the impact of structural measures on the economy and quantify the budgetary costs. The programmes were adopted by the governments, in some cases discussed with social partners and communicated to parliament. Only Malta had a some delay in transmitting the document to the European Commission. The programmes have followed to a very large degree the Commission services' suggestions of the "*2003 Pre-accession Economic Programme: Consolidated outline and external assumptions*" (ECFIN/203/03-EN), as regards general approach, structure and standard tables. The invitation addressed to acceding countries to step up reporting on structural issues in preparation of the 2004 Broad Economic Policy Guidelines was taken on board.

With respect to the analytical capacity, further progress can be noted. All countries except Bulgaria and Malta present cyclically adjusted budgets; the analysis of the cyclically adjusted budgets in the Estonian PEP is limited to the past. Furthermore, most countries (not Bulgaria, Hungary, Malta, Slovakia and Turkey) present indicators on the long-run sustainability of public finances. Efforts have been made to harmonise statistics along ESA 95 standards, but the situation remains uneven and more work needs to be done, especially in the domain of public finance data in some countries. A rather general problem remains that the costs of structural reforms are insufficiently quantified and integrated in the budgetary framework.

The programmes represent a consistent macroeconomic and budgetary framework to strengthen the performance of the economy over the medium term. The documents are rich in detail but there are differences across countries. The main conclusions are:

- The *Cypriot* PEP provides a consistent and for the most part credible macro-economic framework with the overriding objective to correct fiscal imbalances. In a separate annex, the programme elaborates on the consequences of possible re-unification and points at the possibility of higher growth, but also at substantial budgetary costs.

- The *Czech* PEP is an analytically well-prepared document that identifies fiscal consolidation as the main challenge, but the envisaged pace of reducing the general government deficit remains slow. Positively, the focus is on cutting expenditures, which offers better guarantees for a durable consolidation. The authorities make the timetable for ERM II participation and euro adoption contingent on success in fiscal consolidation.

- The *Estonian* PEP gives a comprehensive description of recent economic developments and presents detailed measures for fiscal and structural reform. Its macroeconomic scenario is based on strong growth fuelled by private consumption and the authorities foresee annually balanced government accounts. In order to avoid a

pro-cyclical budgetary policy, more fiscal stabilisation may be required, also given the currency board and the large current account deficit.

- The *Hungarian* PEP takes into account the deterioration of the economic situation and provides an ambitious adjustment programme, which is strongly influenced by the declared goal to fulfil the criteria of euro adoption on 1 January 2008. It is the purpose to join ERM II as soon as possible. The macroeconomic scenario appears feasible, but its realisation in the proposed time frame is a challenge, as some of the assumptions appear too optimistic.

- The *Latvian* PEP rightly emphasises the need for strong and balanced growth as well as structural reform. Strong credit growth and a large share of non-resident deposits require particular monitoring in order to preserve macroeconomic stability. Furthermore, the elimination of wide disparities in regional unemployment is a challenge.

- The *Lithuanian* PEP reiterates the authorities' goal to obtain strong and sustainable growth and enhance the competitiveness of the economy. Maintaining the euro-based currency board is a cornerstone of macroeconomic policy. Some fiscal obligations, related to the restitution of rouble savings and real estate, imply a risk for the budgetary targets.

- The *Maltese* PEP gives a consistent macroeconomic scenario in which the attainment of nominal and real convergence with the EU is an important objective. Putting public finances on a sound footing is instrumental in achieving these goals, but achieving the budgetary targets appears difficult.

- The macroeconomic scenario in the *Polish* PEP appears overly optimistic and crucially hinges on a strong rebound in investment. The fiscal consolidation lacks credibility as the programme does not provide details about the envisaged adjustment measures and remains imprecise about the origin of the consolidation.

- The *Slovak* PEP presents an ambitious fiscal consolidation and reform scenario. However, the planned composition of the fiscal adjustment poses important challenges. In particular, far-reaching tax reforms and an ensuing fall in the tax revenue-to-GDP ratio are not yet matched with the same degree of precision as regards substance and sequencing of corresponding expenditure reforms.

- The *Slovenian* PEP aims at a balanced increase in growth and sees ERM II participation, scheduled for the first half of 2005, as a key policy objective. It should help in bringing inflation down, but reducing the widespread backward looking indexation mechanism is as important.

- The *Bulgarian* PEP presents the medium-term fiscal framework which envisages high discipline, targeting a low budget deficit until 2005 and a balanced budget by 2006, one year later than foreseen in last year's PEP. It adequately emphasises the importance of continuing structural reforms where good progress has been made in several areas, but delays occurred in some areas with fiscal implications, in particular in privatisation and healthcare.

- The *Romanian* PEP broadly restates the macroeconomic projections and policy targets of the 2002 document but allows for a larger fiscal deficit target than previously envisaged due higher outlays seen as instrumental in completing the authorities' reform agenda. Under the framework, a looser fiscal policy would not undermine

macroeconomic stabilisation because of the planned parallel reduction in the quasi-fiscal deficit. Measures to achieve the latter, however, are not clearly spelled out.

- *Turkey's* PEP presents a realistic economic framework and emphasises the importance of reducing macroeconomic imbalances in order to attain a sustainable growth path. The structural reform part focuses on privatisation and public sector reforms, but is still insufficiently linked to the macroeconomic policy framework and not very specific when discussing medium-term measures.

2. REVIEW OF RECENT ECONOMIC DEVELOPMENTS

In general an adequate and sufficiently detailed description of the main economic and fiscal trends in the last years is given. Due attention is paid to the recent economic developments and all the countries cover the first months of 2003, except Malta and Slovenia that stop in 2002. Romania's PEP gives in this section only sparse information on monetary and financial developments. Linked to the international economic slowdown, economic conditions also weakened in most of the acceding and other candidate countries.

3. MACROECONOMIC FRAMEWORK

3.1. Methods

Most PEPs do not make explicit which methodology is used to formulate the macroeconomic scenarios, but some programmes are clearer than others and the approach followed can differ. The outlook covers the period 2003-2006 (2003-2007 for Estonia). The Czech Republic verified the plausibility of the projections by comparing them with the results of an opinion survey held among public and private forecasters. Further checking for consistency occurred against an econometric model. The baseline scenario in the Maltese PEP is mainly model-based and underlying the sensitivity to international developments, alternative scenarios simulating shocks to external demand and prices are presented. Similarly, Slovakia examines and quantifies the impact of a stronger appreciation of its currency, weaker EU demand and faster labour productivity growth. Uncertainty is dealt with in the Hungarian PEP by presenting the projections in the form of forecast ranges and not as point estimates. It is not unambiguously indicated in all programmes to what extent the projections are contingent on the reform measures and macroeconomic polices announced, but Latvia, Malta and Slovakia are clear that it is the case as well as Cyprus. In the latter country's PEP, much attention is paid to possible re-unification with the northern part of the island. However, its consequences are not taken on board in the macroeconomic scenario, but considered as a risk factor threatening macroeconomic stability on the one hand, and on the other hand, offering the possibility of faster growth.

With respect to the external assumptions for the international environment, usually reference is made to the external assumptions as provided by the European Commission based on its Spring 2003 Forecasts. Differences are often explained as requested in the draft outline. In general, the further slowdown of economic activity in the world and in the EU, in particular, led several countries to base their projections on lower EU growth. In the light of the strengthening of the euro against the US dollar, also the exchange rate assumptions deviate from those initially proposed by the European Commission.

3.2. Growth

The achievement of high real growth, which can be sustained without jeopardising economic stability, remains a challenge for most of the acceding countries. Only such growth will allow to catch up with EU income levels. In addition, economic stability and nominal convergence is a pre-requisite to successfully participate in EMU.

There is great detail in the projections and all countries give the basic breakdown of GDP into the main demand components. With the exception of Malta and Poland, also a breakdown in main industry groups is given, allowing an assessment of the implied and assumed structural change over the programmes' time horizon. Furthermore, potential growth calculations (not in Estonia and Malta) are presented, and sometimes, as in the case of Turkey, well documented. These elements help to assess the impact and consistency of the macroeconomic scenarios.

Table 1

Gross domestic product

	average annual real growth rate		GDP/head (PPS, in % of EU average)	
	1998-2002	2003-2006	2002	2006*
Cyprus	4.2	3.8	72.3	77.3
Czech Rep.	1.5	3.0	59.8	62.0
Estonia	4.7	5.5	41.7	47.6
Hungary	4.3	4.0	55.9	60.2
Latvia	5.7	6.2	35.2	41.2
Lithuania	4.5	6.4	39.1	46.1
Malta	2.8	2.7	na	na
Poland	5.4	4.7	39.4	43.5
Slovak Rep.	3.0	4.3	47.3	51.6
Slovenia	3.9	3.9	73.7	79.0
Bulgaria	4.1	5.3	24.7	28.0
Romania	1.4	5.2	24.5	27.6
Turkey	1.2	5.2	22.9	24.5
EU	2.4		100	100

*without demographic effects; candidate countries growth rates 2003 - 06: PEPs; EU growth rates 2003-04: Spring 2003 COM forecast; EU growth rates 2005-06: 2.4 %

Compared to the 2002 PEPs, covering the projection period 2002-2005, growth scenarios have been revised downward in 5 acceding countries for the present projection period 2003-2006. The largest downward revision to average GDP growth occurred in the Czech Republic by 0.7 percentage point. While still within the normal forecast margins, it conveys the message that the way forward may be more difficult than initially anticipated. Extrapolating recent buoyant economic activity in Latvia and Lithuania, average growth has been revised upward by about 1 percentage point as well as in Poland, expressing confidence in the emerging recovery. Compared to the recent past, most countries foresee an acceleration of growth. Only Cyprus, Hungary, Malta and Poland project on average weaker growth in the period 2003-2006 compared to the period 1998-2002. The result is that the growth performance is projected to diverge more and among the acceding countries two groups could be identified. Reaping the benefits of structural reform and macroeconomic stability, partly thanks to the hard currency option, the Baltic States are expected to perform best, according to the PEPs, and to realise average growth rates above 5.5%. The other acceding countries project growth rates below 5%. Due to a weak performance in 2003, the average growth rate in Malta is only 2.7% over the projection period. The remaining candidate countries are, with growth rates of more than 5%, close to the performance of the Baltic countries. Regained macroeconomic stability would allow them to realise their relatively elevated growth potential. Where calculations area available (not in Bulgaria, Estonia and Malta), most countries are expected to close the output gap by 2005, but in Hungary and Slovenia the output gap is expected to remain marginally negative. Poland anticipates actual growth significantly above potential growth at the end of the projection period.

Also because the EU growth outlook suffered, catching up towards EU income levels continues according to the PEPs, but living standards remain very diverse among the acceding and remaining candidate countries. By 2006, Slovenia is expected to have reached 79% of the average EU GDP per head measured in purchasing power standards,

closely followed by Cyprus with more than 77%. Latvia, at 41% of the EU level in 2006, will remain the poorest among the acceding countries, although up from a level of 27 % still 5 years ago. The remaining other candidate countries are well below the level of Latvia and, despite projected catching-up, will continue to do so over the programmes' horizon.

Gross fixed capital formation and exports continue to be the motor for growth, but in the Czech Republic and the Baltic States, private consumption is important as well. Because of the high import content of growth in the acceding countries, the contribution from the external sector is in general small or negative without being a drag on growth.

Imports are expected to rise quite moderately in light of the expansion of domestic demand and exports. The apparent import elasticities are therefore expected to be quite slow and only reach or exceed the value of 2 in five countries (see table 2).

Table 2

Apparent import elasticity
(goods+services, real terms)

	1999 - 2002[1]	2003 - 2006[2]
Cyprus	0.7	1.0
Czech Rep.	5.1	2.0
Estonia	1.7	1.8
Hungary	3.0	2.4
Latvia	0.9	1.3
Lithuania	0.7	2.0
Malta	0.7	1.2
Poland	0.9	2.0
Slovak Rep.	1.4	1.4
Slovenia	1.8	1.4
Bulgaria	3.2	0.9
Romania	5.4	1.3
Turkey	2.5	2.2
EU	2.5	

1: Imports growth 2002 over 1998 / GDP growth 2002 over 1998

2: Av. ann. growth rates imports / av. ann. growth rates GDP 2003-06

Increasing labour productivity rather than employment creation is the major source of growth. In particular the Baltic countries foresee strong productivity gains of more than 5% per year on average against an unweighted average just below 4% for the acceding countries as well as for the remaining candidate countries. There will be virtually no employment growth in the Czech Republic, but all acceding and remaining candidate countries are expected to bring to an end the period of job destruction in 2003 and Poland in 2004.

A strong investment performance is usually associated with strong labour productivity gains. It has to be noted, however, that, partly due to cyclical factors, the growth rate of gross fixed capital formation in Poland is particularly high in comparison to productivity growth. By contrast, labour productivity in the Czech Republic appears high compared to relatively low investment growth.

From the production side, the macroeconomic scenarios are mostly underpinned by strong growth (between 5 and 8%) in the construction sector which represents on average about 6 % of value added, which benefits from the reduction in interest rates as well as the increasing availability of lending in several countries. In particular in Slovakia, a construction boom is expected (growth above 10%), while in the Czech Republic construction is set to contract over the projection period. In several countries, notably the Baltic states and Bulgaria, also industrial production is quite dynamic. Activity in the service sector is projected to rise between 4% and 6% annually in the acceding and remaining candidate countries, while the agricultural sector is trailing behind. However, overall the broad patterns of structural change witnessed over the past decade are seen to continue at a rather modest pace.

3.3. Inflation

Preserving price stability over the past few years of the pre-accession period has become a central objective of monetary and exchange rate policies as pursued by the

newly independent central banks of the acceding countries. Inflation in fact has come down to low levels, despite the catching-up dynamics (in particular the Balassa-Samuelson effect) that are at work in the countries. The annual increase of the aggregate consumer price index of the 10 acceding countries stands at only one percentage point above that of the EU-15 by mid-2003. The fulfilment of the inflation convergence criterion in order to meet the requirements to adopt the euro is a significant driving factor in policies aimed at disinflation in several acceding countries with still relatively high inflation compared to the others. The main inflation strategies of the acceding countries are inflation targeting, a fixed peg or a currency board arrangement. The Czech Republic, Hungary, Poland and Slovakia are maintaining inflation targeting regimes as well as Cyprus, though the latter not in an explicit way as it targets the rate of core inflation around 2%. These inflation frameworks are either combined with managed floating, as in the Czech Republic and Slovakia, free floating as in the case of Poland, or with a euro peg and fluctuation bands of ±15% in Hungary. Cyprus maintains a fixed exchange rate regime against the euro. The other countries have no inflation targeting, but maintain a fixed exchange rate system, except Slovenia, which operates a managed float. Malta's currency is linked to a trade-weighted basket of currencies, while Latvia's exchange rate regime is based on the SDR basket of currencies. Estonia and Lithuania have a euro based currency board arrangement.

Among the remaining candidate countries, Bulgaria has successfully maintained its currency board regime, which had been introduced following the sharp stabilisation crisis in 1997. With that system, it continued to keep inflation rates at relatively low levels. In contrast to this performance, Romania and particularly Turkey have until recently witnessed fairly high inflation, which only recently has started to come down significantly. Both countries are determined to pursue their disinflation strategy, which, if successful, should lead to inflation rates of slightly above 6% towards the end of the PEP horizon, still relatively high compared to the EU, but quite remarkably different from the double-digit levels of the past years. Romania will switch to inflation targeting. Turkey has the same objective, even if it will, as a first step, pursue only some implicit inflation targeting. Switching to outright inflation targeting will be contingent on the fulfilment of certain enhancing factors, including the reduction of fiscal dominance on capital markets, allowing effective monetary policy.

Table 3

Consumer price inflation
(annual % change)

	2002	2006
Cyprus	2.8	2.0
Czech Rep.	1.8	2.5
Estonia	3.6	3.2
Hungary	5.3	3.0
Latvia	1.9	3.0
Lithuania	0.3	2.6
Malta	2.2	2.0
Poland	1.9	2.9
Slovak Rep.	3.3	3.0
Slovenia	7.5	3.7
Bulgaria	5.8	3.9
Romania	22.5	6.0
Turkey	45.0	6.2
EU	2.1	:

Inflation in the beginning of 2003 was very low (less than 1% or even negative) in the Czech Republic, Lithuania, Malta and Poland. However, all four countries expect a somewhat higher inflation in the medium-term. In Poland the PEP foresees a gradual increase in inflation, from the present very low level, to around 3%. The Czech Republic has experienced deflation or CPI growth of just above zero since the beginning of 2003, although inflation is expected to slightly accelerate in the second half of the year. In Lithuania a rise in inflation due to an increase of administered prices for regulated services is to be expected, but the medium-term level is projected to stay below 3%. The Maltese PEP assumes a steady rise in inflation from of 1.3% in 2002 to 2% in 2006, as economic activity gathers momentum and labour market conditions become tighter.

Also in Estonia inflation has fallen below the euro area's inflation level for the first time since 1999, mainly as a result of falling food prices and a strong Estonian kroon vis-à-vis the dollar. The decline of the still relatively high inflation is, however, rather slow in Slovenia. The Slovenian PEP envisages to reduce it gradually to 3.7% in 2006.

Temporary factors linked to price liberalisation or tax harmonisation are expected to push up inflation in Slovakia and somewhat in Hungary. In Slovakia the PEP assumes a rise in headline inflation of over 8% in 2003 and 2004. In Hungary a halt in the successful disinflation and a presumably temporary rise in inflation can already be observed. Both countries expect, however, a decrease of the CPI to 3% by 2006, envisaging that year to meet the Maastricht inflation criterion. A temporary rise of inflation is also expected in Cyprus and in Latvia, although from a lower level, from a 2% annual average in 2002 to a peak of 4.6% in 2003 in Cyprus, and from 2.5% in Latvia. In Bulgaria and Romania the adjustment of administered prices, particularly for energy, is still far from achieved. Further significant rises in energy end-user prices will push up inflation. The Bulgarian PEP estimates that this effect will increase headline inflation by around two percentage points annually over the PEP horizon.

With declining inflation rates in most countries, the convergence of price levels towards average EU levels will be slow (see table 4). In 2002, the consumer price levels in acceding and other candidate countries varied between 90% of the EU average to 41% in Bulgaria. Assuming the inflation rates provided in the PEPs and constant exchange rates vis-à-vis the euro, this picture will change only slightly, and also in 2006 price levels will be significantly below EU levels. The situation is somewhat different in Romania and Turkey, with much higher inflation differentials towards the EU. In these countries the more critical assumption of constant nominal exchange rates would indeed lead to a significant rise of the relative price levels in these countries.

Table 4

Consumer price levels
(in % of EU-15)

	2002	2006
Cyprus	90	92
Czech Rep.	47	47
Estonia	52	54
Hungary	50	55
Latvia	52	54
Lithuania	51	51
Malta	n/a	n/a
Poland	61	61
Slovak Rep.	42	50
Slovenia	70	77
Bulgaria	41	43
Romania	49	67
Turkey	71	a)
EU	100	100

Inflation rates: PEPs; EU: 2%; const. nominal exchange rates

a) not meaningful

In parallel with progress in disinflation, also convergence of interest rates has made impressive progress in recent years, fostered by positive market sentiment and declining risk premiums. Short-term interest rates are on average slower to adapt in Hungary, Poland and Slovakia, due to relatively high inflation rates and relatively wide fiscal deficits.

3.4. External balances

Despite a weak external environment, most acceding and other candidate countries showed a reasonably good export performance in 2002. Nevertheless, significant differences were registered among them, ranging from very robust export growth in Lithuania to stable or declining export receipts in Malta and Cyprus (largely due to faltering tourism arrivals).

All acceding and remaining candidate countries, except Slovenia, showed a deficit in the balance of current account in 2002. Although the deficits broadly reflect the current transformation process and investment needs of catching-up economies, they are relatively large and some levels are a matter of concern, particularly in Estonia, Latvia and Slovakia, although in the latter country the current account is improving in 2003.

The rigidity of the exchange rate regime and strong credit growth in Estonia and Latvia adds an extra dimension to the need for the authorities to closely monitor external sector developments, and adjust the policy mix if high imbalances were to persist in the medium-term.

Most acceding and all other candidate countries foresee an increase in the investment-to-GDP ratio over the medium term, which partly reflects investment needs associated with EU accession. Domestic savings are also expected to rise in most countries, primarily driven by increasing public savings in the form of lower government deficits and contribute to the financing of the high investment needs. In Estonia, where the government surplus declines between 2002 and 2006, it is mainly private sector savings which increase. Hence, the savings-investment balances are foreseen to improve in most acceding countries: the investment-to-GDP ratio increases and domestic savings cover a larger part of investment. In consequence the current account deficit declines over the projection period in most countries. Nevertheless, all of them, but Slovenia, anticipate current account deficits over the forecast period.

Table 5

Current account balance (% of GDP)

	2002	2006
Cyprus	-5.3	-1.4
Czech Rep.	-6.5	-6.2
Estonia	-12.3	-9.0
Hungary	-4.0	-5.0
Latvia	-7.8	-7.6
Lithuania	-5.3	-5.6
Malta	-4.7	-4.4
Poland	-3.5	-5.1
Slovak Rep.	-8.2	-3.3
Slovenia	1.7	1.1
Bulgaria	-4.4	-3.8
Romania	-3.4	-4.6
Turkey	-0.8	-1.2
EU	-0.2	

Sizeable improvements in the current account balances are anticipated in a number of countries, particularly in Cyprus, Estonia and the Slovak Republic. In contrast, Hungary, Poland and Romania foresee a deterioration of their deficits by one percentage point of GDP by 2006. Fiscal policy in Poland appears to be insufficiently supportive to sustain the current account over the medium-term. In Hungary, an ambitious fiscal consolidation plan appears insufficient to compensate a marked deterioration of the private savings-investment balance. The slight deterioration in Turkey between 2002 and 2006 masks a profile that foresees significantly higher deficits in the intervening years.

Most current account deficits are expected to be financed to a large extent by non-debt creating foreign capital inflows. The situation in Turkey contrasts with this general picture. Here, FDI inflows are small and are not expected to pick up to an extent that they would be able to finance large parts of the current account deficit. In general, the sustainability of the external debt positions of most countries is not a source of immediate concern, assuming that the reported structural reform plans are implemented. On the one hand, structural reforms should improve the business climate and therefore the incentive for FDI inflows. On the other hand, economic flexibility and export capacity should be increased, thus generating foreign exchange earnings that enhance the potential to repay external obligations. Maintaining sound fiscal policies will be crucial to guarantee that enough domestic savings are generated to face increasing investment needs. This should also contribute to ensure a high degree of macroeconomic stability and better access to foreign capital, against a background of decreasing FDI flows linked to the end of the privatisation process.

4. MONETARY AND EXCHANGE RATE POLICIES

Candidate and acceding countries have maintained their monetary and exchange rate regimes unchanged since last year's programmes. The only exception is Malta, which, as announced in the 2002 PEP, increased the share of the euro in its reference currency basket from 56.8% to 70% in August 2002. Also the Romanian reference basket for its managed float seems to have shifted more towards the euro. In addition, the central parity of the Hungarian forint against the euro was lowered by 2.26% in June 2003. The programmes provide information on the changes to monetary policy instruments already adopted or planned in order to further harmonise them with those of the Eurosystem. In addition, in the case of Romania, changes to the monetary policy framework reflect the envisaged transition towards inflation targeting that the authorities intend to start implementing in 2005.

Table 6

Goals for ERM II participation and subsequent adoption of the euro

	Current exchange rate regime	Euro introduction target date	ERM II participation target date	Envisaged changes to exchange rate regime
Cyprus	Peg to the euro with wide band (±15%)	In 2007	No date specified	None
Czech Republic	Managed float	No date specified [a]	Entry date conditional upon date of compliance with convergence criteria	No indication in PEP
Estonia	Currency board arrangement (CBA) based on the euro	In 2006	Immediately after accession	None
Hungary	Peg to the euro with wide band (±15%)	On 1 January 2008	As soon as possible after accession	None
Latvia	Peg to SDR	On 1 January 2008 at the earliest	On 1 January 2005. Intention to limit the lat fluctuations to a narrower band than ±15%	Peg to the euro as from 1 January 2005
Lithuania	CBA based on the euro	No date specified	No date specified	None
Malta	Peg to a trade-weighted basket	As soon as economic convergence allows it	As soon as possible after accession	No indication in PEP
Poland	Float	In 2008 or 2009	No date specified. Plan to use the fluctuation band of ±15%	None
Slovakia	Managed float with the euro as reference currency	In 2008-2009	No date specified	No indication in PEP
Slovenia	Managed float	No date specified	In the 1st half of 2005	No indication in PEP
Bulgaria	CBA based on the euro	No date specified	No date specified	None until accession
Romania	Managed float with the euro as main reference currency	No date specified	No date specified	Transition towards a floating exchange rate in the context of introducing inflation targeting
Turkey	Float	No date specified	No date specified	Transition towards, first only implicit, inflation targeting

a On 13 October, the Government adopted the Czech euro area participation strategy, which targets euro area participation by 2009-2010.

Compared to last year, the PEPs provide more indications on the acceding countries' strategies towards monetary integration, especially on their optimal timing of ERM II entry and euro adoption. Bulgaria, Romania and Turkey do not refer in their programmes to their future participation in ERM II and in the euro area, as their time horizon for the adoption of the euro is different from that of the acceding countries. Table 6 summarises the countries' positions with regard to the timing of monetary integration and envisaged changes to exchange rate regimes.

With regard to the introduction of the euro, Estonia and Cyprus have the most ambitious target dates: they plan to adopt the euro in 2006 and in 2007, respectively. The other acceding countries foresee a later adoption of the euro. Hungary and Latvia aim at introducing the euro on 1 January 2008, while Poland and Slovakia mention 2008 and 2009 as target dates for joining the euro area. For the other acceding countries, namely the Czech Republic, Lithuania, Malta and Slovenia, the programmes do not specify the authorities' timetable for full euro area membership.

For some countries, the programmes emphasise that the central bank and the government have not yet agreed on the strategy towards monetary integration. For example, the PEP of the Czech Republic stresses that it presents the views expressed by the central bank in its strategy paper, but in the meantime on 13 October, the Government adopted the Czech euro area participation strategy. In Slovakia, the strategy is further elaborated based on a joint paper by the central bank and the Ministry of Finance. In Hungary, the target date of 1 January 2008 is the result of a joint decision of the central bank and the Ministry of Finance.

About half of the acceding countries have in the PEPs clarified their intentions with regard to the timing of entry into ERM II, and this with varying precision. Latvia and Slovenia aim for an entry in 2005, on 1 January 2005 and in the first half of that year, respectively. Estonia intends to join ERM II immediately after accession, while Hungary and Malta plan to join ERM II as soon as possible after accession. Some programmes, in particular the Czech one, refer to the intention of limiting ERM II participation to the required two-year period before adoption of the euro.

For most countries with floating currencies, ERM II participation is seen as a formal requirement for euro adoption. However, the Hungarian programme explicitly states that the ERM II central parity will serve as a nominal anchor underpinning monetary policy. The Czech programme underscores that ERM II participation will not eliminate exchange rate turbulence, while the Polish programme envisages a participation of the zloty in ERM II for the required two year period before adoption of the euro, with the zloty being allowed to make full use of the ± 15%fluctuation band. In this regard, it should be noted that merely respecting the 15% fluctuation band will not be sufficient to meet the Maastricht exchange rate criterion.

A number of countries have either indicated that they do not foresee a change in their exchange rate regimes, or the programme does not include information on this. However, the Bank of Latvia plans to replace the existing peg to the SDR basket with a peg to the euro on 1 January 2005. The intention of Latvia is also to join ERM II at the same time. Latvia intends to keep, unilaterally if necessary, the lat within a narrower fluctuation band than the standard one of ± 15%. The Maltese PEP does not give indications on the changes envisaged to further increase the share of the euro in the currency basket. As for the countries with a euro-based currency board arrangement or a peg to the euro, i.e. regimes compatible with ERM II, they envisage no change to their

current exchange rate regimes until joining ERM II and possibly until the adoption of the euro.

5. FISCAL POLICY

5.1. Budgets

As last year, data on general government balance and debt are in principle presented according to ESA95 methodology, following the same approach as the Fiscal Notification presented in April 2003, but some issues still have to be clarified. Most countries have submitted in their programs additional fiscal data, beyond the aggregate figures related to total revenue and expenditure, deficit and public debt, enhancing the information provided and making possible a detailed analysis of public finances as well as comparisons across countries.

In 2002, almost all countries were running general government deficits in the single-digit range, varying from the lowest deficits of Lithuania (1.7% of GDP) to the highest of Hungary and Slovakia (9.2% and 7.2% of GDP, respectively). The exceptions were Estonia (1.3% of GDP surplus) and Turkey with a particularly elevated deficit of 13.1%. Hungary and Slovakia also had the highest primary balance deficit (5.5% and 3.5% of GDP, respectively). Estonia and Cyprus achieved primary surpluses (1.6% and 1.4% of GDP, respectively). Turkey, again, was an outlayer, combining a high total deficit with a primary surplus of more than 6%, reflecting the very high debt burden of the country.

The PEPs indicate for most countries a, sometimes, substantial consolidation of their public finances. The amount of consolidation is clearly, although far from perfectly, correlated to the respective starting levels: Turkey foresees the most dramatic reduction of its general government deficit, by more than 10 percentage points, between 2002 and 2006, mainly driven by sharply lower interest payments. It is followed by Hungary (reduction by 6.7 percentage points) and Slovakia (4.3 percentage points). Displaying a different path, Estonia plans to bring the 2002 government surplus down to balance by

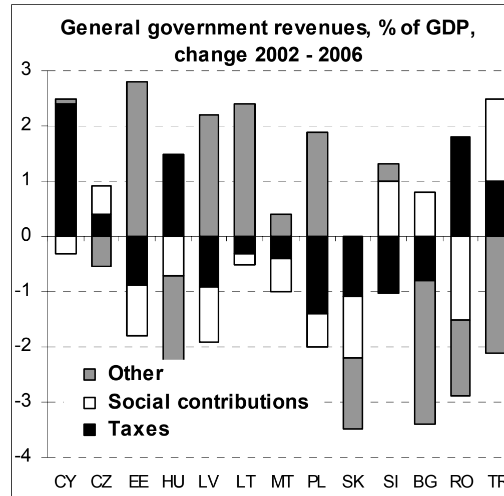
Table 7

General government (% of GDP)

	Revenue		Expenditure		Total balance				Primary balance			
					actual		*'cyclically adj.**		*actual*		*'cyclically adj.**	
	2002	2006	2002	2006	2002	2006			2002	2006	2002	2006
Cyprus	36.3	38.5	39.8	40.7	-3.5	-2.2	-2.5	-2.2	1.4	2.5	2.4	2.5
Czech Rep.	42.4	42.7	49.1	46.8	-6.7	-4.0	-6.5	-4.1	-5.0	-2.4	-4.9	-2.5
Estonia	39.7	40.7	38.4	40.7	1.3	0.0	n/a	n/a	1.6	0.3	n/a	n/a
Hungary	44.5	43.6	53.7	46.1	-9.2	-2.5	-9.1	-2.4	-5.5	0.4	-5.4	0.5
Latvia	41.9	42.2	44.9	44.2	-3.0	-2.0	-3.1	-2.3	-2.6	-1.3	-2.6	-1.6
Lithuania	33.8	35.6	35.6	37.4	-1.7	-1.8	-1.7	-1.6	-0.2	-0.5	-0.2	-0.3
Malta	43.8	43.2	50.0	46.6	-6.2	-3.4	n/a	n/a	-1.4	1.5	n/a	n/a
Poland	42.1	42.1	45.9	45.5	-3.8	-3.4	-3.4	-3.8	-1.0	-0.8	-0.5	-1.1
Slovak Rep.	41.8	38.3	49.0	41.2	-7.2	-2.9	-7.2	-3.7	-3.5	-0.6	-3.5	-1.4
Slovenia	41.5	41.7	43.9	43.0	-2.4	-1.3	-2.2	-1.1	-0.2	0.0	0.0	0.2
Bulgaria	38.7	36.1	39.4	36.1	-0.7	0.0	n/a	n/a	1.5	2.8	n/a	n/a
Romania	36.4	35.3	38.6	38.5	-2.2	-3.2	-2.5	-3.6	0.3	-1.4	-0.1	-1.7
Turkey	41.9	42.3	55.1	44.8	-13.1	-2.5	-13.3	-4.8	6.2	7.2	4.8	4.9
EU	46.4		47.2		-0.8				2.9		-1.2	

* as indicated in the PEPs on the basis of varying methodology

2006 and Poland's consolidation endeavour looks weak as the government has embarked on an expansionary fiscal policy leading to further deficit increases in 2003 and 2004. Romania plans, as the only country, a widening of its general government deficit until 2006. Only the Czech Republic, Malta, Poland and Romania foresee general government deficits above the 3% of GDP reference value by 2006.



On the revenue side, four countries (Hungary, Malta, Poland) plan to keep government revenues practically unchanged or envisage slight declines in terms of GDP in the period 2002-2006. Slovakia posts the highest drop by 3.5% of GDP between 2002 and 2006, on grounds of significant decreases in direct tax collection (linked to tax reform) and contributions to the social insurance system and less non-tax revenues. Bulgaria's reduction (by 2.6% of GDP) will be driven mainly by falling capital income, reflecting past privatisations and lower incomes from licenses and lower fee incomes. The relative fall of Romania's revenues is less clearly explained. The remaining seven countries expect to increase their revenue share in GDP. The biggest rise is observed in Cyprus, were revenues are planned to jump 2.2% of GDP by 2006 compared to 2002, as a result of a renewed effort by the current government to strengthen fiscal consolidation. In addition, it envisages to improve tax administration and collection and impose higher fees and royalties levied by the government. Lithuania also plans to boost revenues by 1.8% of GDP by 2006, as the key aspects of a tax reform are to be implemented from 2004. Estonia foresees a 1% increase in revenues by 2006, as the item Other Receipts offset diminishing of both tax income and social contributions. Five countries (Romania, Lithuania, Bulgaria, Slovakia and Cyprus) would maintain budgetary revenues below 40% of GDP, Lithuania standing at 35.6% of GDP in 2006. The other countries' revenues would exceed 40% of GDP by 2006, while Hungary is the country with the biggest share (43.6% of GDP).

Table 8

Change in government balance 2002-2006 and contributions (% of GDP)

	Actual balance	Cyclically adjusted primary balance*	Interest pay-ments	Cyclical component
	(1)+(2)+(3)	(1)	(2)	(3)
Cyprus	1.3	0.1	0.2	1.0
Czech Rep.	2.7	2.4	0.0	0.3
Estonia	-1.3	-	-	-
Hungary	6.7	5.9	0.8	0.0
Latvia	1.0	1.0	-0.2	0.2
Lithuania	-0.1	-0.1	0.2	-0.2
Malta	2.8	-	-	-
Poland	0.4	-0.6	0.2	0.8
Slovak Rep.	4.3	2.1	1.4	0.8
Slovenia	1.1	0.2	0.9	0.0
Bulgaria	0.7	-	-	-
Romania	-1.0	-1.7	0.6	0.1
Turkey	10.6	0.1	8.4	2.1

* as indicated in the PEPs on the basis of vairying methodology

As regards government expenditures, only Cyprus (by 0.9 percentage points), Estonia (by 2.3 percentage points) and Lithuania (by 1.8 percentage points) are programming higher expenditure figures in terms of GDP by 2006 compared to 2002, as a reflection of comparatively favourable starting conditions of their public finances. The three countries registered expenditure-to-GDP ratios below 40% in 2002, but only Lithuania foresees to stay below this level by

2006, while both Cyprus and Estonia increase public expenditure to 40.7% of GDP. The Czech Republic will have the biggest expenditure share in GDP at 46.8% by 2006, stemming from the cost of industrial and financial restructuring and from the burden of mandatory and quasi mandatory expenditures. The highest reductions in the period are listed by Turkey, Slovakia, Hungary and Malta.

All countries, with the exception of Estonia, Lithuania and Romania, predict improvements in the primary balance by 2006, reflecting the commitment for a sounder fiscal balance and the need to limit the growth or to reduce the stock of public debt.

Except Bulgaria, Estonia and Malta, all countries have provided estimates for cyclically adjusted balances. Based on developments in the cyclically adjusted primary balance over the 2002-2006 period, the Czech Republic, Hungary and Slovakia expect substantial public deficit reductions as a result of policy changes. Other acceding countries, like Cyprus and Poland, rely mainly on the impact of the cycle, while also Slovakia seems to expect a contribution to fiscal consolidation from improved economic conditions. In Slovenia and Turkey lower interest payments form the main contribution to the decline in government expenditure. Most countries foresee in 2006 lower structural balances (i.e. cyclically adjusted balances), compared to 2002, with the exception of Poland, although also there, after the expansionary fiscal policy in 2004, the structural deficit is declining. In the Czech Republic, Poland, Slovakia and Hungary the structural deficits remain relatively high at more than 3.5% of GDP in 2006. Romania's cyclically adjusted deficit will rise by more than one percentage point between 2002 ands 2006. Hence this country programmes the strongest fiscal loosening of all thirteen countries. Turkey's cyclically adjusted balance, mirroring the actual deficit, is expected to fall sharply against the backdrop of significantly lower interest payments.

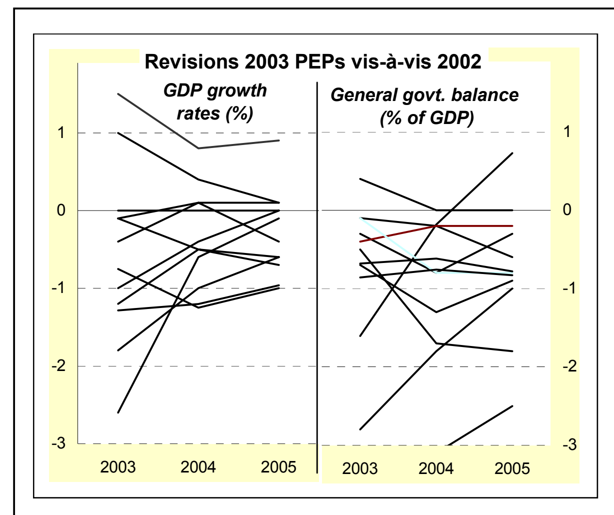
Table 9

Change vis-à-vis 2002's PEPs
(average 2003-05)

	GDP growth rate (in %)	General government balance (% of GDP)
Cyprus	-1.1	-3.0
Czech Rep.	-1.1	-0.4
Estonia	-0.5	0.1
Hungary	-1.0	-0.5
Latvia	0.5	-0.3
Lithuania	1.1	-1.0
Malta	-1.1	-1.9
Poland	-0.1	-1.3
Slovak Rep.	-0.4	-0.8
Slovenia	-0.8	-0.7
Bulgaria	0.0	-0.3
Romania	-0.1	-0.6
Turkey	0.2	-5.5

5.2. Revisions to last year's programmes

Cyprus, Malta, Poland and Turkey have significantly modified their budgetary targets as compared to last year's PEPs' data (see table 9). In particular, Turkey revised the general government deficit upward by an average of 5.5% of GDP over 2003-2005 and Cyprus by 3%. Estonia is the only country with upward revisions to its fiscal balance. All other countries made downward revisions, increasing the expected deficit.



Overall, the relation between the revisions of general government balance positions and the reappraisal of economic environment seems weak (the correlation coefficient is 0.27) but positive. Revisions appear to become less significant over time. As regards GDP, this reflects mainly unchanged views on the

growth potential over the medium term. With respect to government balances, this might point to some determination to stick to previously set targets.

5.3. Government debt

The general government debt position differs widely among countries. At the end of 2002, The government debt of Turkey and Malta were clearly exceeding 60% of GDP. Cyprus, Hungary and Bulgaria were slightly below the 60% threshold. On the other side, Estonia and Latvia post very low levels of debt, in absolute and relative terms (5.8% and 14.6% of GDP, respectively), but their debt is mainly owned by foreign creditors. Most of the acceding countries hold low levels of foreign public debt: some programmes show a preference for a steady reduction in external financing to lower exchange risk exposure, widen domestic capital markets and decrease financing costs. On the other hand, particularly Bulgaria and Turkey still have relatively high levels of foreign pubic debt, reflecting past high financing needs combined with very limited domestic capital markets.

Table 10

General government debt

	(% of GDP)		foreign debt (% of total debt, 2002)
	2002	2006	
Cyprus	59.7	56.1	22.9
Czech Rep.	26.9	39.4	2.3
Estonia	5.8	4.6	93.0
Hungary	56.3	54.0	n/a
Latvia	14.6	17.4	61.5 [1]
Lithuania	22.7	23.3	69.7 [1]
Malta	66.6	68.4	
Poland	41.8	49.1	33.1 [1]
Slovak Rep.	44.3	48.5	
Slovenia	27.8	25.9	41.1
Bulgaria	56.2	39.0	88.4
Romania	22.7	25.1	55.0
Turkey	102.5	83.2	47.0
EU	63.1		

1: central governement

Six acceding countries and Romania anticipate a worsening of their debt levels over the period. The Czech Republic's PEP reports a further deterioration of 12.5% percentage points between 2002 and 2006, this projection being worse than that made in last year's programme. Also in Poland a large increase in government debt by 7.4% of GDP up to 2005 is forecast, but a stabilisation in 2006. While the debt ratios in the Czech Republic and Poland remain relatively low, their rapid increase has to be closely monitored in order to keep the debt dynamics under control. Despite gradually lower deficits, the Slovak Republic estimates an increase in its debt level by 4.2% of GDP by 2006. Malta, already running a debt ratio well above 60% of GDP, foresees a further deterioration to 72.2% of GDP up to 2004. Subsequently, this ratio is expected to decline to 68.4% of GDP by 2006. Cyprus, Estonia, Hungary and Slovenia expect a gradual improvement of their debt ratio in line with their fiscal consolidation path. In Bulgaria and Turkey very sizeable reductions of the government debt ratios are expected, by 17 and 19 percentage points respectively, made possible by sizeable primary surpluses and predicted solid economic growth.

5.4. Fiscal risk

Most programmes present an analysis of budgetary risks over the period, notably by considering both explicit and implicit contingent liabilities. Analysis of the long-term sustainability of public finances, especially in the light of the envisaged trends in pension and health care expenditures, are provided as well, but the extent of the analysis varies widely among countries.

The existence of state guarantees provided to semi-government organisations and domestic institutions is identified as being one of the main sources of risk. As reported by Lithuania, other sources of fiscal risks regard deposit insurance, restitution of real estate ownership rights, debt of state-owned enterprises to banks and privatisation of state-owned assets. Poland points out compensations to former owners for real estate expropriated in the years 1944-62 as a specific fiscal risk element. For Poland, the relatively high share of foreign debt and the high risk of servicing domestic debt given their short-term average maturity make up an important financial risk as well. In the Czech Republic and Slovakia legal disputes are mentioned as a possible risk to the budgets. Bulgaria's and Turkey's still high, although rapidly falling, foreign-currency debt makes their budgets still vulnerable to adverse changes in exchange or foreign interest rates. Bulgaria and, in particular, Turkey present fairly detailed sensitivity analyses in their PEPs. Romania mentions, among other things, the fact of high arrears to the budget as a risk factor.

The amount, composition and assessment of the actual risk level are unevenly appraised among the acceding countries. As far as guarantees are concerned, not all PEPs give a clear indication about their volumes. Where information is given, these appear to be relatively high in Malta (22% of GDP), and somewhat more bearable in Cyprus and Czech Republic (around 10%), Romania (7.9%), Slovenia (6.6%) and Hungary (5.4%).

All countries are aware of those risks and seem committed to reduce them over the period. Some countries report the implementation of stricter budgetary rules (e.g. Czech Republic, Slovakia and Hungary) in order to reduce their amount. Others work towards better management of public finance. Fiscal targeting, mechanisms to split the credit risk between the guarantor and the lender and the creation of reserves for guarantees are mentioned as measures to limit the associated risk of guarantees.

6. STRUCTURAL REFORM

6.1. Enterprise sector

The reforms in the enterprise sector were given the necessary enhanced attention in the PEPs. Where the transition to a market economy has been accomplished, the authorities consider the shift to a knowledge-based economy and the creation of conditions for sustainable growth as the main objectives for the enterprise sector over the medium-term. In some cases references to the Lisbon strategy and the Cardiff and Luxembourg process are made (Czech Republic, Estonia, Malta and Slovakia).

Enhanced efficiency and increased competitiveness of the economy are expected to be achieved in most of the countries through business stimulation and SMEs development, industry restructuring and privatisation, as well as liberalisation of utility sectors.

Some attention has been devoted to the aim of fulfilling the outstanding requirements of the acquis, especially in the area of competition policy and state aid (Cyprus, Malta, Bulgaria, Romania, Turkey). The diversification of economic activities is also a matter of concern in Cyprus. Some countries make particular efforts to further liberalise and promote exports (Czech Republic, Malta, Latvia and Lithuania). One of Turkey's main stated goals is to create an environment more conducive to foreign direct investment, reflecting the presently very low levels of inward FDI.

Like in the previous year, the PEPs reflect all these objectives by an overall and fairly detailed lists of government actions in the enterprise sector. For most of the countries, the programmes do not prioritize the measures implemented or envisaged. The targeted sectors for liberalisation continue to be air transport, energy, telecommunication and postal services. Execution of planned privatisation is still lagging behind in several countries where the completion dates have been postponed. In the case of Poland, the continuation of privatisation in some specific sectors (mining, gas industry, heavy chemicals and defence industry) will strictly depend on the restructuring process. Romania's PEP gives a very detailed overview of planned or started privatisation individual measures over the short to medium term, without providing too much information on the underlying strategy and the overall rate of progress. The acceding and remaining candidate countries developed a range of measures aiming at decreasing the administrative burden (the so-called red tape) for entrepreneurs, at facilitating the access to finance for small and medium firms, promoting innovation and improving quality standards. The Hungarian PEP presents a new business-credit programme for SMEs aiming at providing firms with access to credit combined with business advice. Romania and Turkey report on having greatly simplified registration and authorisation procedures for new enterprises. Reforms in the tax system (incentives for entrepreneurs and a decrease of the tax burden) are implemented or foreseen across future Member States (Hungary, Poland, Malta) and particularly noteworthy in Slovakia.

As last year, in many cases the documents lack precision about the measures announced as regards their content, timing and, where relevant, their overall budgetary impact. Often, there is no indication of whether the commitments set previously have been achieved or of specific reasons for delay.

6.2. Financial sector

All countries have made strides in reforming their financial sectors. Most transition countries have completed, or advanced to a substantial degree, the restructuring and privatisation of their banks and, usually with some lag, of their non-bank financial sectors as well – with the notable exceptions of Slovenia and Romania, where delays in restructuring and privatisation complicate the development of financial markets. Romania's PEP sets, however, the clear goal of fully privatising the remaining two large banks, partly in state hands. The largest bank is already very close to a majority non-state ownership. In most countries, the substantial involvement of strategic foreign investors has been a salient feature of the privatisation process and, as a result, foreign ownership is prevailing.

In spite of these developments, the financial sector in the transition countries has so far remained relatively small and, notwithstanding considerable progress, there remains further room for enhancing efficiency. Altogether, the sector's intermediation role and its supporting function for economic growth and macroeconomic policies and stability need further strengthening. Limited financial sector intermediation has in particular been detrimental to small and medium-sized enterprises, which are usually not able to tap direct foreign financing and to use it as a substitute for domestic credit. In most countries, the private sector credit-to-GDP ratio is still only about one third or less of the euro-area. Financial systems are very bank-dominated and diversification has been embryonic, as the size and liquidity of the non-bank financial sector has been lagging behind.

Meanwhile, both banking and non-bank sectors are expanding fast in most countries. The role of the non-bank sector is in particular fostered by the introduction of funded pension schemes. As regards the banking sector, a very rapid credit growth can, for example, be witnessed in Latvia and Estonia, where it is coupled with high current account deficits. Especially in such cases, the authorities need to remain vigilant against potential stability risks. Also in Bulgaria and Romania, banking intermediation has started to rise fast, though from very low levels after the respective banking crises in those two countries. Turkey, after its deep macroeconomic and financial crises in 2001/2002, embarked on a far-reaching process of consolidation and strengthening of supervision in the banking sector. As a result, bank lending has started to rise considerably again, and the balance sheets of banks have become more shockproof. All countries should keep on strengthening their regulatory and supervisory framework so as to safeguard their expanding, increasingly competitive, and potentially more risk-prone financial sectors. Given the high levels of foreign ownership, this will of course involve correspondingly close cooperation with home country supervisors. In a related vein, countries are encouraged to expand their own surveillance capacity on macroeconomic and financial stability, in particular with respect to fiscal deficits and sustainability, current account deficits, the composition of capital inflows, credit growth and structure, aggregate and sectoral foreign debt dynamics and composition.

The chapters in the PEPs on the financial sector are rather diverse. The focus is, in general, on market development and institutional aspects. Most PEPs also discuss the alignment of the countries' legislation with the requirements of the acquis communautaire. In contrast, stability issues are usually not sufficiently elaborated, although some PEPs, for instance the Czech, Lithuanian and Polish ones, probe somewhat deeper into this area. The Turkish PEP provides a relatively detailed programme on the further development of capital markets, aiming at the same time at increasing the volumes, raising efficiency and strengthening supervisory standards.

6.3. Social security reform

Almost all countries indicate their awareness of the negative impact of population ageing on the financing of their social security, notably pension and health-care systems. Through increases in pension and health-care expenditures, population ageing is expected to have a negative impact on the medium and long-term fiscal sustainability. This is one of the major fiscal risks as pension and health-care spending are in many countries the biggest single items among all budget expenditures.

When facing this problem, most countries adopted, or are adopting, parametric changes in their pension PAYG pillars. Their primary objective is to link pension benefits closer to pension contributions and to bring the unfunded public scheme closer to actuarial balance. The measures include cuts in pension benefits, increase in retirement age, increase in pension contributions or a combination of those. There are however some exceptions: In Hungary, the first pillar old-age pensions should be increased by introducing a 13th month pension gradually over four years. Latvia plans to introduce higher indexation of pensions. Romania introduced a quarterly indexation of its pensions, pensions for certain groups, in particular farmers, will be raised. The objective of those measures is to improve the social situation of pensioners.

In addition to parametric changes, the majority of the countries have introduced a 3-pillar pension system, including state managed, PAYG pillar and two fully funded pillars (one obligatory and one voluntary). In this year's PEP, Lithuania and Slovakia

presented plans to implement a multi-pillar pension scheme (in 2004 and 2005, respectively).

Also Romania's PEP refers to draft legislation on the introduction of occupational pension schemes in Romania. The introduction of the second (funded, obligatory) pillar requires a high degree of administrative preparation in order to avoid implementation problems. For instance in Poland, there have been delays in transfers of social insurance contributions from the Social Insurance Institution ZUS to private pension funds.

Table 11

Main measures in the PEPs concerning pension reform

	3-pillar system introduced	Planned reforms
Cyprus	✓	- Parametric reforms in 1st pillar
Czech Republic	-	- 1st pillar: parametric reforms within fiscal consolidation, NDC reform foreseen for 2010 - No plans for the funded compulsory pillar
Estonia	✓	
Hungary	✓	- Gradual introduction of the 13th month pension - Increase contribution rate to 2nd pillar
Latvia	✓	- More generous indexation rule in the NDC pillar
Lithuania	✓	- Introduction of a 3-pillar system as of 2004
Malta	-	- Reform of 1st pillar planned - No plans for the compulsory funded pillar
Poland	✓	
Slovakia	✓	- Introduction of a compulsory funded pillar planned for 2005
Slovenia	-	- Parametric reforms in the 1st pillar
Bulgaria	✓	- Balance 1st pillar by 2007 - Increase contribution compliance
Romania	-	- Parametric reforms in 1st pillar - Introduction of occupational pensions scheme
Turkey	-	

Major motives behind reform steps in health care are to increase the quality of health care services and to cut health-care costs that are likely to further increase in the process of population ageing. Many countries mention improvements in the health-care sector as being important for the human capital development. Another motive for health-care reforms is to contribute to sound general government finances. Radical reform measures are in progress in Slovakia, including private co-financing. Cyprus plans to introduce a General Health Insurance Scheme. Romania is planning a major overhaul of its health care system, by strengthening market mechanisms in this field, improve management and make the system financially viable. Bulgaria, which had outlined similar plans in previous PEPs, reports implementation delays due to "political and public pressure".

6.4. Labour market

Labour markets differ considerably across the acceding countries. While in 2002 Cyprus, with an unemployment rate at 3.2% effectively does not have an unemployment problem, Poland holds has the highest unemployment rate, slightly under 20%, and in Slovakia the unemployment rate is decreasing from 18% of the labour force. The average unemployment rate of the acceding countries is thus markedly above the EU figure. Countries plan to operate their labour markets differently, depending on the structural mismatch between labour demand and supply as well as recent economic developments. In general, the macroeconomic scenarios project a very gradual path of

lowering unemployment over the next few years; between 2002 and 2006 the unemployment rate is to drop most significantly, by about 4 percentage points, in Lithuania. At the same time, countries anticipate participation rates to remain broadly stable as the upbeat growth prospects are mostly translated in relatively strong growth in labour productivity, rather than attracting more people to the labour market.

All programmes address the labour market performance by outlining the key policy objective of increasing labour market flexibility. Most countries confer to active labour market policies the most important role in tackling the structural shortcomings mainly related to an inappropriate skill structure. While some (Czech Republic, Hungary, Poland) present only tentative and fairly general lists of policy directions, others specify the reform plans in much detail. Their programmes are geared towards establishing better incentives for job creation and employment promotion and applying specific measures aimed at particular groups of unemployed. Provision of adequate education and training is seen as the key instrument in improving the labour markets, and is usually complemented also by measures enhancing social cohesion, equal opportunities, poverty reduction, and social insurance. Unfortunately, other issues are in many programmes only marginally covered, such as the challenges of achieving further flexibility on labour markets and of achieving or maintaining wage moderation, i. e. to keep wage rises below productivity growth.

Table 12

Labour markets

	Unemployment rate[1]		Participation rate[2]	
	2002	2006	2002	2006
Cyprus	3.2	3.0	70.0	70.0
Czech Rep.	7.3	7.5	71.1	70.9
Estonia	10.3	9.2	62.3	62.5
Hungary	5.8	5.8	59.7	61.5
Latvia	12.0	10.1	68.8	68.8
Lithuania	14.0	10.2	69.3	70.5
Malta	5.2	4.9	56.8	58.0
Poland	19.7	n/a[4]	76.4	76.1
Slovak Rep.	18.5	16.1	70.0	70.3
Slovenia	6.4	5.0	67.8	68.3
Bulgaria	17.8	14.0	53.3[3]	54.4[3]
Romania	8.4	6.8	47.1	46.4
Turkey	10.3	9.6	49.6	50.8
EU	8.2	:		:

1: ILO definition; 2: Age 15-64 3: Population aged 15 years and over 4: rates based on registered unemployed: 2002: 18.1%; 2006: 15.1%

III. COUNTRY ASSESSMENTS

CYPRUS

PRE-ACCESSION ECONOMIC PROGRAMME 2003

ASSESSMENT

1. OVERALL SUMMARY AND ASSESSMENT

In comparison with last year's PEP the main differences are a downward revision of GDP real growth projections for this year and next; the marked adjustment of public finance deficit targets; and, to a lesser extent, of current account deficits. GDP growth for this year and 2004 is revised down to 2% and 4% instead of previously 4.6% for both years, before returning to close to the potential growth rate of 4.5%. The government deficit is now set to reach 2.2% of GDP by 2006 instead of (near-) balance by 2005, while the structural deficit is projected to drop from an anticipated 4.3% of GDP this year to 2.2% of GDP by 2006. At the same time, the current account deficit is projected to diminish from 5.3% of GDP in 2002 to 1.4% of GDP by 2006. These revisions, as last years', were mainly ascribed to the adverse external environment in 2002 and early 2003 which hit Cyprus particularly hard, as tourism is a mainstay of the economy. Unemployment rates remained very low, however, and Cyprus effectively does not have an unemployment problem; the labour market is relatively flexible and well-functioning while imported seasonal labour also takes some of the strain in segments of the labour market. Price developments in 2002 and 2003 were mainly pushed by shifts toward higher VAT taxation related to the EU harmonisation process, and headline inflation is expected to peak at 4.6% in 2003 but then fall back to 2% for the remaining period. Even though since August 2001 the exchange rate policy framework has become more flexible through the abandonment of maintaining narrow margins around central euro-parity, the actual fluctuations of the Cyprus pound against the euro have continued to be small. In the programme the current exchange rate policy framework aimed at providing a stable exchange rate is set to continue.

The programme also explicitly notes the continuing commitment of Cyprus to meet the conditions to adopt the euro as soon as possible after EU accession, in 2007. It further describes a number of ongoing structural reform initiatives, and foreshadows to a substantial degree the Cardiff report, which Cyprus – like all other candidate countries – has been invited to provide in October this year. The PEP pays particular attention to environmental measures and the need to increase Cyprus' much-lagging performance on R&D, setting forth commensurate policies aimed at bringing the country in line with the Lisbon strategy. Progressive steps have continued toward liberalisation in a number of sectors, including telecommunications, air transport and energy, according to the commitment to full liberalisation by 2003. The programme outlines strategies on diversifying the economy to diminish the high tourist dependency and discusses regional policy, environment, health care, social security and the key issue of water management.

The current Cypriot PEP represents a consistent and mostly credible, albeit on the optimistic side, macro-economic framework covering the period 2003-2006, with GDP expansion again reaching close to potential growth by 2005. Significant progress has been made in the statistical field toward compliance with ESA95 although further efforts are required, in particular in the recording of government receipts. The government rightly underlined that the overriding objective within the macroeconomic

framework is "to correct fiscal imbalances… and reduce the fiscal deficit on a sustainable basis", and in this year's PEP the government re-committed to a new fiscal consolidation plan. The PEP budgetary scenario does no longer aim for balance within the projection period. This can be considered more feasible and more realistic compared to previous 'moving horizon' projections with each revision promising fiscal balance without actually progressing toward that point, thereby undermining credibility. However, it is also clear from the analysis that to reach even the rather modest proposed targets, significant corrective measures are required. Most of the projected fiscal adjustment comes from the expenditure side, which is welcome; however, this implies strict control of expenditure, an item on which the Cypriot record is not reassuring. A number of measures are described and quantified, and it can be positively noted that the measures on the expenditure side do not intend to decrease government investment but only consumption. Regarding the current account, the aim remains to bring down the high deficits to more modest and manageable levels via the fiscal consolidation program. However, the indicated current account deficit projections have in fact in the past only seldom been met and hence, the described path is subject to risk and conditional upon a successful implementation of the fiscal consolidation program.

Enactment of new legislation aimed at liberalising telecommunications and postal services is a positive step forward, as is the establishment of a new regulator in this sector. Implementation, however, has been slow, as has been liberalisation in the electricity sector. The discussion on the key issues of water management still does not include a timetable on commitments and appropriate pricing.

It can be positively noted that for a first time a text has been included -as an appendix- with an analysis of important institutional economic concerns regarding the Annan plan and the economic issues and significant costs and benefits regarding a possible reunification of Cyprus.

2. JOINT OPINION

"On 4 November 2003 the ECOFIN MINISTERS OF THE PRESENT MEMBER STATES AND THE ACCEDING COUNTRIES examined the 2003 Pre-Accession Economic Programme of Cyprus on the basis of an assessment prepared by the Commission Services, with a contribution from the ECB. In accordance with the Conclusions of the High-Level Meeting with the Candidate Countries in Athens (EFC/ECFIN/227/03) Ministers adopted this joint opinion.

The third Pre-Accession Economic Programme (PEP) provides a medium-term policy framework, covering the period 2003-2006. It includes public finance objectives and structural reform priorities needed for EU accession and prepares further the institutional and analytical capacity necessary to participate in EMU. The Programme was adopted by the government and submitted to Parliament.

…

Opinion

[…], Ministers urge Cyprus to vigorously implement the necessary budgetary measures to achieve the proposed deficit and debt level targets. In particular the measures to increase tax compliance and administrative efficiency deserve full attention, as do those on containment of defence outlays. Ministers note

> positively that on the expenditure side the consolidation program is based mainly on limiting government consumption and not investment. A forceful application of the fiscal consolidation program is also necessary to bring down the current account deficit.
>
> Ministers note positively the achievement of Cyprus to keep unemployment low. It is observed with satisfaction that the exchange rate of the Cyprus pound has established a good track record of maintaining stability vis-à-vis the euro despite capital liberalisation. Ministers affirm the importance of bringing inflation back to pre-2003 levels, they take note as well of the good track record of Cyprus in this domain and of the firmly stated intention to continue the use of monetary and exchange rate policy to keep inflation under control.
>
> In addition, Ministers would recommend Cyprus to forcefully continue the liberalisation of the utilities sectors and clearly address the issue of water management and water pricing with a timetable of commitments. Finally, Ministers encourage Cyprus to implement measures to increase the still low investment in R&D."

3. REVIEW OF RECENT ECONOMIC DEVELOPMENTS

Relatively low rates of growth in Cyprus main tourist markets coupled with a steep fall in tourist demand after September 11, 2001 led to modest but still positive GDP growth of 2.0%, supported by domestic demand. While for 2001 the tourism arrival growth rate was flat (following the stark drop after September 11), in 2002 arrivals dropped by 10.3% so that total exports declined by 5.1%, and imports fell by 1%. Further restraining factors on growth were a slackening in fixed investment growth and lower private consumption growth to 2.5%, due to weaker confidence amongst households and entrepreneurs and only partially offset by higher disposable income linked to tax reform. Nonetheless, overall investment growth still reached 10% as interest rate reductions (from 7% in early 2001 to 5% by December 2002) to counter the external demand shock positively affected construction demand. At the same time, fiscal policy slipped further from the fiscal consolidation program and turned more expansionary as public consumption rose strongly and revenues decreased, leading to a widening of the government deficit to 3.5% in 2002. With falling tourism arrivals and higher government consumption (including defence and aircraft) the current account deficit in 2002 rose further to 5.3% of GDP. Despite a halving of GDP growth, the registered unemployment rate rose only marginally to 3.2%. Inflation increased to 2.8% in 2002 compared with 2% in 2001, but this spike is mainly linked to a VAT tax harmonisation with the EU and higher oil prices.

The fiscal consolidation programme, first introduced in 1999, was revised and extended in 2001 and 2002 and, in the 2002 revision, aimed at reaching fiscal balance by 2005. Although successful at first, slippage occurred in 2001 and again in 2002 and the deficit climbed to 3.5% of GDP as against a 2.6% target. The programme was effectively abandoned in the course of 2003 with the budget deficit now expected to sharply rise to 5.4% of GDP for 2003 due to the economic slowdown, negative revenue impact of tax reform, increased defence outlays, and expansionary expenditure measures introduced end-2002 to offset subdued external demand

Table 1: Economic development

		PEP framework			
	2002	2003	2004	2005	2006
GDP growth at constant market prices	2.0	2.0	4.0	4.6	4.6
Contribution to GDP growth:					
- Final domestic demand	4.9	1.8	2.5	4.4	4.3
- Change in inventories and net acquisition of valuables	0.2	0.0	-0.4	-0.1	-0.1
- External balance of goods and services	-3.8	-0.1	2.0	0.4	0.3
Investment ratio (% of GDP)	20.0	18.3	18.4	18.6	18.8
GDP per head (PPS, % of EU average) (1)	72.0	72.5	73.6	75.2	76.8
Participation rate (% of 15-64 age group)	70.0	70.0	70.0	70.0	70.0
Unemployment rate (ILO definition)	3.2	3.5	3.4	3.2	3.0
Employment growth	1.2	0.5	0.9	1.1	1.2
Labour productivity growth	0.8	1.5	3.1	3.5	3.4
Average real wage growth	2.4	1.0	3.3	2.5	2.5
CPI inflation (annual average)	2.8	4.6	1.8	2.0	2.0
Exchange rate vis-à-vis EUR (percentage change of annual average)	2.1	0.0	0.0	0.0	0.0
Current account balance (% of GDP)	-5.3	-4.4	-2.1	-1.7	-1.4
Net foreign direct investment (% of GDP)	3.0	2.3	2.1	2.0	1.9
Foreign debt (% of GDP)	39.4	39.36	38.12	36.22	34

Source: PEP, if not otherwise indicated

(1) calculated, without demographic or price effects; growth rates: candidate countries: PEPs / EU: 2003-04: Spring 2003 COM forecast; thereafter same as in 2004

Even though in the last two years the exchange rate policy framework has become more flexible through the abandonment of the policy of maintaining the narrow margins around the central parity in August 2001, the actual fluctuations of the Cyprus pound against the euro have continued to be small, for the most part not exceeding the narrow margins of ±2,25%. In the meantime, monetary policy accommodated a subdued economic activity, leading to declining growth rates in money supply and lower interest rates.

4. MEDIUM-TERM MACROECONOMIC FRAMEWORK

This PEP provides a comprehensive and mostly credible, albeit on the optimistic side, macro-economic policy framework covering the period 2003-2006 and the projections are largely based upon cautious and realistic macroeconomic assumptions. The framework gives the following main economic policy priorities, unchanged from last year: achievement of a satisfactory rate of growth with internal and external macroeconomic stability; full employment and social cohesion; liberalisation of the economy as well as further diversification in line with comparative advantage and the promotion of structural reforms; fostering the knowledge-based economy in line with the Lisbon strategy; promotion of balanced regional development.

Each point in turn is discussed clearly and very extensively. In comparison with last year's PEP, a main difference concerns the introduction of a new fiscal consolidation program. With the continued difficult international economic and political situation in 2002 and early 2003 and an alarmingly rapid slipping of the fiscal consolidation

program, new fiscal targets have now been introduced. The programme does no longer aim at balancing the budget by the end of the forecast period (now 2006) but to reach 2.2% of GDP by that year. At the same time the adjustment path in bringing down the current account deficit has also been revised and moved further in time.

4.1. Real sector

The medium-term growth assumption of real GDP growth of 4.4% for the period 2003-2006 is not unreasonable and in line with previous growth performance, albeit on the optimistic side. As a result of the ongoing weak external environment, the GDP growth rates for 2002 and 2003 have been revised downward to 2% instead of 2.8% and 4.6% previously, while for the rest of the period a rebound is expected. Especially external demand but also domestic demand, notably private consumption and investment demand, are assumed to drive growth. On the external side, a rebound in export growth is anticipated to 6% for the period 2004-2006, based on a conservative -given historical growth rates- assumption of a 5% annual growth for tourist arrivals. This would by 2006 bring the level of tourist arrivals back to the level of 2000.

Regarding domestic demand, fixed investment is projected to grow by around 6.5% annually, also reflecting a rebound after the expected decline this year. Nevertheless, the investment ratio in Cyprus remains among the lowest of the Acceding Countries or compared to the EU MS. The indicated factors pushing for investment growth more or less remained the same to last year’s, such as the positive outlook on EU accession and continuing pressure for enterprise restructuring, financial market and foreign investment liberalisation, structural reforms in utilities sectors (particularly energy and telecommunications) and planned major infrastructure projects (new airports in Larnaca and Paphos and a new port in Larnaca). The growth rate of private consumption is expected to be moderate with an annual rate of 3.8% (after 5.3% for 1998-2002). Underlying factors here are, *inter alia*, modest increases in real earnings as well as the effects of a relative shift in tax burdens to consumption through increases in VAT rates linked to harmonisation with EU acquis.

4.2. Inflation and wages

The medium-term programme envisages a continuation of the convergence path to EU inflation levels, with a core inflation[1] towards 2% annually. Close monetary control, a stable euro-peg policy since 1999 (preceded by an ECU-peg since 1992), and moderate real wage growth despite near full employment conditions resulted in a good track record in low inflation and make this a credible policy objective. Despite the projected continuation of a low core-inflation path, prices in 2002 and 2003 especially are pushed by shifts toward higher VAT taxation related to the EU harmonisation process. As a result of these developments, headline inflation is expected to peak at 4.6% in 2003 but then fall back to 2% for the remaining period.

With unemployment rates at 3-3.5%, Cyprus does not have an unemployment problem. The labour market is relatively flexible and well-functioning while imported seasonal labour also takes some of the strain in segments of the labour market. The wage system

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[1] Defined as a measure of inflation that excludes changes in the prices of agricultural goods and petroleum products, as well as changes in indirect taxes.

is based on a central system of collective bargaining with a backward-looking indexation adjustment to the cost of living (COLA) but this excludes the impact of the VAT and excise tax rises. Annual real wage increases are projected at 2.8% for the period, slightly below projected labour productivity growth. This looks feasible, although it remains to be seen to what extent wage pressures might increase when growth recovers.

4.3. Monetary and exchange rate policy

The Central Bank has achieved a solid track record on containing inflation through monetary and exchange rate policy. The monetary policy operational framework is based on ECB practices with as prime monetary policy objective price stability over the medium-term, which is interpreted to be a targeted range of core inflation around 2%. It is envisaged that the current ERM2-type exchange rate framework shall continue to be in place until the eventual adoption of the euro. Notwithstanding the recent fiscal slippage, the government firmly intends to join the euro zone as early as possible after accession, with 2007 remaining the target date.

4.4. External sector

As in the previous PEP, a moderate current account deficit continues to be envisaged for the medium-term. The current account deficit is projected downward over the period, declining from a deficit of 5.3% of GDP in 2002 to a deficit of 1.5% of GDP by 2006[2]. The improvement reflects a recovery in export markets growth, gains in terms of trade in 2003, and reduced import demand stemming partly from the new fiscal consolidation programme. It also includes a number of *ad hoc* factors such as a significant fall in imports for defence equipment in 2004 and 2005 and positive spillover of the economic impact from the 2004 Olympic Games in Athens. Services exports, excluding tourism, are projected to increase by about 11% in the period 2004-2006, in line with historical growth rates. Following the fall in tourist arrivals in 2002 and 2003, tourism is also expected to rebound slowly. Revenue in the period 2004-2006 is projected to grow at about 8% annually while arrivals increase by 5%, implying a slightly higher rate of growth in spending per tourist compared to last year's report.

The envisaged continuation of structural reforms, including capital account liberalisation, is expected to increase competitiveness and boost export performance, especially that of services. In that same vein, capital account liberalisation, structural reforms and investment opportunities in the services sector are projected to help financing the deficit through non-debt flows, notably foreign direct investment (FDI). The latter is to increase further from 4.3% of GDP reached in 2002 to 5.5% by 2006, while outward FDI is also set to rise. This is relatively high, also historically (although this was also due to capital restrictions), and could be too optimistic, but it still looks viable.

Although current account deficits are not bad *per se*, continuing current account deficits are a weak spot in the economy. At the same time, financing has not been a problem so far, while capital liberalisation and ongoing economic restructuring make non-debt creating financing easier and more attractive. The authorities are nevertheless well

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[2] Given that in the 2003 PEP Balance of Payment (BoP) statistical data from 2002 onward are based on Eurostat methodology, data are not strictly comparable with last year's PEP BoP statistics.

aware of the potential problems of continuous and sometimes high current account deficits. Aiming to reduce these deficits from the high current levels to less than 1.5% of GDP by 2006 is slightly more realistic than aiming to reach balance, as was projected in the first PEP. This does require the implementation of the fiscal consolidation program, even though the fiscal budget targets are rather modest. Nevertheless, this projected path still looks rather optimistic, given that similar projected paths have not been achieved with the previous fiscal consolidation programmes; it should be noted that the aimed-for current account deficit levels have in fact only seldom been achieved in the last decade (in 1995 and 1999). Furthermore, notwithstanding the necessity of fiscal consolidation for reaching a more sustainable external balance, the picture is not straightforward; not only fiscal slippage but also private sector dissaving has on occasion prevented the current account deficit from declining (for instance in 1998 and especially in 2000).

5. PUBLIC FINANCE

5.1. The medium-term fiscal framework

Cyprus has a mixed record on fiscal consolidation since some slippage started in 2001 and increased in 2002-2003, despite earlier PEP target projections on reaching fiscal balance over the medium term. The slippage can partly be ascribed to the modest growth of European economies, the repercussions of September 11, 2001 and other terrorist events on air travel, the Iraqi war and SARS, which have all contributed to diminishing external demand feeding into a deterioration of the public finances. However, another factor affecting adversely the outcome of public finances both for 2002 and 2003 was the higher than originally expected defence outlays and expenditure to partly offset the economic downturn. These expenditure increases more than offset declining outlays resulting from a phasing out of subsidies and much lower interest payments. In addition, the tax reform, (moving from direct taxes to indirect VAT taxation in line with EU acquis) that aimed at a zero impact on public finances was not implemented as originally planned as concessions were made in order to secure broad political support. As a consequence, the outcome in 2002 and in the first half of 2003 showed a considerable deviation compared to the anticipated net impact.

As a consequence of these developments, general government net borrowing rose to 3.5% of GDP in 2002 compared with last year's projection of 2.6%. For 2003, the fiscal deficit is estimated to increase further to 5.4% of GDP, or 3.5%-points higher than the target of last years' PEP. To counter this alarming development, and given that the newly elected government has a clear policy priority to achieve entry into the euro zone by 2007, a revised fiscal consolidation programme for the period 2004 to 2006 was adopted and presented in this PEP. The programme indicates a set of measures, aimed at improving revenue performance and containing expenditure growth over the programme period. The newly implemented programme seeks to reduce general government net borrowing from 5.4% of GDP estimated for 2003 to 2.2% of GDP by 2006; in contrast to the previous PEP projections, this programme therefore no longer aims at reaching (near) balance over the medium term. Such adjustments are understandable in the light of the difficult international economic situation. The less ambitious fiscal program targets can be considered more feasible compared to previous 'moving horizon' projections, with each revision promising fiscal balance without actually progressing there and thereby undermining credibility. However, it is also clear from the analysis that to reach even these rather modest targets, significant corrective

measures are required. A number of measures are described and quantified, and it can be positively noted that the measures on the expenditure side do not intend to decrease government investment but only consumption. Regarding the current account, the aim remains to bring down the high deficits to more modest and manageable levels through the implementation of this fiscal consolidation program. Nevertheless, despite earlier fiscal consolidation programmes, the indicated current account target levels have only seldom been reached.

The structural deficit[3] is projected to drop from an anticipated 4.3% of GDP this year by 0.8% points to 3.5% of GDP in 2004 and further down to 2.8% and 2.2% of GDP in 2005-2006, respectively.

Concurrently, the programme targets to put the general government gross debt as a % of GDP on a downward trend. This is to be realised mainly from the progressive reduction of general government net borrowing. The steady reduction of general government gross debt over the period is also based on the gradual convergence of domestic interest rates to those in the eurozone and the targeted rise in the primary balance from –0.4% of GDP in 2003 to 2.5% of GDP by 2006. Hence, general government gross debt is estimated to decline from 63.6% of GDP in 2003 to 56.1% of GDP by 2006.

As with the previous consolidation programme in the 2002 PEP, policies aimed at a sustained reduction in the fiscal deficit continue to rely on the containment of defence

Table 2: Fiscal development
(general government, % of GDP)

		PEP framework			
	2002	2003	2004	2005	2006
Receipts	36.3	37.3	37.8	38.3	38.5
Expenditures	39.8	42.7	41.5	41.1	40.7
Net lending	-3.5	-5.4	-3.7	-2.8	-2.2
- Cyclically adj.	-2.5	-4.3	-3.5	-2.8	-2.2
Primary balance	1.4	-0.4	1.2	2.0	2.5
Gross debt level	59.7	63.6	62.6	60.7	56.1

Source: PEP, if not otherwise indicated

outlays, slowdown of government employment growth following increases associated with EU harmonisation, lower agricultural subsidies, and savings from the extension of the government employees retirement age. Taxation and social expenditure associated with taxation reform are also part of the fiscal policies implemented over the medium term. This includes measures such as raising the standard VAT rate to 15% as prescribed by the acquis, in the second half of 2002 and in 2003. In the projections of public finances, the costs of harmonisation with the acquis are taken into account, including the -modest- budgetary costs of structural reforms. It is estimated that the maximum flow of funds towards Cyprus from the EU budget will amount to about 0.6% of GDP (in 2005), while the contribution of Cyprus to the EU budget is estimated to around 1.5% of GDP (in 2005). During the period 2004-2006, the EU will cover the resulting deficit and provide additional net financing of the order of 0.3% of GDP on an annual basis.

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[3] The structural deficit is a cyclically-adjusted deficit

5.2. Public debt management and deficit financing

Government deficits were to a large extent financed through Central Bank of Cyprus (CBC) financing, but this window was subsequently closed with the independence of the CB per July 2002 and lending to the government ceased. Changes in the composition of government debt since CB independence reflect debt management policies aimed at lengthening debt maturity and smoothing the repayment schedule rates.

With the prohibition of CBC financing of government deficits it was envisaged that the non-bank private sector would rapidly become an important holder of government debt. However, this has proven difficult to realise so far. Banks are now the main holders of government bonds, accounting for 54% of government debt, up sharply from 40% in 2001. At the same time, the share of the non-bank private sector dropped from 33% in 2001 to 25% by mid-2003, much contrary to last year's PEP targets. Promoting the growth of government debt holding by the non-bank private sector is now put forward as key objective of the government's debt policy. As the PEP indicates, this will necessitate modernisation and structural adjustment for the still thin and underdeveloped secondary government bond market in order to increase its attractiveness.

5.3. Fiscal risks

This part of the PEP is virtually unchanged from last year. The fiscal consolidation projections are accompanied by an updated sensitivity analysis evaluating the impact of changes in economic growth and interest rates on the fiscal deficit and public debt. The analysis suggests that debt and deficit trajectories are most sensitive to changes in GDP growth, but that fiscal policy is likely to remain on a sustainable path in the event of (relatively small) changes in these factors. Nevertheless, the elasticity of the deficit to GDP growth is relatively large, which strengthens the assessment that significant measures are indeed required to keep the new fiscal consolidation program on track in the face of uncertainty and risks of not meeting the fiscal programme targets in case of lower growth.

The main contingent liability is the borrowing guarantees provided to various government organisations and domestic institutions, totalling 10% of GDP at end-2002. The report notes that in the past there has been only one major case of the exercising of a guarantee but that in any case this liability can be adequately met.

Other fiscal risks discussed in detail concern long–term (up to 2050) future obligations in meeting pension and health expenditures. Such projections are of course tentative but they provide a useful analytical framework of the impact of long-term demographic developments on government expenditure. Up to 2020, pension and health care outlays do not seem to pose a significant threat to fiscal sustainability. Beyond this date, the simulations show that wide-ranging policy reforms are necessary, especially with regard to the pension scheme. Unchanged from last year, the PEP suggests a range of possible policy pension reforms and it also contains a brief discussion of ongoing health sector reforms.

6. STRUCTURAL REFORMS

The largest part of the PEP is dedicated to an extensive discussion of structural reforms and the text tracks last year's PEP. In response to the Commission's suggestion, the information provided foreshadows to a considerable extent the Cardiff report, which Cyprus – like all other candidate countries – has been invited to provide in October this year. It will be comprehensively evaluated in the respective assessment, whereas the following will describe the presented reforms only briefly. The major objective of structural reforms in Cyprus is to enhance the effectiveness of market mechanisms, mainly through the elimination of remaining market rigidities. The objective is to enhance potential GDP growth, making the Cyprus economy competitive in the EU internal market, to increase the ability to absorb external shocks, and to contribute towards achieving macroeconomic objectives. Specific objectives of the structural reforms are to create conditions conducive to maintaining productive investment; to increase competitiveness and diversification by improving the efficiency of factor markets; and to facilitate adjustment to intensified competition from the social perspective, taking also into account environmental concerns.

The budgetary costs of structural reforms are not significant as it amounts to around 0.4% of GDP over the period 2003-2006. The programme provides a detailed structural reform agenda covering the enterprise sector, financial sector, the labour market, administrative reform, agriculture, and other reform areas (environment, healthcare, taxation, and regional policy). Each is accompanied by an overview of progress achieved. Like last year, there is no indication of where commitments set previously have not been met, or specific reasons for delay. On the latter, the text does note as a general reason that this was due to the legislative- and resource efforts linked to the preparation of new laws relating to the provisions of the Annan Plan. On the issue of water management and pricing the report notes again that policy will be revised and higher tariffs will be charged in the context of the EU New Water Framework Directive. However, precise commitments or timetables are still lacking (although footnotes 103 and 104 provide assumptions about timing and size of such price increases).

6.1. The enterprise sector

The reform agenda for the enterprise sector is dominated by the need to meet the requirements of the EU acquis. The text deals with competition policy, state aid, privatisation, and liberalisation of the utility sectors. The authorities are committed to the full liberalisation of the air transport sector, the electricity sector, telecommunications and postal services by 2003. Regarding the electricity sector, progress has been made in approval of legislation concerning the liberalisation of the sector, the establishment of an independent regulator and tariff re-balancing. However, the liberalisation provisions will only come into effect after accession and therefore Cyprus lags behind. Furthermore, there is no indication in the PEP of a commitment to implement the directive relative to free choice of electricity suppliers by non-household customers is made. Important steps to deregulate and open up the telecom sector have been taken since the previous PEP with the entry into force of the new harmonised telecommunications and postal services legislation per 31.12.2002, the appointment of a regulator, completing the required regulatory framework for mobile telephony and inviting tenders for licensing. The further liberalisation of air transport has been delayed to the date of accession instead of 01.01.2003, as previously committed to. The relevant law was approved by parliament in December 2002 and the liberalisation clauses will enter into force upon accession.

Regarding the complex issue of tourism dependency, as indicated in previous years as well the authorities perceive a need to diversify economic activity as tourism and financial services have grown rapidly over time while other traditional areas of activity, such as manufacturing and agriculture, have declined. It introduced an action plan aiming at enhancing private sector services outside tourism, while existing restructuring programmes have been adjusted to comply with objectives of the new Strategic Development Plan and EU structural co-financing actions. The government has in the last years introduced restructuring schemes for support for manufacturing restructuring, increasing foreign direct investment in the high-tech sector and improving industrial research and innovation. Especially in the latter area Cyprus is trailing behind the EU in terms of R&D as a % of GDP (as it does in total investment levels as well). The PEP enumerates a number of policy measures to address this issue and on the transition to a knowledge-based economy. Regarding the tourism sector, the government has introduced a 10-year strategic plan aimed at improving its quality. Nevertheless, with such a strong comparative advantage, tourism is expected to remain of major significance also over the long-term. Its prospects will depend on the success of the policies directed to upgrading the tourism sector.

6.2. The financial sector

Cyprus has generally a well-developed and competitive financial sector and the sector has seen rapid growth, particularly over the 1997-2002 period, despite the problems experienced through the fall in share prices in 2000-2002. The text discusses the progress in the liberalisation of the financial sector including banking (both banks and Co-operative Credit and Savings Societies or CCSS), insurance, investment services and securities markets, and capital market liberalisation. Liberalisation in line with the *acquis* is to be completed this year and the programmes are more or less on schedule. The environment in which credit institutions operate changed from 1.1.2001 with the abolition of the interest rate ceiling and liberalisation of interest rates. This liberalisation has taken place smoothly while competition in the banking sector has increased as witnessed e.g. by diminishing margins and a differentiation of interest rates. At the same time, there has been continued progress in the capital market liberalisation programme, even somewhat ahead of the timetable for complete liberalisation of capital flows upon accession. This liberalisation has so far not led to increased exchange rate instability.

Regarding the regulatory and supervisory framework in the financial sector, Cyprus is in general at an advanced stage of harmonisation with the relevant acquis and the programmes aim at full compliance. Last year's evaluation pointed out that the situation on the various regulatory agencies was not transparent, with potential supervisory competition and overlap. This year some clear progress has been made, although implementation has been slow so far. Noteworthy is the increase in administrative capacity of the Securities and Exchange Commission (SEC) over the past two years. Additionally, the Central Bank of Cyprus (CBC), SEC and the Insurance Companies' Control Service signed a Memorandum of Understanding which came into effect on 1 January 2003, paving the way for closer co-operation and co-ordination among the three regulatory authorities. This is a positive step forward, although it still remains open how implementation will function in practice.

The CCSS are to be fully aligned with the acquis on credit institutions in a transitional period of 5 years (by end-2007). The CBC is the supervisory agency to regulate banks,

while for the CCSS the Department of Co-operative Development (DCD) will continue to be the supervisory agency, and hence similar financial institutions are supervised by different agencies. Positive steps here are the increase in administrative capacity of DCD and the parliament approval of the amending bill to the Banking Law that will bring the legal framework in full conformity with the EU acquis on credit institutions. The law now includes an explicit provision for enhanced co-operation between the CBC and DCD and enables the CBC to exercise, in co-operation with the DCD, consolidated supervision of the CCSS. Nevertheless, here as well it remains to be seen how this will operate in practice.

Last year's assessment also pointed to potential problems of supervisory competition between the SEC and the Cyprus Stock Exchange (CSE). A 'blueprint' has now been finalised for legislative action clearly delineating the supervisory duties for the SEC and the CSE and which needs to be further implemented, but no further timetable was indicated.

6.3. The labour market

The labour market in Cyprus is relatively flexible and well functioning. The government aims to further improve labour market flexibility, notably on mismatches between demand and supply in a number of occupations. The PEP extensively discusses measures including, *inter alia*, the introduction of a national system of vocational qualifications, promotion of part-time work, and the reduction of marginal tax rates. The text also considers education & training, gender (in-) equality and social insurance and gives specific measures and progress achieved, much along the lines of the previous PEP. It also refers to human capital development, promotion of equal opportunities and strengthening of social cohesion as a development priority of the Strategic Development Plan 2004-2006, and the preparation of the Single Programming Document for Objective 3 of EU Structural Funds.

6.4. Administrative reform

The government has been implementing public service reform schemes that aim at increasing transparency and accountability, improving productivity and the service quality. Measures include personnel training in public administration and the introduction of Citizen's Charters in an increasing number of departments.

6.5. Agriculture

Reforms aim at restructuring the sector and harmonisation of agricultural policies and markets with the CAP. Cyprus initiated the process of alignment and gradual harmonisation at an early stage, particularly in structural policy where all new programmes have been undergoing evaluation for acquis conformity for a decade. In many other areas, it applies legislation and instruments similar to those under the acquis. Where this is not so, corrective actions have been included in the harmonisation programme. Rural development policy objectives and instruments are for the most part in line with the CAP. In the framework of the Structural Funds of the EU, a Rural Development Plan 2004-2006 was prepared and submitted to the Commission in June 2003.

Water management is one of the most challenging environmental constraints confronting the island. Although the severe water shortage has been mitigated in recent years through construction of desalinisation plants and more normal rainfall, the issue remains. As regards water pricing, prices still are below costs, especially for agriculture that uses the bulk of water. The observation that pricing policy will be revised in line with the EU New Water Framework Directive is unchanged from last year and again a precise commitment or timetable is lacking.

6.6. Additional reform areas

The other reform areas discussed are environment, healthcare, taxation, and regional policy. Activity in the environmental area has been high since the previous PEP, and the text notes that Cyprus will complete the process of legislative transposition by the end of 2003. Until the end of June 2003, 110 new laws, regulations and orders were issued in the broader environment sector, whereas over the past two years greater emphasis has been attached to the effective implementation of the acquis. On taxation, a broader tax reform was approved by parliament in July 2003. The tax reform aims at harmonisation with the acquis minimum indirect taxation levels and shifts taxation to indirect taxation. This reduction of the tax burden on capital and labour is expected to contribute to the creation of a more favourable business climate and work incentive.

In a separate annex, the Cyprus PEP also contains a broad analysis of institutional and economic aspects of a settlement of the Cyprus problem on the basis of the Annan plan. It discusses the significantly different sizes and levels of development of the Greek Cypriot and Turkish Cypriot economies, and critically reviews, *inter alia*, the proposed but still unclear or underdeveloped institutional set-up regarding the powers of the federal government, economic and development policy responsibilities -with particular focus on monetary and fiscal policy, taxation and public finances-, compensation issues, and the need for international financial support. Provided such complex issues and very real challenges are constructively resolved, the report also observes on the potential strong positive macro-economic growth effects over the short -to longer term for the whole of the island.

This annex is a positive and welcome addition to the Cyprus PEP. It is encouraging that the authorities have added it in the first place, while the text itself provides a helpful first analysis addressing complex key economic issues. It facilitates discussion and thinking on the economic aspects on issues that inevitably have to be faced for all parties involved in case of a settlement.

CZECH REPUBLIC
PRE-ACCESSION ECONOMIC PROGRAMME 2003
ASSESSMENT

1. OVERALL SUMMARY AND ASSESSMENT

Compared to the PEP of 2002, major changes include the medium-term macroeconomic outlook and the reform of public finances. Growth rates have been revised downwards by about 1 percentage point for each year of the 2003-2005 period, but GDP growth is expected to accelerate from 2.4% in 2003 to 3.6% in 2006. The PEP projects a small and diminishing negative output gap until 2005 and a slightly positive output gap in 2006. As regards domestic demand, the growth rate of household consumption (4.0% in 2002) is expected to decrease but still to remain high. The high growth rates in government consumption in 2002 and 2003 are expected to become negative in 2004 (–0.5%) and zero in the two consecutive years. On the contrary, the PEP foresees the growth rates of gross fixed capital formation to increase substantially and reach 4.2% in 2006. The contribution of net exports to growth is expected to be negative in 2003 and neutral later on. In 2003-2006, the current account deficit is expected to stabilise or even slightly decrease, staying in the range of 6-7% of GDP. The rate of registered unemployment is projected to remain high – about 10%. As regards monetary and exchange rate policy, inflation targeting is accompanied by a managed float of the currency. From the second half of 2003, inflation is expected to accelerate from the current level around zero, but to remain fairly low (about 2.5% annually). The PEP only presents a broad approach towards euro area accession, while referring to a strategy being prepared by the Czech authorities. According to this strategy, the Czech koruna should participate in ERM II only when pre-conditions have been met for a positive assessment of the fulfilment of the criteria for euro adoption two years later. Taking into account the overall macroeconomic framework and, in particular, the current fiscal situation, the government foresees euro area accession around 2009-2010.

Public finances present the most critical part of Czech economic policy. The already high general government deficit in 2002, currently estimated at 6.7% of GDP, is likely to further increase in 2003 to 7.6% of GDP. The PEP presents a comprehensive fiscal reform plan which foresees a reduction in the general government deficit to 4% of GDP in 2006 and a compliance with the Maastricht criterion on the general government deficit in 2008 at the latest. The focus of fiscal consolidation is on the expenditure side. The envisaged expenditure savings should represent more than two thirds of total consolidation, the remaining consolidation should be reached by increased revenues. In 2006, the cyclically-adjusted general government deficit remains high at 4.1% of GDP. The gross debt is expected to increase by more than 12 percentage points, from 26.9% of GDP in 2002 to 39.4% of GDP in 2006.

The programme presents a number of structural policy initiatives, namely in the area of product, capital and labour markets. Serious is the situation in the labour market which is characterised by a high and slightly increasing rate of registered unemployment with significant regional differences. Structural reforms will be addressed in depth in the autumn when the Czech government will submit the so called Cardiff Report.

The presented medium-term macroeconomic outlook is consistent and credible. The transparency of government figures and their conformity with the ESA 95 methodology

have been improved considerably. Greater efforts could be made in setting clearer priorities and more rigorous streamlining of structural reforms.

The PEP rightly identifies fiscal policy as the main bottleneck of the current macroeconomic situation. There are two main positive features of the fiscal consolidation package. First, it is the concentration on expenditure cuts, and second, it is the introduction of medium-term expenditure frameworks. Those frameworks are expected to include not only current spending of individual ministries, but expenditures of extra-budgetary funds and the creation of reserves for state guarantees. The medium-term expenditure frameworks will create binding ceilings for central government expenditures in the medium term (three years). This would represent a substantial and positive institutional shift in the Czech budgetary process. The overall credibility of the plans for fiscal consolidation can be assessed only after the next year's budget and the expenditure ceilings are approved by the Parliament.

Achieving steady reduction of the general government deficit to 4% of GDP in 2006 is not without risks. First, measures on the expenditure side rely to a large extent on discretionary measures – cuts in spending of individual ministries and in the wage bill in the public sector. Second, mandatory and quasi-mandatory expenditures which constitute the major part of the overall spending have not been substantially reformed. This concerns mostly the pension and health-care system. Third, state guarantees remain a source of potential risk. In 2002, the volume of outstanding state guarantees was almost 13% of GDP and their total expiration will not be sooner than in 2028. Those guarantees, when called, might worsen both the government deficit and debt.

The present framework for monetary and exchange rate policy has usefully contributed to enhance economic stability. In the field of structural reforms, the PEP only partly addresses the main bottlenecks in the Czech labour market and remains general. For instance, the problem of low labour force mobility is mentioned only in terms of professional and qualification flexibility, but not in terms of geographical mobility which seems to be linked to the heavily regulated housing prices and limited availability of houses in some areas with strong job creation. Some other problems are not mentioned as well, for example the high share of long-term and youth unemployment. The PEP would also benefit from an evaluation of active labour market policy measures.

2. JOINT OPINION

"On 4 November 2003 the ECOFIN MINISTERS OF THE PRESENT MEMBER STATES AND THE ACCEDING COUNTRIES examined the 2003 Pre-Accession Economic Programme of the Czech Republic on the basis of an assessment prepared by the Commission Services with a contribution from the ECB. In accordance with the Conclusions of the High-Level Meeting with the Candidate Countries in Athens (EFC/ECFIN/227/03) Ministers adopted this joint opinion.

The third Pre-Accession Economic Programme (PEP) provides a medium-term policy framework, covering the period 2003-2006. It includes public finance objectives and structural reform priorities needed for EU accession and prepares further the institutional and analytical capacity necessary to participate in EMU. The Programme was adopted by the government in July 2003.

…

Opinion

[…],Ministers welcome the recent solid macroeconomic performance of the Czech Republic and support the implementation of medium term expenditure ceilings as an instrument to prevent further budgetary slippages. Ministers note positively that fiscal consolidation takes place mainly on the expenditure side.

The fiscal consolidation measures as presented in the 2003 PEP are welcome. However, the Czech Republic is urged to vigorously implement the necessary budgetary measures to achieve fiscal consolidation. In particular, the cuts in spending of individual ministries and in the public wage bill deserve full attention. It is important to introduce further reforms, mainly in the field of pension and health-care spending. Ministers identify that a forceful application of the fiscal consolidation programme would ease possible risks of unsustainable current account developments and contribute to contain government debt dynamics.

Ministers positively note the progress achieved in the financial sector and in other structural policy areas. However, they encourage the Czech authorities to develop a more coherent plan encompassing the interdependencies of individual structural measures. More specifically, Ministers are concerned about unemployment which seems to be mostly of a structural nature. The Czech Republic is recommended to implement further measures in the labour market as it is crucial to enhance growth potential. In particular, the professional and geographical mobility of the labour force should be increased."

3. REVIEW OF RECENT ECONOMIC DEVELOPMENTS

The PEP provides a good overview of recent economic developments. In 2002, the Czech Republic experienced an economic slowdown. The GDP growth rate reached 2.0 percent. However, this performance was satisfactory, taking into account the lower dynamics of foreign demand and the negative impact of the August floods. In the first half of 2003, there was a slight improvement in the economic performance as the year-on-year GDP growth reached 2.3%. The Czech Republic maintained a positive growth differential vis-à-vis the EU Member States.

Economic growth in the Czech Republic is characterised by the ongoing restructuring. Some traditional industries like heavy engineering are phasing out, whereas new industries emerge, mostly stimulated by foreign direct investment (e.g. computer manufacturing). Calculations of the potential output suggest that the economy was growing below its potential and that the negative output gap slightly increased. On the one hand, this indicates that the pre-conditions for sustainable higher economic growth are created which is needed for the convergence of the Czech economy to the EU level. On the other hand, it underlines the necessity of further structural reforms.

The main source of economic growth in 2002 was domestic demand which contributed 3.7 percentage points to the GDP growth rate. The contribution to the GDP growth rate of household consumption was 2.1 percentage points and government consumption 1.0 percentage point. Gross capital formation contributed only 0.5 percentage points, mostly due to the economic downturn outside the Czech Republic. Nevertheless, the investment ratio of 26% of GDP remained quite high.

The dominance of household consumption as GDP driving force can be explained by the increase of real wages. The wages rose by 7.2% in nominal terms, whereas annual growth in CPI was only 0.6%. At the same time, the use of consumer credit by households became more frequent due to declining nominal interest rates and due to constant gross household savings.

As regards the external sector, the Czech economy realised relatively high export and import growth in 2002 (8.9% and 5.7% in current EUR prices). Despite slower economic growth in the partner countries, the trade balance deficit improved from 5.1% in 2001 to 3.3% of GDP in 2002. On the contrary, the balance of services and the balance of income substantially worsened compared to 2001. This was mostly due to the decline in tourism after the floods and due to an increase in the repatriated and reinvested profits in foreign-owned companies. The contribution of the net export of goods and services on the overall economic growth was negative (-1.7 percentage points). This was mostly due to the negative contribution of the balance of services (-2.7 percentage points) as the contribution of the net exports of goods was positive (1.0 percentage points).

Table 1: Economic development

		PEP framework			
	2002	2003	2004	2005	2006
GDP growth at constant market prices	2.0	2.4	2.8	3.2	3.6
Contribution to GDP growth:					
- Final domestic demand	3.4	2.8	2.3	2.8	3.3
- Change in inventories and net acquisition of valuables	0.3	0.2	0.5	0.2	0.2
- External balance of goods and services	-1.7	-0.7	0.0	0.1	0.1
Investment ratio (% of GDP)	26.3	25.3	25.3	25.1	25.0
GDP per head (PPS, % of EU average) (1)	60.0	60.6	60.8	61.3	62.0
Participation rate (% of 15-64 age group)	71.1	70.9	71.0	71.0	70.9
Unemployment rate (ILO definition)	7.3	7.2	7.5	7.5	7.5
Employment growth	0.8	0.1	0.2	0.1	0.1
Labour productivity growth	1.2	2.2	2.6	3.1	3.5
Average real wage growth	4.6	6.1	2.8	3.0	3.5
CPI inflation (annual average)	1.8	0.4	2.6	2.5	2.5
Exchange rate vis-à-vis EUR (percentage change of annual average)	-9.6	1.6	-3.1	-1.1	-1.0
Current account balance (% of GDP)	-6.5	-6.7	-6.8	-6.5	-6.2
Net foreign direct investment (% of GDP)	13.0	7.3	6.7	6.2	5.7
Foreign debt (% of GDP)	33.94	33.09	31.38	30.03	28.6

Source: PEP, if not otherwise indicated
(1) calculated, without demographic or price effects; growth rates: candidate countries: PEPs / EU: 2003-04: Spring 2003 COM forecast; thereafter same as in 2004

In total, the current account deficit experienced deterioration (by 0.8 percentage points compared to 2001). Its level reached 6.5% of GDP. The current account deficit was financed by a large surplus in the capital account. The inflows of foreign direct investment were more than twice as high as the current account deficit (13% of GDP). This inflow was however exceptional as it was encouraged by the ongoing privatisation of state property which amounted approximately to 41% of the total FDI in 2002.

The risks to the macroeconomic outlook remained the same as in the year 2001. First, the general government deficit further increased and reached 6.7% of GDP, mostly due to higher mandatory and quasi-mandatory expenditures and due to the losses of the CKA (the Czech Consolidation Agency). Second, the labour market situation further worsened. On average, the unemployment rate grew by 0.6 percentage points in 2002, reaching 9.8% at the end of the year. The issue of major concern is the development of real wages that have grown faster than labour productivity. Those two internal negative factors were accompanied by a third one – the ongoing appreciation of the Czech koruna. In 2002, its nominal exchange rate strengthened by 10.6% against the euro and by 16.2% against the US dollar. If sustained, each of those factors or their combination could have a negative impact on the external balance.

4. MEDIUM-TERM MACROECONOMIC FRAMEWORK

The macroeconomic framework of the 2003 PEP is based on a combination of formal (economic modelling) and less formal tools of economic forecasting. Like in the last year, the quantitative framework was subject to two independent consistency checks: first, its feasibility was examined by a survey of opinions of Czech governmental and private economic forecasting institutions, and second, it was verified at the Prague University of Economics by applying the HERMIN model.

The scenario relies on realistic assumptions which take into account upside and downside risks in a balanced way. Restrictive demand effects of fiscal reform are expected to be offset by later positive supply effects and increasing growth dynamics. The accession of the Czech Republic into the EU is not expected to bring about any dramatic changes for the internal economic environment. Future developments of the external environment were derived from the Spring 2003 Commission's forecast. Significant downside risks to the forecast, in particular related to the German economy, were included. In this sense, the macroeconomic scenario is rather conservative.

4.1. Real sector

The growth outlook of the Czech economy appears reasonably positive. The Czech authorities expect GDP growth rates to gradually accelerate from 2.4% in 2003 to 3.6% in 2006. Compared to the 2002 PEP, GDP growth is lower by about 1 percentage point. This correction reflects the impact of the economic slowdown in the main trading partner countries and the effects of the expected public finance reform on both government and household consumption. On the other hand, fiscal reform and other economic policy measures together with the ongoing inflow of foreign direct investment are expected to reinforce the supply side of the economy. Those positive effects are expected to materialise already at the end of the 2003-2006 period.

The PEP indicates some changes in the structure of the demand side of the economy. As regards domestic demand, the growth rates of household consumption (4.0% in 2002) will decrease but still remain high. More dramatic changes are expected in the case of government consumption as it will be the factor mostly influenced by the reform of public finances. The high growth rates in government consumption in 2002 and 2003 are expected to become negative in 2004 (–0.5%) and zero in the two consecutive years. On the contrary, the growth rates of gross fixed capital formation are expected to increase substantially and reach 4.2% in 2006. As regards external demand, the

contribution of the trade balance of goods and services to the overall GDP growth should be slightly negative in 2003 and neutral over the period 2004-2006. In 2002, the Czech economy is estimated to have a negative output gap (-0.4% of potential output) which is expected to close in 2005 and to become slightly positive in 2006.

The labour market seems to be affected by the structural mismatch between the labour supply and labour demand. On the demand side, there is an increase in employment which is expected to continue due to economic growth and due to jobs created in the developing small and medium-sized business sector. At the same time, the ongoing restructuring means pressure for higher labour productivity and changing qualifications. As labour supply is largely rigid, both in terms of professional and qualification flexibility, the restructuring leads to redundancies, especially among less qualified workers. This process is further aggravated by low geographical mobility of the labour force. Higher geographical mobility is hindered by the badly functioning housing market and by less developed transport infrastructure. As a result, the rate of registered unemployment is expected to remain high – about 10%.

4.2. Inflation and wages

Since mid-2001, the Czech Republic has been facing decreasing inflation (measured as the year-on-year growth of CPI). Since the beginning of 2003, the Czech Republic has experienced deflation or CPI growth just above zero. From the second half of 2003, inflation is expected to accelerate, but to remain on fairly low levels. In the years 2005-2006 annual inflation should oscillate around 2.5%. The loose fiscal policy does not seem to have any inflationary impact.

The inflation outlook is coherent with the overall macroeconomic environment. The development of prices in the long run is likely to be affected by the convergence of the Czech economy to the EU level (particularly by the Balassa-Samuelson effect). In the short and medium term, future price development is subject to the expected increases in excises and VAT and to the expected price deregulation, mostly in rental prices. As the deregulation in housing market is politically highly sensitive issue, its dynamics is difficult to predict. The Czech authorities expect regulated rents to grow by up to 15% in 2004. Another source of inflationary pressures could be the growing volumes of credits to households and growth in real wages beyond the increase in labour productivity.

4.3. Monetary and exchange rate policy

The framework of monetary and exchange rate policy remains unchanged – inflation targeting is accompanied by managed floating. Monetary policy is set up in the "Long-Term Monetary Strategy", according to which inflation is targeted in the framework of a continuous band. The objective of this strategy is that inflation should lie between 2-4% at the end of 2005. The strong nominal appreciation tendencies of 2001 and 2002 have eased. Since mid-2002, the Czech koruna has been depreciating against euro. This is mostly due to the fact that capital inflows linked to the privatisation process in the Czech Republic ceased. The PEP, however, foresees that the appreciating trend of the Czech koruna vis-à-vis euro will return, be it at a lower pace than in 2001 and in the first half of 2002.

As the “Long-Term Monetary Strategy” will expire at the end of 2005, the Czech National Bank is going to prepare a new concept of monetary policy framework by the end of May 2004. It is likely that this framework will be linked to the strategy of euro area accession. The strategy has been prepared by the Ministry of Finance in co-operation with the Ministry of Industry and Trade and after consultation with the Governor of the CNB. According to the draft of the strategy, the Czech Republic should not stay longer in ERM II than needed to meet the Maastricht criteria. More specifically, ERM II participation should happen only when other convergence criteria are likely to be fulfilled in the 2-years period after the ERM II entry. Due to the difficulties in public finances, the Czech Republic does not intend to enter ERM II at the moment of EU accession in May 2004. The Czech authorities foresee that the Czech Republic will be able to fulfil the criteria for euro area accession at the end of the decade.

4.4. External sector

Despite the PEP foresees an improvement in the trade balance resulting from the launch of export-oriented production, the current account is expected to stabilise or even to slightly increase. In the period 2003-2006, the current account deficit should reach 6-7% of GDP. This is due to the fact, that the improvement in the trade balance is going to be offset by a worsening in the income balance as foreign investors will repatriate their profits.

The current account deficit is expected to be further covered by surpluses in the financial account. This should be viewed with caution as the major part of financial capital inflows – foreign direct investment – is likely to decrease substantially, as the privatisation process will be completed.

5. PUBLIC FINANCE

Public finances present the most critical part of the Czech economic policy. In this field, the PEP provides a major improvement compared to the year 2002 as it presents a comprehensive reform plan.

The general government deficit has been rising over recent years and public debt rapidly increased. In 2002, the general government deficit is estimated 6.7% of GDP and in 2003 it is expected to reach 7.6% of GDP (including the losses of the CKA). As a result, public debt is expected to increase by more than 12 percentage points, from 26.9% of GDP in 2002 to 39.4% of GDP in 2006. The simulations of the Ministry of Finance show that without fiscal reform, the general government deficit would reach the level of 8-9% of GDP in 2004-2006 (GFS 86, i.e. cash-based methodology), if the current path continues. Those rising deficits appear at a time when the Czech economy is on the upward part of the business cycle. This indicates a structural nature of the deficits.

The fiscal deficits have three major causes. First, social and health-care expenditures not only constitute the main share in general government expenditures, they also have the highest dynamics. Second, the Czech public finances have been characterised by the expansion of extra-budgetary spending. And third, major expenditures are linked to the

transformation costs related to restructuring of the corporate and banking sector (losses of the CKA).

A positive feature of this year's PEP is that, for the first time, the analysis of the fiscal framework included a sensitivity analysis of the impact of external shocks on economic performance, in particular on the fiscal situation. Also the quality of data has been improving as many of them were provided in the required ESA 95 methodology.

5.1. The medium-term fiscal framework

The medium-term fiscal framework is based on macroeconomic forecast and uses the situation of 2003 as the starting point. The development in the years 2004-2006 is marked by public finance reform which aims at reducing the general government deficit to 4% of GDP in 2006 and to comply with the Maastricht fiscal criteria in 2008 at the latest.

The focus of fiscal consolidation is on the expenditure side. The envisaged expenditure savings should reach 70-80% of total consolidation, 20-30% should be reached by increased revenues. Apart from fiscal consolidation, there are several institutional changes foreseen in the fiscal policy process. Those include the medium-term expenditure targeting and inclusion of the extra-budgetary funds under the spending of individual ministries.

Table 2: Fiscal development (general government, % of GDP)

		PEP framework			
	2002	2003	2004	2005	2006
Receipts	42.4	42.4	43.8	43.4	42.7
Expenditures	49.1	50.0	49.7	48.2	46.8
Net lending	-6.7	-7.6	-5.9	-4.8	-4.0
- Cyclically adj.	-6.5	-7.5	-5.8	-4.8	-4.1
Primary balance	-5.0	-6.0	-4.6	-3.2	-2.4
Gross debt level	26.9	30.5	34.2	37.7	39.4

Source: PEP, if not otherwise indicated

The three major expenditure-side measures include cuts in wage expenses in public sector, cuts in discretionary spending of individual ministries, and reductions in sickness benefits. Those three measures constitute more than ¾ of all expenditure cuts. Savings in the public sectors' wage spending are planned to be reached mostly through the reduction of the number of employees (annually by 2% over the period 2004-2006). Cuts in discretionary spending will concern mostly military expenditures, the state subsidy for housing savings programmes, subsidies to businesses and the operating costs of individual ministries.

Some additional savings should come from parametric changes in the pension system, including reductions in early-retirement pensions, minimal indexation of pension benefits and a further increase of the statutory retirement age. In a longer perspective, the negative impact of the Czech pension scheme on public finances should be avoided by the transformation of the currently defined-benefit to a defined-contribution system.

The new (so called notional defined-contribution, NDC) system is preliminary planned to be introduced in 2010. The reform also foresees cuts in social assistance and social care. Whereas cuts in discretionary expenditures will be more pronounced at the beginning of reform, from 2005 onwards, the focus should shift towards systemic measures.

Important consolidation measures will be introduced on the revenue side as well. In general, there should be a shift in the structure of budget revenues – decreases in the corporate income taxes should be more than offset by an increase in VAT and in excise duties. Higher VAT revenues are planned to be generated by broadening the tax base (a lower limit for obligatory VAT registration) and by transferring some goods and services from the reduced VAT rate (5%) towards the standard rate (22%). The corporate income tax rate is planned to be reduced from current 31% to 24% in 2006. Other measures on the revenue side include introduction of the value principle into the assessment of real estate tax, modernisation of the tax and customs administration, introduction of cash registers and the tendency to create a level playing field between self-employed persons and employees. Social policy contributions base of self-employed persons should increase and reach 50% of the difference between revenues and costs (from the current 35%). Changes in tax legislation are expected to increase the ratio of state revenues by 1 percentage point over the whole period 2004-2006.

Very important is the institutional part of fiscal reform. The major institutional innovation is the introduction of medium-term expenditure frameworks. With the annual budget for year *n*, the government has to present expenditure ceilings for years *n+1* and *n+2*. Those ceilings will be binding as they have to be approved together with the state budget. This means a shift from the current annual ineffective budget negotiations and the introduction of a medium-term fiscal planning. It also allows the government to fix its annual fiscal targets for the general government deficit as percentage of GDP. However, given binding expenditure ceilings, but uncertain revenues, these fiscal targets can only be indicative.

Another important institutional innovation is the inclusion of the extra-budgetary spending under the budget headings of individual ministries. The National Property Fund should be abolished by the end of 2005. Similarly, the Czech Consolidation Agency should be closed by the end of 2007 (only preliminary date).

The evaluation of credibility of fiscal reform will be possible only on the base of the 2004 budget which should be accompanied by expenditure ceilings for 2005 and 2006. However, this is still an open issue.

Fiscal reform plans display several shortcomings. First, the fiscal target – 4% deficit in 2006 – is not very ambitious, in particular when taking into account a relatively good growth outlook. In 2006, the cyclically-adjusted general government deficit is expected to be still very high (-4.1% of GDP). Further consolidation is therefore required. Second, some measures are not systemic. For instance the decrease in the deficit of the pension scheme should be financed by a shift from employment policy contributions (2 percentage points). This means, on the one hand, an effective increase in the already very high contribution rate on pension policy. On the other hand, it is a decrease of financial resources for the labour market policy in the situation of high and further rising rate of unemployment. Nevertheless, if implemented in its current shape, fiscal reform can generally be considered as a step in the right direction. Institutional changes will not only increase transparency of the budgetary process, but they also could

introduce a new framework for thinking on public finances. It is necessary to develop a clear concept to reform mandatory and quasi-mandatory expenditures, mainly pensions and health.

A part of the chapter analyses the impact of the EU accession on public finances. In the period 2004-2006, the EU accession is expected to increase the government sector deficit by 0.3-1.0% of GDP. The general government expenditures (the contributions of own resources, co-financing of structural operations) will be payable immediately after the accession. Those expenditures are already included in the medium-term expenditure frameworks of individual ministries.

5.2. Public debt management and deficit financing

Despite the Czech Republic still belongs to countries with the lowest levels of public debt, its dynamics is alarming. Public debt is expected to increase by more than 12 percentage points from 2002 to 2006 and reach a level of 39.4% of GDP. A substantial part of this increase is due to losses of the Czech Consolidation Agency, but this factor should diminish over time. It is not possible to rely on high inflows of privatisation revenues which slowed down the growth of public debt in the last few years as those resources are nearly exhausted.

As the major bulk of public debt is created by the state, the main focus of fiscal reform is on the central government. Debt of local governments is still very low, but it is expected to increase. The debt of health insurance companies is expected to be almost zero.

The state debt has almost fully concentrated on the domestic market. It allowed the Czech government to avoid exchange rate risk and to profit from relatively low interest rates. However, this situation is likely to change due to a still expansive fiscal policy. This increases the refinancing risk. The underselling of new bonds in July 2003 already pointed to possible problems with refinancing of the state debt in the Czech capital market. It is therefore likely that the Czech government will try to circumvent the narrowness of the Czech securities market by issuing euro-denominated bonds. This step was avoided in 2001 and 2002 because it would strengthen appreciation pressures on the Czech koruna prevailing at that time. This pressure seems now to be weakened. Nevertheless, the issuance of bonds in foreign capital markets should be co-ordinated with the Czech National Bank.

The Czech Government should improve the unfavourable term structure of the debt financing. Currently, almost 40% of the state debt is subject to refixing of the interest within one year. This exposes the debt financing not only to the above mentioned refinancing risk, but also to interest risk.

5.3. Fiscal risks

The PEP identifies state guarantees as the main source of fiscal risk. The total volume of those guarantees is very high – it reached almost 13% of GDP by the end of 2002. Those guarantees will not fully expire before 2028. However, there have been some improvements in this area. In 2002, only two new guarantees were provided. A more

systemic solution is proposed in public finance reform, according to which the creation of reserves for new state guarantee has to be included into the medium-term expenditure frameworks. This should further decrease the willingness of the government to provide state guarantees.

The PEP mentions the explicit state guarantee covering the liabilities of the Railway Route Administration (RRA), a state-owned company which was created after the Czech Railways were split into two separate units. This state guarantee is extremely risky as the RRA does not carry out any entrepreneurial activities. The PEP mentions that the Czech Statistical Office has already included the RRA into the government sector. However, more specific information would be welcome as there are still several open legal issues linked to the separation of property between the RRA and the reformed Czech Railways.

Another issue which is not discussed in the PEP and which also presents a possible financial threat are arbitration proceedings. In 2003, the Czech Republic had to pay about 0.4% of GDP as a result of the arbitration proceeding. Currently, several arbitration proceedings against the Czech Republic are still open. In the case "Nomura vs. the Czech Republic" the Czech Republic is claimed to pay about 1.7% of GDP. However, it must be acknowledged that systematic treatment of the fiscal impact of those one-off events is difficult as the outcomes of arbitration proceedings are very uncertain.

6. STRUCTURAL REFORMS

The PEP recognises the necessity to continue with structural reforms in order to achieve the strategic objectives defined by the Lisbon Summit and in accordance with the Cardiff and Luxembourg processes. The programme provides an exhaustive overview of structural reform agenda, covering product markets, financial markets, labour market and other areas of structural policies, e.g. environmental, transport, or regional policy. A more profound analysis of structural reforms will be provided in the Cardiff Report which will be submitted to the European Commission in the autumn.

The coverage of this chapter is very broad. It is the reason why the analysis of structural measures seems to be unbalanced. It does not always take into account links between various reform fields. For instance, it would be interesting to study what impact fiscal reform is likely to have on SMEs or on the labour market. In some areas it is difficult to identify the progress compared to the last years' PEP. A better systematisation, use of more quantitative indicators and a clear setting of priorities would be very useful. It would also help if the government tried to asses the impact of structural measures on GDP growth and on budgetary revenues.

6.1. The enterprise sector

Further privatisation of state-owned enterprises is recognised as an important strategy for increased competition in product markets. Since selling the gas industry to the strategic investor in 2002, the privatisation process has been lagging behind. Only the steel company VITKOVICE was sold to a strategic investor. The government did not succeed in selling the petrochemical company Unipetrol. The privatisation was re-opened, but the result will not be known before the spring 2004. The Czech electricity

company CEZ is not for sale. The government considers to sell only a part of the shares (about 15%) and to keep the majority.

The Czech government adopted several measures to support and develop the business environment, mostly the small- and medium-sized enterprises. Those measures include: improvement of the legislative regulation of bankruptcies, acceleration and simplification of registration in the Commercial Register, acceleration of the functioning of commercial courts. It is, however, not very obvious at what stage these measures are and what results they have so far delivered.

6.2. The financial sector

The analysis on financial markets development has been done thoroughly, both in terms of coverage and in terms of depth. In a highly monetarised economy, smooth functioning and stability of financial institutions have a crucial impact on the growth potential. The financial sector displays several positive features. Within the banking sector, which dominates the Czech financial market, the share of non-performing loans is continuously decreasing (almost 11%, after deducting collateral). Collective investment is the most dynamic segment of the Czech capital market. The volume of savings in open-ended mutual funds shows a long-term growth tendency. Also the life insurance industry displays a very high dynamics. The main shortcoming of the Czech capital market is that it still does not function as a source of funding for companies.

As regards legislative measures, a number of law amendments is mentioned which should increase transparency of capital markets. The Czech government together with the Czech National Bank also plan to merge the three supervisory bodies over banking sector and financial markets.

6.3. The labour market

Apart from fiscal policy, labour market seems to be the next major issue for the Czech economic policy management. Since 1996, the registered unemployment rate has been increasing, reaching 9.2% in 2002. At the beginning of 2003, the unemployment rate reached its historical maximum (10.2% in February). Unemployment in the Czech Republic is predominantly of structural nature, the share of long-term unemployed is increasing. At the same time, there are substantial regional differences. The structurally weak regions (Moravia-Silesia, Usti nad Labem) have unemployment rates about four times higher than Prague.

The PEP only partly identifies the main bottlenecks in the Czech labour market. For instance the problem of low labour force mobility is mentioned only in terms of qualification's mobility, but not in terms of geographical mobility which seems to be linked to the heavily regulated rental prices. In general, labour policy measures are very general and vague. The PEP would benefit from evaluation of active labour market policy measures.

6.4. Administrative reform

The PEP mentions that the Czech government set information society as its clear priority. In charge of this policy field is the newly established Ministry of Informatics.

One of its main objectives is to improve functioning of public administration in favour of both citizens and businesses. Reforms of public administration and of justice are broadly discussed. As for justice reform, some indicators on its success should be included. It is however not clear what of those fields have higher priorities or in which the current government faces the main challenges.

ESTONIA

PRE-ACCESSION ECONOMIC PROGRAMME 2003

ASSESSMENT

1. OVERALL SUMMARY AND ASSESSMENT

The Estonian Pre-accession Economic Program (PEP), which was drafted along the lines of the structure proposed by the EU Commission services, provides a comprehensive outline of recent economic developments, structural policies, and detailed medium-term plans in the areas of fiscal policy and structural reform. The PEP was prepared by the Ministry of Finance in consultation with the Bank of Estonia and the Ministries of Economic Affairs, Communications, Environment, Social Affairs, Agriculture, and Education and Science, was approved by the Government cabinet, and published subsequently, in August 2003.

The PEP envisages GDP growth of some 6% in the medium term, driven by private consumption and investment, but a somewhat limited contribution from net exports. Inflation is set to increase somewhat in 2004 to 3.8%, but to stabilise thereafter at some 3% in the medium term, while the unemployment will stabilise at 9% of the labour force. The envisaged recovery in the world economy and the resulting pick-up in export demand—underlying the medium-term forecast and fiscal framework—are expected to lead to an improvement in the current account deficit, which nonetheless is forecast to remain high at some 8.6% of GDP in 2007. A pickup in the external demand combined with relatively sluggish import growth, and an increase in domestic saving—stemming from rising disposable incomes, buoyant company profits, and subdued investment growth compared to recent years—appear to be the principal reasons behind the narrowing of the current account deficit; in particular as the general government budget is forecast to remain in balance throughout the period. Private consumption, underpinned by strong wage growth, is set to continue to grow unabated. A balanced budget and the currency board arrangement will continue to be the foundations of macroeconomic stability in Estonia. The authorities have declared their intention to participate in the Exchange Rate Mechanism (ERM II) upon accession, and to be ready to adopt the euro as early as 2006, if by that time the conditions for membership have been fully met.

Reforms in Estonia have progressed rapidly and the PEP sets out the conditions for sustainable growth in the medium term: prudent fiscal policy, open and flexible markets operating at full capacity, and investment in physical and human capital. Undoubtedly, investment is likely to boost productivity and the economy's potential growth in the medium- and long-term. Indeed, under the currency board arrangement, market flexibility, and a strong productivity growth are key in sustaining economic growth. Plans to lower unemployment, through training and education, will also contribute toward that aim. Further market liberalization will strengthen competition, raise standards of living and bring Estonia's economy in line with the EU. The PEP presents a broad overview of planned structural reforms, and foreshadows to a substantial degree the Cardiff report, which Estonia has been invited to provide in October 2003.

The PEP is comprehensive and covers adequately the main areas where attention should be focused in the medium term. Nonetheless, the envisaged scenario raises questions

about the policies set out in the PEP, in particular the objective of a balanced general government budget and in this context the proposed tax cuts. Although a moderately high current account deficit could have been justified if mainly driven by imports of capital goods, the dynamics of the present scenario appear to be largely based on a consumption-led domestic boom; currently supported by strong credit demand. Under these circumstances—and given the above-trend GDP growth—fiscal policy, which remains the only instrument for macroeconomic stabilization purposes, should play a more active role to counterbalance booming domestic demand. Balancing the budget over the cycle is more appropriate on stabilization grounds, than the emphasis on balancing the budget on a year-by-year basis, which entails a pro-cyclical fiscal stance exacerbating the cyclical fluctuations of the Estonian economy. This would imply achieving budgetary surpluses in the program period. Ensuring that the proposed tax cuts are accompanied by measures to control expenditure could contribute to achieve a general government surplus, and allow for a correction of the current account.

Progress in completing structural reforms has been satisfactory and the list of planned reforms is appropriate from an economic and social viewpoint, while its budgetary impact seems to be consistent with the overall fiscal framework. The emphasis on the labour market is particularly welcome given the high structural unemployment rate in the country. Nonetheless, more solid plans pertaining to the strengthening of the regulatory bodies in a number of areas (e.g., Communications, Energy, and Transport), and further liberalisation of the energy market would have been warranted.

2. Joint Opinion

"On 4 November 2003 the ECOFIN MINISTERS OF THE PRESENT MEMBER STATES AND THE ACCEDING COUNTRIES examined the 2003 Pre-Accession Economic Programme of Estonia on the basis of an assessment prepared by the Commission Services with a contribution from the ECB. In accordance with the Conclusions of the High-Level Meeting with the Candidate Countries in Athens (EFC/ECFIN/227/03) Ministers adopted this joint opinion.

The third Pre-Accession Economic Programme provides a medium-term policy framework, covering the period 2003-2007. It includes public finance objectives and structural reform priorities needed for EU accession and prepares further the institutional and analytical capacity necessary to participate in EMU. The Programme was adopted by the government cabinet in August 2003.

…

Opinion

[…], Ministers commend the authorities for pursuing structural reforms, while following credible and prudent macroeconomic policies. Ministers note particularly the success of the currency board system in fostering macroeconomic stability, and note the low levels of general government debt, and budget surpluses realised recently.

Nonetheless, Ministers emphasise the important role of fiscal policy, in terms of macroeconomic stabilisation, in particular against the background of a widening current account deficit. Hence, Ministers call upon the authorities to allow

automatic stabilisers to operate, thus achieving surpluses during the program's period, and to focus more on balancing the budget over the cycle rather than on a year-on-year basis. Indeed, Ministers note that over the medium term vigilance is required in relation to the level and financing of the current account deficit, to ensure that the external debt ratio is prudently contained. In this connection the authorities are also encouraged to monitor carefully developments in private sector credit growth and explore ways to increase the level of domestic savings.

Ministers note the progress achieved in structural reforms but encourage the authorities to present more solid plans for the further strengthening of the regulatory bodies in a number of areas (e.g., Communications, Energy, and Transport), and liberalisation of the energy market."

3 REVIEW OF RECENT ECONOMIC DEVELOPMENTS

3.1. Real sector

The Estonian economy continued to grow unabated in 2002, against the backdrop of a global economic slowdown. Real GDP growth of 6%, which was considerably stronger than had been forecast in the 2002 PEP, was supported by investment and private consumption. Low real interest rates, strong wage and employment growth and improving consumer confidence were the main factors behind the growth in private consumption. Furthermore, buoyant FDI inflows, and large one-off investment projects provided a significant additional boost to aggregate demand. Nonetheless the economic slowdown in the world economy continued to have its toll on external demand in 2002, and the contribution of net exports turned negative. The conditions in the labour market improved markedly in 2002 and the unemployment rate declined to 10.3% of the labour force, the lowest rate in four years.

3.2. External sector

The continued weakness in the global economy had a considerable effect on growth during 2002. Export demand was weakest in the low value added (electronics subcontracting) sector, while imports for inputs also declined significantly. However, exports of more traditional goods (e.g., wood, paper production and furniture) remained solid compensating for the weakness in technology and hence the electronics subcontracting trade. A resilient domestic demand was also translated into a strong demand for imports particularly for capital, and other consumer, goods. Hence imports of goods grew by 13%, compared to 2001. Consequently, the current account deficit, at some 12.3% of GDP, was considerably wider than had been anticipated in the 2002 PEP. The current account deficit continued to deteriorate into the first quarter of 2003, but has improved slightly in the second quarter as a result of a pick-up in demand for good, and particularly services.

3.3. Inflation

Inflation continued to ebb, reaching 3.6% in 2002, mainly as a result of falling food prices, and a strong Estonian kroon. Price pressures eased further in the beginning of

2003, and Estonia's inflation rate fell below the eurozone's inflation for the first time since 1999.

4 MEDIUM-TERM MACROECONOMIC FRAMEWORK

Table 1: Economic development

		PEP framework			
	2002	2003	2004	2005	2006
GDP growth at constant market prices	6.0	4.5	5.6	6.0	6.0
Contribution to GDP growth:					
- Final domestic demand	9.5	8.9	5.1	6.7	6.5
- Change in inventories and net acquisition of valuables	0.8	-0.4	-0.1	-0.2	0.0
- External balance of goods and services	-4.3	-4.1	0.6	-0.4	-0.6
Investment ratio (% of GDP)	31.4	33.1	33.0	33.1	33.5
GDP per head (PPS, % of EU average) (1)	42.0	43.3	44.7	46.3	47.9
Participation rate (% of 15-64 age group)	62.3	62.2	62.2	62.2	62.5
Unemployment rate (ILO definition)	10.3	9.9	9.6	9.4	9.2
Employment growth	1.4	0.2	0.5	0.3	0.6
Labour productivity growth	4.4	4.2	5.1	5.7	5.8
Average real wage growth	7.0	8.7	5.0	5.4	5.6
CPI inflation (annual average)	3.6	1.7	3.8	3.4	3.2
Exchange rate vis-à-vis EUR (percentage change of annual average)	0.0	0.0	0.0	0.0	0.0
Current account balance (% of GDP)	-12.3	-12.7	-10.4	-9.6	-9.0
Net foreign direct investment (% of GDP)	2.4	5.9	5.0	5.2	5.3
Foreign debt (% of GDP)	65.1	71.8	74.2	75.9	77.2

Source: PEP, if not otherwise indicated
(1) calculated, without demographic or price effects; growth rates: candidate countries: PEPs / EU: 2003-04: Spring 2003 COM forecast; thereafter same as in 2004

The main focus of economic policy in Estonia is to achieve sustainable and balanced economic growth. In that regard, macroeconomic stability, which supports growth and development and preserves price stability, and a continuing implementation of structural reforms are viewed as the cornerstones of the medium-term economic policy framework. The PEP emphasizes the need for a liberal trade policy, enhanced competition in the marketplace, and declares the government's unremitting commitment to the principle of balancing the general government budget, and of maintaining the currency board arrangement. Indeed, the PEP emphasises the similarities between Estonia's planned economic reforms, and the EU's Lisbon strategy which aims at raising economic growth through increased employment and enhanced productivity.

4.1. Monetary and Exchange Rate Policies

Under the currency board arrangement, which has served Estonia well over the last few years, price stability remains the key focus of the monetary policy framework. Nonetheless, a gradual nominal convergence with the EU and the harmonization of the monetary policy framework with that of the eurosystem are viewed as prerequisites for

the eventual adoption of the euro. The PEP declares the authorities' intention of participating in the ERM II—while maintaining the currency board arrangement—immediately after their accession into the EU, and their objective to (eventually) adopt the euro sometime in 2006. These plans, the PEP acknowledges, entail continuation of the current policy framework, and structural reforms that should contribute further into transforming Estonia into a more dynamic, flexible, and competitive economy. Further reforms are also needed to align institutions, particularly in the financial sector and the monetary policy framework, with those in the euro area. According to the official projections included in the PEP, Estonia is set to meet the Maastricht criteria, assuming that it maintains the current thrust of its policies.

4.2. Real Sector

Investment is expected to continue to expand at a rapid pace, raising further the country's productive capacity and sustaining robust growth rates into the medium term. Government spending on infrastructure is likely to remain strong, supported by pre-accession and structural funds, while investment in the transport and energy sectors is also anticipated to remain particularly buoyant over 2005-2007. Low interest rates, planned tax changes, and the ongoing pension reform which has stimulated activity in the financial markets and hence investment, are likely to spur private sector demand in the medium-term. Additionally, foreign direct investment is expected to continue to stimulate investment activity in Estonia. Consumption, sustained by strong wage and employment gains and low interest rates, will also continue to support growth in the medium term. On the external side, a continuation of the strong performance of the more traditional exporting sectors, and an expected revival in sub-contracting demand in 2003-04, are set to boost exports and provide an impetus to GDP growth.

The medium-term projections envisage real GDP growth of some 6% in 2005-2007, which is somewhat higher than the estimated potential growth rate of 5-5½%. In the medium- to long-term that assumption is hard to reconcile with a stable, or falling, inflation rate assumed in the medium-term framework. Hence, it would have been more realistic for the program to assume a more conservative growth rate for the medium-term, say in line with the potential GDP growth, but highlight the significant upside risks emanating from, inter alia, a sustained decline in the unemployment rate, and potential for strong foreign direct investment inflows. Downside risks to the medium-term framework include delays in implementing the structural reforms, and improvements in the labour market.

This year's PEP includes a number of analytical notes which provide a useful background material to the medium-term economic program, including estimates for the cyclically-adjusted fiscal balance, a discussion of the impact of privatization on FDI inflows, and analysis of the effect of the depreciation of the US dollar on Estonia's external balance. These are useful background notes, which improve the analytical content of the program.

4.3. Inflation and wages

The PEP assumes a rather benign outlook for inflation in the medium term. Although some inflationary pressures are likely to emerge as a result of planned price, tax increases—largely related to the EU accession in 2004—the forecast envisages a continuation of a deceleration of inflation which is now expected to reach 2.8 percent

by 2007. Notwithstanding the diminishing pressures emanating from administrative price rises, this is a particularly over-optimistic assumption given the envisaged productivity differential vis-à-vis the EU which also appears to be widening during 2004-2007.

4.4. External Sector

The envisaged recovery in the world economy and the resulting pick-up in export demand are expected to lead to an improvement in the current account deficit, which nonetheless is forecast to remain moderately high at some 8.6% in 2007. A recovery in the external demand combined with relatively sluggish import growth, and an increase in domestic saving—which for the most part must be due to a moderating investment growth,—appear to be the principal reasons behind the narrowing of the current account deficit; in particular as the general government is forecast to remain in balance throughout the period. Private consumption, underpinned by strong wage growth, is set to continue unabated.

Such a downbeat outlook—especially for the current account deficit,—could raise questions about the sustainability of current policies, in particular the assumption of a balanced general government budget. Although a moderately high current account deficit could have been justified if that was mainly driven by imports of capital goods, the dynamics of the present scenario appear to be largely based on a consumption-led domestic boom. Under these circumstances—and given the above-trend GDP growth—fiscal policy, which remains the only instrument for macroeconomic stabilization purposes, would have provided a considerable counterbalance to the booming domestic demand. Merely allowing the automatic stabilisers to operate fully should result in a sizeable general government surplus, and allow for an ample correction of the current account.

A number of risks to this assessment are mentioned but are not incorporated into the analysis. A more analytical evaluation of the risks would have been warranted since it would have provided some magnitude to these risk factors. The possibility of a prolonged global slowdown, worsening labour conditions, and slower progress in pursuing structural reforms are likely to hinder growth prospects and contribute to a worsening of the external balance. The prospect of gradually tightening monetary policy in the euro area—which have an impact on domestic demand and consequently the current account—is also not taken up in the analysis.

5. PUBLIC FINANCE

5.1. The medium-term fiscal framework

The Estonian PEP includes data consistent with the ESA 95 methodology and therefore with the figures submitted to the Commission as part of the Fiscal Notification exercise in April 2002. The general government deficit has remained comparatively low in Estonia as the government pursued vigorously a fiscal consolidation plan. However, the local government continued to be a drain on public finances and the issue of the finances of the local governments remains crucial. As the authorities rightly acknowledge fiscal policy remains the only instrument for (limited) macroeconomic

management, but the efforts by the central government to compensate for the local government deficit lead to a considerable loss of control over discretionary fiscal policy, and leave little room for the automatic stabilisers to operate over the cycle.

The principle of a balanced general government is the backbone of fiscal policy in Estonia. Over the medium term while expenditures will increase in line with GDP, the tax burden is set to decline as the government plans to implement its pledge to lower taxes on labour. The PEP acknowledges the importance of fiscal policy as a stabilization instrument, particularly under a currency board arrangement and against a background of a volatile current account balance, but also stresses the need to allow considerable room for maneuver in light of the prospective EMU membership and the constraints—both institutional but also financial—that the adoption of a single currency entails.

Table 2: Fiscal development
(general government, % of GDP)

		PEP framework			
	2002	2003	2004	2005	2006
Receipts	39.7	41.0	42.1	41.0	40.7
Expenditures	38.4	40.6	42.1	41.0	40.7
Net lending	1.3	0.4	0.0	0.0	0.0
- Cyclically adj.	n/a	n/a	n/a	n/a	n/a
Primary balance	1.6	0.7	0.3	0.3	0.3
Gross debt level	5.8	5.5	5.2	4.9	4.6

Source: PEP, if not otherwise indicated

In contrast to last year's PEP, the policy to lower the tax burden appears to be at the center of the authorities' medium-term fiscal plan. Such an objective, together with the aim to set up a simple and equitable tax system, is seen laying the groundwork for long-term economic growth, and hence real convergence with the rest of the European Union. Hence taxes on labour income are set to decline from 26% to 20%, and the non-taxable monthly income to be doubled for the next three years. The impact on the budget is forecast to be positive in the long run, although expenditure cuts will have to cover a short-term revenue shortfall. A strategy to consolidate expenditure management, and keep expenditure growth in line with GDP growth, should provide the required resources for the proposed tax reform. The PEP outlines a number of options that would ensure that the tax revenues of local authorities remain unaffected after the proposed tax cuts. Invariably these options involve somehow an increase in share of tax revenue that is transferred from the central to local government, and hence a significant, and disproportional, fall in the central government tax receipts. Other changes to indirect taxes are also planned both to bring about harmonization with EU requirements, and to eliminate several tax exemptions. Following the tax reform, the tax burden is expected to decline from 35.3% of GDP in 2003, to 33.5% by 2007.

The authorities propose measures to improve medium-term planning by government departments, increase the efficiency of public administration, and curtail its role in the economy. The planned reforms in the budgetary process will increase transparency and the effectiveness of the public sector, and will ensure that spending priorities are addressed more effectively. Hence, the PEP identifies the areas where government attention must focus, including research and development, education, healthcare and other social areas that are seen as a priority in tackling the negative demographic trends.

To achieve savings that are essential to make up for the proposed tax reform the authorities will allow expenditures to increase in line with real GDP growth. In 2003, the tax reforms will cost some 2.2 billion kroons, or some 1¾% of GDP, while the authorities also anticipate additional expenditures of 1.8 billion, most of which will be paid to the EU budget. The presentation of the envisaged financing for these changes is particularly helpful, as it lays out important new commitments—including to the EU budget (some ¾ of 1 percent of GDP),—and the sources for stronger revenue. The number of expected reforms, and anticipated expenditure cutbacks, seem appropriate and should bring about considerable savings to the government, although one quarter of the expected revenue boost is purely the result of secular growth (some ¾ of 1 percent of GDP).

The emphasis on the structural balance is welcome although the assertion that fiscal policy was contractionary in 2002—in spite of two supplementary budgets—appears to be highly controversial. Revenues for the central government were particularly buoyant in 2002 as growth turned out significantly stronger than had been anticipated (i.e., 6% compared to 4.3 assumed in the 2002 PEP). In contrast, local governments ended with a significantly higher deficit that had been forecast on account of increased expenditures—particularly by the city of Tallinn.

The prominence given to the issue of local government finances is important, and welcomed. The local government in Estonia is playing an even more significant role in shaping the general government balance, and the lack of effective coordination between the central and local governments is becoming problematic. Indeed, ex ante the annual central government budgetary strategy is severely constrained by the expected local government deficit, while ex post the general government position is effectively determined by the eventual outturn for the local government deficit. The problem seems to be becoming more serious as local governments take increasingly more responsibilities from the central government but maintain important constitutional rights that guarantee their financial independence—at least as far as expenditures are concerned. On the revenue side local governments rely heavily on the central government for funding but are also able to raise funds through borrowing, albeit subject to a number of relatively innocuous borrowing constraints.

Although part of the problem seems to be related to the excessive number of local authorities (currently more than 200), the bulk of the deficit is also linked to the city of Tallin, which in 2002 accounted for some 90% of the local government deficit. Gradually more decentralisation,—and hence costs related to education, as well as significant investment-related expenditures—have put the local governments under considerably pressure in recent years. As the PEP acknowledges, however, the financial situation of local authorities tends to worsen during election years making the overall fiscal situation even more unpredictable.

A number of small, albeit positive, steps to deal with the issue have been taken, but no concrete plans are being put forward to address the problem conclusively. In particular, limits on borrowing have been set, although these seem to be rather generous, and a requirement to report all financial obligations has been introduced recently. In addition, a number of local governments, particularly Tallinn, have announced plans to achieve a balanced budget in the medium term. Furthermore, the PEP also argues that EU accession will partly deal with the matter, as structural funds will provide funding to a number of projects that the authorities are currently undertaking. Finally, the authorities

are also preparing a new bankruptcy act that should remove a significant risk from the central government balance sheet. These are indeed welcome but more must be done to enhance the coordination between central and local governments, in terms of budgetary planning, and deter local authorities from excessive borrowing and resorting to unorthodox, and less transparent, means of financing budgets (e.g., off-balance sheet operations, leasing, factoring). More fiscal autonomy should be accompanied by more financial independence, particularly in terms of revenue raising, but also with a set of rules that ensure the long-run sustainability of public finances. A balanced budget principle for local governments, for example, should address effectively the issue.

The medium-term fiscal plan envisages a balanced general government budget in the medium term. As a result of the tax reform total revenue is set to fall somewhat, from 41% of GDP in 2003 to some 40.3% in 2007, while expenditure is forecast to remain broadly constant, as a share of GDP. Nonetheless, the assumption of a strong GDP growth throughout the forecast horizon is crucial for the sustainability of the plan in terms of revenues and expenditures. At the same time the medium-term plan masks the absence of any stabilisation role of fiscal policy over the business cycle. Allowing the automatic stabilisers to work during the course of a robust economic upturn, particularly in the face of a persistent current account deficit, would entail significant surpluses in the medium-term. Hence, it appears that either the authorities are content with the evolution of the cycle and the current account or, if automatic stabilisers are actually allowed to operate, may face significant deficits in the medium term.

5.2. Public debt management

The general government debt, at some 6% pf GDP, remains particularly low by international standards and is expected to decline further to 3% of GDP by 2007. The debt management strategy, as set out in the PEP,—which aims at controlling the debt of the local governments, reducing the exchange rate risk associated with foreign borrowing, and minimizing interest payments through debt rescheduling—seems appropriate in light of the currency board arrangement and the aspiration of Estonia to join EMU. A number of rules determine the foreign-currency borrowing limits of the government, and are clearly aimed at limiting the exchange rate risk on the national debt. An increase in the debt ration during 2002—from 4.8% to 5.8% of GDP—was due to a new Eurobond issue, equivalent to some 100 million euros, which is to be used for debt refinancing. Local government borrowing also increased by some 0.6% of GDP, both for debt rescheduling purposes and for financing the large deficit for 2002. Several financing deals involving leasing and factoring contracts enabled local governments—particularly Tallinn—to borrow significant amounts. Such transactions—although not always particularly transparent—are in principle reported, to, and accounted for, by the central government. The PEP provides estimates of possible expenditures that may arise from several contingent liabilities of the state, which include student loans, and implicit liabilities related to local government debt. Such commitments seem rather low, although the total value of outstanding implicit liabilities of the state—including loan guarantees of some ¾% of GDP —remain non-negligible.

6. STRUCTURAL REFORMS

The authorities have pursued structural reforms vigorously during the years after independence, and these polices have created a dynamic and open economy. The PEP

sets out plans for structural reforms in the medium term that are largely aimed at increasing further the flexibility of the economy, and pursuing legislative and institutional changes. Whereas past reforms have contributed toward liberalizing the market and creating a favourable business environment, future reforms will aim at creating conditions for sustainable growth. Hence, future reforms will focus on enhancing productivity, boosting employment, creating a competitive economy, and strengthening the social security system. The emphasis on the labour market is particularly welcome given the high structural unemployment rate in the country. The list of proposed reforms is sensible from an economic and social viewpoint, and the budgetary impact seems to be consistent with the overall fiscal framework.

In response to the Commission's suggestion, the information provided foreshadows to a considerable extent the Cardiff report, which Estonia – like all other candidate countries – has been invited to provide in October this year and which will be evaluated comprehensively in their respective assessment.

6.1. The enterprise sector

The PEP outlines various schemes that are aimed at helping smaller- and medium-sized enterprises. The Enterprising Estonia Strategy, which was adopted in January 2002, outlines the policy of the Estonian Government, particularly toward small and medium-sized enterprises. Improving access to finance, for example through start-up aid and credit guarantees, is one of the important elements of the industrial policy. The accession of Estonia in the EU, and the commencement of structural reform, and other related, financing programs will require beefing up of the existing administrative capacity particularly at the enterprise, and more generally the regional, level. The added focus on these issues is warranted, and will be key in enabling Estonia to successfully integrate with the EU, and benefit from its redistribution mechanisms. These policies should help in enhancing further enterprise development, attract more foreign direct investment to the country, and stimulate private sector research and development—which remains low by international standards.

6.2. The financial sector

The financial sector is Estonia has undergone a huge transformation in recent years, with the consolidation, and foreign acquisition, of the banking system. The growth and deepening of the financial sector, which is ongoing, has been impressive. These changes have also resulted in increased efficiency and hence to lower costs for, particularly, the consumers. Interest rates spreads vis-à-vis the EU have narrowed significantly, and bank profitability continued to remain strong. The development of the non-bank financial sector is lagging, although recent institutional changes—particularly the introduction of the new Securities Market Act and a number of other related regulations—should improve confidence in the market. The small size of the domestic market and widespread foreign ownership of enterprises suggest that the issue of the (lack of) depth of the non-bank financial sector may be less of an issue for Estonia. Nevertheless, the problem of finance for smaller- and medium-sized enterprises is indeed important and relevant and should continue to be addressed appropriately. Several related changes in the monetary policy framework have been enacted since 2000, and more are planned essentially to harmonise the framework with that of the European System of Central Banks (ESCB). In the near future, the efforts will focus on

developing the payment settlement systems so as to achieve the technical readiness during membership in the ERM, and before the adoption of the euro.

6.3. The labour market

Planned reforms to increase employment, and the flexibility of the labour market, are also of great importance to the authorities. Active labour market policies that target specific groups of unemployed, and discouraged, workers are important in reducing the structural unemployment in Estonia. Additionally, to facilitate the search process for the unemployed the relevant government agencies are being restructured and enhanced both in terms of facilities and training. These reforms are expected to contribute in bridging the skill gap in Estonia, and facilitate the job search process. Improving, and widening, the provision of vocational training is also seen as imperative in bridging the skill gap and lowering structural unemployment.

6.4. Additional reform areas

Pension reform has advanced considerably with the implementation of the 2nd pillar. Participation in this pillar has been impressive to date, with more than 250 thousand employees already subscripting to the 2nd Pillar, and another 50 thousand expected to join by year-end. As a result there has been an impressive activity in the financial market, where the participation in the 2nd Pillar led to a remarkable growth of the assets of pension funds.

Health care reforms, and improving the work environment, also remain high on the agenda and detailed plans on how to proceed are set out in the PEP. The reforms, which are currently ongoing, are intended to modernise and consolidate the hospital system and beef up financial management, broaden accessibility and availability of quality healthcare to the population, and finally boost human resource development. The success of these reforms depends greatly on progress toward consolidating the hospital system, and improving financial management.

The government aims to improve further the functioning of the market and to introduce regulatory mechanisms that enhance the market’s efficiency. Considerable progress has been made with the adoption of the Competition Act, which was enforced in 2001, while more legislative changes are envisaged to bring Estonia’s legal framework in line with the EU standards. The PEP acknowledges that strengthening of the regulatory bodies in a number of areas (e.g., Communications, Energy, and Transport) is crucial, but no solid plans are presented in that regard. These reforms should ensure that the independence of these regulatory bodies is safeguarded.

Reform of the regulatory framework in the electricity market, for example, must become a priority for the government given the sector's impact on the economy. The Energy Market Inspectorate remains largely under the control of the government, and its mandate too broad. More generally the plans for reforming the energy sector are less ambitious relative to the significant progress achieved in all other areas. The electricity market remains largely closed—at both production and retail level—and the monopoly power of Eesti Energia is, effectively, strengthened by the price regulatory system and the Government's implicit support. The authorities are therefore urged to proceed faster with the liberalization of the electricity market since that will enhance competition, and safeguard the competitiveness of the economy.

Important changes will also have to take place to prepare the Estonian agricultural community for EU entry. The authorities are aware of the needs in this area, in particular as far as budgetary requirements are concerned. In addition, the PEP presents plans to improve the road, railway and water-transport networks, enhance the public transport system, and a strategy for sustaining and improving environmental conditions in Estonia. A number of projects are planned in these areas, and specific financing terms are outlined.

HUNGARY

PRE-ACCESSION ECONOMIC PROGRAMME 2003

ASSESSMENT

1. OVERALL SUMMARY AND ASSESSMENT

The third Pre-Accession Economic Programme (PEP) provides a medium-term policy framework, covering the period 2003-2006. It includes public finance objectives and structural reform priorities needed for EU accession and represents a further refinement of the institutional and analytical capacity necessary to participate in EMU. The Programme was adopted by the Hungarian government in mid-August 2003.

The PEP describes recent economic developments and elaborates a medium-term macroeconomic strategy, which is strongly determined by the declared goal of the government to fulfil the criteria to adopt the euro as of 2008. Following a relatively high GDP growth of 3.3% in 2002, Hungary's economic performance deteriorated in 2003, in particular as regards the composition of GDP. While investment of the business sector declined to growth rates of 3-4% of GDP, the share of government and household investment increased, and private consumption expanded more than twice as rapidly as GDP growth. Unemployment rose to over 6% in the first half of 2003, whereas real wages, at 13.1% year-on-year in the January-July 2003 period grew still well above productivity. The successful disinflation of the recent years came to a halt in mid 2003, and inflation is expected to rise again in 2004, reflecting increases in administered prices and indirect taxes. After an exceptionally high government deficit of 9.2% of GDP in 2002 (which, however, contained a number of one-off items and statistical reclassifications amounting to roughly 2.5% of GDP), fiscal policy tightened, aiming at a deficit rate of below 5% of GDP in 2003. The current account deficit reached 4% of GDP in 2002, and widened further in 2003. Over its projection horizon until 2006, the PEP foresees the acceleration of growth to 4.8% in 2006. Unemployment is expected to gradually fall to 5.8%. After the temporary upturn in 2004 the inflation rate is expected to fall below 3% by 2006. Due to expected EU-transfers, the current account deficit level is not expected to deteriorate much further – despite the negative external balance of goods and services – but to remain around a level of 5% of GDP over the entire PEP period. While maintaining the intention to join the ERM II exchange rate regime as soon as possible after EU accession, the PEP postpones the envisaged date for being ready to adopt the euro by one year, to 2008, as compared to last year's PEP.

After last year's strong fiscal expansion, particular emphasis is put on fiscal consolidation in the PEP. The medium-term fiscal framework targets a reduction of the general government deficit in ESA 95 terms to 4.8% in 2003 – although admitting to the possibility of a higher deficit. From 2004 onwards, the deficit is envisaged to decline by one percentage point annually, reaching of 2.5% of GDP in 2006. The plans for fiscal consolidation in 2004 are based on raising revenues, while cutting marginally the size of expenditures. In the following two years, the improvement of the international environment and EU-transfers are expected to contribute to the improvement of the general government balance. First estimates point towards a correction in the cyclically adjusted budget balance from –4.6% of GDP in 2003 to –2.4% in 2006.

The PEP describes a number of ongoing structural reform initiatives, aiming at regaining competitiveness, such as the numerous support schemes for SMEs or

investment into the road network. The structural part foreshadows already the Cardiff report, which Hungary – like all other accession countries – has been invited to provide in October this year on a voluntary basis.

The third Hungarian PEP provides an adequate assessment of recent economic developments and a credible, though, to some extent, overly optimistic macroeconomic scenario. Given this year's available data, there are strong downside risks in the forecasted economic growth of 3.5%. An upswing in the international economic situation could, however, contribute to achieve the medium-term targets of 3.5% in 2004 and 4-4.5 in 2005 and 2006. There are furthermore already first signs, such as the strong growth of industrial production over recent months, which indicate an ongoing change in the composition of GDP growth, towards a more export led growth path. Taking the plans of the government with regard to tax reform and administrative price liberalisation into consideration, the PEP's inflation forecast for 2004 also appears to be on the optimistic side. Regarding the envisaged fiscal consolidation path, there are – despite the significant tightening in 2003 – risks of missing this year's general government budget deficit target. The plans of fiscal consolidation for 2004, relying on a revenue-side consolidation of the budget by raising the total receipts by 1.2 percentage points of GDP, instead of a comprehensive reform of the revenue and expenditure side, also do not appear fully satisfactory. However, the new budgetary framework, which was adopted at the end of September 2003 together with the 2004 budget, seems more credible and sustainable in the medium-term, as compared to the PEP. Several central assumptions of the PEP have been furthermore revised downwards since the PEP's submission. The PEP's overall quality benefits from a sensitivity analysis of the aggregate general-government-to-GDP ratio to changes to the GDP, projections on the estimated output gap and the cyclically-adjusted balance. The structural part of the PEP is kept in rather general terms, and would have benefited from details of the budgetary effects of the envisaged measures. On the whole, most of the outlined plans are adequate, as those on the SMEs and in the health care sector.

2. JOINT OPINION

"On 4 November 2003 the ECOFIN MINISTERS OF THE PRESENT MEMBER STATES AND THE ACCEDING COUNTRIES examined the 2003 Pre-Accession Economic Programme of Hungary on the basis of an assessment prepared by the Commission Services with a contribution from the ECB. In accordance with the Conclusions of the High-Level Meeting with the Candidate Countries in Athens (EFC/ECFIN/227/03) Ministers adopted this joint opinion.

The third Pre-Accession Economic Programme (PEP) provides a medium-term policy framework, covering the period 2003-2006. It includes public finance objectives and structural reform priorities needed for EU accession and represents a further refinement of the institutional and analytical capacity necessary to participate in EMU. The Programme was adopted by the Hungarian government in mid-August 2003.

…

Opinion

[…], Ministers support the efforts to return to a more balanced economic growth path. Some risks in the medium-term macroeconomic scenario are presented in

the PEP. They point out that in particular the ambitious growth targets depend strongly on a rapid international economic recovery. They urge the authorities to proceed decisively with measures in order to improve the overall competitiveness of the Hungarian economy, especially through a commitment to bring real wage developments under control. Ministers encourage Hungary to consolidate the disinflation achievements of 2001 and 2002 and underline the importance of avoiding second-round effects of higher inflation in 2004 due to past strong wage increases. They point out that a well balanced policy mix is crucial for Hungary to return to a sustainable growth path with low inflation.

Ministers welcome the envisaged planned fiscal consolidation path and urge the authorities to implement it vigorously. They point out that the fiscal consolidation envisaged in the PEP for 2004 is based on raising revenues, without a thorough reform on the expenditure side. They therefore encourage the authorities to vigorously carry out public expenditure reforms as envisaged in the new 2004 budgetary framework of the government in order to achieve the budgetary targets of the program. They recommend to continue to reform the administrative sector through an identification of priority and non-priority areas.

Ministers commend on the reforms achieved in the area of structural reforms. They urge, however, to continue with the outstanding issues, such as the further opening-up of the electricity and gas markets, and the ongoing reform of the country's healthcare system."

3. REVIEW OF RECENT ECONOMIC DEVELOPMENTS

The comparison of actual economic developments in late 2002 and 2003 to date with those forecasted in last year's PEP, shows a clear deterioration of the Hungarian macroeconomic situation. This is due to the continuing difficult global economic environment, but also to inconsistencies in the Hungarian economic policy mix.

Following a still relatively high GDP growth of 3.3% in 2002, the economy's performance deteriorated in 2003: GDP growth in the second quarter of 2003 reached a six years' low of just 2.4% year-on-year, on a quarterly downward trend. While the growth rate of exports, including foreign tourism, and investment continued to decrease, the dynamic increase in domestic consumption could not make up for the previously dominant role of exports in growth. The composition of GDP deteriorated significantly. In 2002, private consumption expanded more than twice as rapidly as GDP growth, at close to 9%. At the same time, overall investment growth declined to 5.8%, and the structure of investments further deteriorated. Investments of the business sector declined to growth rates of 3-4%, the share of government and households investments increased within the total investments of the national economy.

The year 2002 was characterised by a significantly higher than expected general government deficit of 9.2% of GDP. This was the result of a strongly expansive fiscal policy during an election year, but also to a certain extent (approximately 3% of GDP) of a number of statistical reclassifications and one-off items. In 2003, a redirection of fiscal policy is implemented, that is expected to lead to a contraction in domestic demand. It is marked by limited further wage increases in the public sector, a freeze of operational spending across the board and delays in public investment. However, due to the slowing economic performance and strong carry-over effects of last year's demand-

side policies, the fiscal turnaround so far remained behind expectations. The initial target of a general government deficit of 4.5% of GDP for 2003 had to be revised to 4.8% of GDP.

Disinflation continued in 2002 with an annual average CPI inflation of 5.3%. Also the inflation target for end-2002 could be met at 4.8% year-on-year in December. Successful disinflation was due to the strong nominal appreciation of the currency until the beginning of 2003, along with a continuous fall of some domestic prices. However, there are signs that the disinflation process has come to a halt, as monthly CPI figures have started to slightly increase again since June 2003.

The constant nominal currency appreciated constantly throughout 2002. By the end of

Table 1: Economic development

		PEP framework			
	2002	2003	2004	2005	2006
GDP growth at constant market prices	3.3	3.5	3.5	4.3	4.8
Contribution to GDP growth:					
- Final domestic demand	7.2	6.8	2.8	4.3	5.0
- Change in inventories and net acquisition of valuables	-1.9	-1.0	0.8	0.8	0.8
- External balance of goods and services	-1.9	-2.3	-0.5	-1.0	-1.0
Investment ratio (% of GDP)	22.3	22.0	22.5	23.5	24.5
GDP per head (PPS, % of EU average) (1)	57.0	58.2	58.9	59.9	61.3
Participation rate (% of 15-64 age group)	59.7	60.0	60.3	61.0	61.5
Unemployment rate (ILO definition)	5.8	5.9	5.9	5.8	5.8
Employment growth	0.1	0.5	0.0	1.0	1.3
Labour productivity growth	3.2	3.0	3.3	3.3	3.5
Average real wage growth	13.6	11.0	0.0	1.5	2.5
CPI inflation (annual average)	5.3	4.9	5.0	4.0	3.0
Exchange rate vis-à-vis EUR (percentage change of annual average)	-5.3	4.3	0.6	0.0	0.0
Current account balance (% of GDP)	-4.0	-5.3	-5.0	-5.0	-5.0
Foreign direct investment (% of GDP)	1.3	1.4	1.8	2.0	2.1
Foreign debt (% of GDP)	46.4	48.1	47.6	45.8	44.0

Source: PEP, if not otherwise indicated
(1) calculated, without demographic or price effects; growth rates: candidate countries: PEPs / EU: 2002-03: Spring 2002 COM forecast; thereafter same as in 2003

2002, the nominal exchange rate approached the top of the trading band. This was primarily a result of tight monetary policy conditions providing high interest spreads in a low-risk environment. By January 2003 the nominal exchange rate reached the stronger side of the fluctuation band, triggering a speculative attack. The attack was fought with success by the authorities. Subsequently the currency permanently shifted away from the stronger end of the band. However, the forint became volatile as a result of this crisis and central bank intervention became a necessary feature in order to stabilise the exchange rate. In June 2003, the government and central bank devalued the central parity of the forint's euro peg by 2.26% in a surprise move, in order to improve the competitiveness of Hungarian exports and tourism. Contrary to these intentions and due to severe communication failures that were later admitted by the authorities, the forint started to weaken significantly (though still well within the stronger side of the band). The depreciation of the currency was brought to a halt by a rapid increase of the

reference interest rates by 3 percentage points, to a total of 9.5%. This is an outstandingly high level, both in international and regional comparison.

The loss of competitiveness of the Hungarian economy in terms of wage and exchange rate (though the latter improved with the weakening of the forint in May 2002) was perceivable also in the decline of foreign direct investments (FDI). FDI in terms of GDP decreased both in 2002 and in the first half of 2003. The substantial real wage increases of 2001 and 2002 were well in excess of productivity growth. A number of large lay-offs in low-wage industries that were priced out by the rapid minimum wage increases that had been implemented over the past two years let unemployment temporarily rise to over 6% in the first few months of 2003, from 5.8% in 2002. The trend has in the meantime reversed, and May-July unemployment stood again at 5.8%. The labour market in the skilled segment and in the industrialised regions remains, however, tight.

The trend of the current account has been deteriorating since the second half of 2001, reaching a deficit of 4% in 2002. The main reasons in 2002 were the decline of the surplus of the trade in services, in particular foreign tourism, whereas in 2003 the deficit merchandise trade became increasingly dominant. One important reason for the deterioration of the export industry's competitiveness has been – beside the declining foreign demand – the strong currency appreciation of the forint until May 2003. At the same time, the expansion of outward direct investment of Hungarian enterprises led to a net outflow on the capital account.

4. MEDIUM-TERM MACROECONOMIC FRAMEWORK

The medium-term macroeconomic framework of the 2003 PEP is anchored in the target of fulfilling the necessary criteria in order to adopt the euro in 2008. Thus, particular emphasis is put on fiscal consolidation. The government plans to reduce the budget deficit to 4.8% in 2003 (on ESA95 basis), thereafter by one percentage point each year, finally bringing it down to ca. 2.5% of GDP in 2006. Over the same time period, inflation is expected to reach an annual average of 5% in 2004, whereafter it would be reduced by one percentage point a year, in order to reach 3% in 2006. Fiscal consolidation and disinflation are planned on the basis of an assumed GDP growth of 3.5% in 2004, and 4–4.5% in 2005 and 2006.

As in previous years, the PEP also presents two alternative growth scenarios. The first scenario describes a lower growth path due to a slower than assumed recovery of the international economy. The PEP argues that in such a case the main revenue items of the budget, which are affected mostly by wage and consumption trends, would not be effectively influenced by the lower growth rate, as lower growth would occur through lower rates of exports and investments. The second scenario discusses a slower than expected consumption growth due to higher inflation than forecasted in the baseline scenario. According to the second alternative scenario, nominal GDP growth would not change significantly as a result of higher prices and slower real growth, since the income items are based on nominal figures. Both alternative scenarios hold that in none of these cases there would be any significant changes in the fiscal position. However, some other possible scenarios could have dealt with risks, not only affecting those items of the expenditure and revenue side that are set in nominal terms. Examples for such real risk scenarios could have been risks concerning tax revenues or risk factors for the budget highlighted in the PEP for the year 2003, such as an unexpected rise in the demand for housing subsidies.

According to a sensitivity analysis calculated in the PEP 2003, assuming an unchanged internal composition of GDP, a 1% change in GDP would have the effect of changing the aggregate general-government-to-GDP ratio by approximately 0.3 percentage points.

4.1. Real Sector

Although this year's growth estimates already represent a marked downward correction, as compared to last year's PEP, the underlying macro-economic forecast appears still to be somewhat optimistic, at least in the short term. Recent data show a relatively strong deceleration in economic growth in the first half of 2003 when GDP grew at a mere 2.5% as compared to the corresponding period of last year. This poor growth performance makes it rather unlikely to achieve the 3.5% growth target set in the PEP for 2003[4]. Next year's growth target of 3.5% is strongly based on the assumption of an upturn in the global economy. There are in fact signs in the economy that may indicate a change in the composition of GDP, towards a more export led growth path. As a result, the consumption-fed growth of the past two years might change to a more sustainable equilibrium growth, although household demand is expected to remain strong for some time to come. Latest industrial production growth rates also look promising, and an improvement to the global economic situation would contribute through higher external demand.

According to the PEP estimates, the investment ratio would start rising again from 2004 onwards, to a large degree also due to EU-related investments. Stress is also put on a correction to the present structure of investments. Concerning exports, the PEP forecasts raising growth rates during the observed period. As to the projected import demand, the PEP estimates that it would be brought back in line with export growth from 2004 onwards. Assuming that the economic upswing that according to the PEP is in the pipeline takes place, the medium-term growth rate looks more realistic, taking into consideration the delayed effects of the ongoing correction to the distorted GDP growth structure, and the Hungarian economy's proven ability to recover rapidly in a favourable external economic environment.

After a temporary uptake in early 2003, unemployment is forecasted by the PEP around 5.8-6% for the year as a whole. In the subsequent years it should fluctuate in a range of 5.5-6%. The PEP assumes an approximately 3-3.5% annual increase in labour productivity, and a slight increase in the activity rate, which is expected to gradually grow from 59.7% in 2002 to 61-62% until 2006. 2002 was marked by a decline in the number of persons employed in the business sector, and an increase in the number of employment in the public sector.

4.2. Inflation and wages

According to the PEP, inflation is expected to increase somewhat over the second half of 2003, reaching an annual average of 4.8-5%. The increase is expected to be a result of the weaker exchange rate, the proposed increase of regulated prices and measures aimed at reducing the excess supply of foodstuffs. In 2004, it reckons with an additional increase, due to the pending deregulation of administered prices and the expected one-

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[4] This growth target was in the meantime revised downwards by the government to around 3%.

off upward pressure on the price level due to the projected changes of indirect taxes. The PEP forecasts therefore approximately 5% average inflation for the year 2004, followed by a resuming decline of the overall price level by approximately 1 percentage point each year until 2006.

In fact, available data show that the successful disinflation of the recent years came to a halt in the first half of 2003. Consumer prices over the first half of 2003 rose by 4.3% year-on-year, on a slight upward trend since the first quarter of 2003. A continuously weak growth environment, however, along with a sustained decrease in core inflation based on producer and food price deflation continue to exert downward pressure on prices. The recent re-strengthening of the forint to a level which the authorities have officially declared as sufficient to reach their medium-term inflation goals, promises in addition to exert stabilising effects on the inflation rate. Therefore, given the durable decline in core inflation over the 2001-2003 period, a lasting halt in disinflation seems unlikely. An instant rebound in inflation expectations (which have just started not to play any longer a major role in economic operators' decision making in Hungary) also does not look very likely from today's perspective. Nevertheless, the PEP's inflation forecast for next year seems rather too optimistic, given that the one-off direct impact on prices of planned TVA increases alone is estimated at around 1%[5].

With regard to the household income policy, there is a marked deviation from last year's PEP. While the PEP 2002 reckoned with an overall 33% real wage increase per wage earner over the entire 2001-2005 period, real wage growth is now expected to have reached 34-35% already over the 2001-2003 period alone. In the PEP 2003 the government signals a strong determination to bring real wage developments under control, starting with the public sector. This commitment is most welcome. However, the government's power to influence real wage developments in the overall economy seems very limited, since Hungary has a highly decentralised wage bargaining system. Available data on 2003 is also not too encouraging: real wage growth of January-July was 13.1% as compared with the same period last year. The increase of gross average wages in the public sector is expected to remain significantly above the economy's average rate also in 2003. This is due to carry-over effects from last year's wage increases and to further wage increases in the public sector. However, this year's public wage increases were limited to the implementation of a pre-determined second phase of the salary increases of civil servants, and targeted at a limited circle of priority areas, like e.g. judges and public prosecutors. A certain adjustment in public sector wages appeared justified with a view to EU accession, and to the fact that public sector wages had undergone considerable real wage losses over the high-inflation period of the late 90's. However, this development has clearly over-stretched its budgetary limits by now. Public wage growth is also exerting effects on the business sector's wage developments. Therefore, any postponement of the necessary adjustment as announced in the 2003 PEP would contribute to a further deterioration of the macroeconomic environment, and further endanger Hungary's competitiveness and investment climate.

4.3. Monetary and exchange rate policy

The formal decision of the government and the central bank to set the target for euro adoption for 2008, and the declared intention to participate in ERM II as soon as

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[5] Accordingly, the government's forecast for the year 2004 has been revised to 6.0% on annual average in the meanwhile.

possible after EU accession determines the medium-term monetary and exchange rate policy. This policy decision was based on the assumption that an early participation in the euro area would create an environment conductive to faster economic growth and promote macro-economic stability. The present exchange rate system with its ±15% intervention band around a euro peg is basically mimicking the ERM II system. Thus, ERM II participation should not pose technical problems, according to the PEP. Setting a clear target for adoption of the euro may contribute to the reduction of the costs of disinflation through anchoring long-term inflationary and exchange rate expectations. Joining the ERM II, in turn, may contribute to a more stable exchange rate in the medium term.

4.4. External sector

After a current account deficit of 4% of GDP in 2002, the government expects it to deteriorate to 5-5.5% of GDP in 2003, then – also due to EU-transfers – to improve slightly in the following years to approximately 5%. This year's available data indicates, however, that this target will most likely be overshot. This negative trend supports the assumption of the deterioration of Hungary's competitiveness. Another reason for concern is that the financing of the current deficit depends to a large degree on portfolio-inflows, which is less stable than FDI. A positive sign, though is, that July 2003 was the first month since August 2002, when Hungary's current account deficit was financed by non-debt inflows, rather than by the increase in net foreign debt.

5. PUBLIC FINANCE

5.1. The medium-term fiscal framework

The PEP acknowledges the government's intention to reconsolidate fiscal policy as already announced in the 2002 programme. The consolidation of the budget which started in 2003, has become more difficult as a consequence of the carry-over effects of last year's expansive fiscal policy. It is not yet clear to what extent this unfavourable trend in current expenditures can be brought under control already in 2003.

Meeting the upwards revised fiscal target of 4.8% of GDP for 2003, as compared to the original target of 4.5% indicated in the PEP 2002, looks difficult to achieve, given budget execution figures for the first 8 months of this year. Restrictive measures contained in the 2003 budget were e.g. an across-the-board freezing of 2.5% of the transfer appropriations to budgetary organisations for 2003 and a modification on the system of interest subsidies to loans for the purchasing of housing. An additional fiscal correction package to the tune of 0.5% of GDP was adopted in June 2003, following a slippage of expenditure over the first few months of this year, in order to improve the credibility of the government's commitment to fiscal consolidation. However, a number of unbudgeted expenditure items, such as the necessity to implement an unexpected Supreme Court ruling of June 2003 which obliged the government to considerable retroactive one-off child allowance payments or the higher than budgeted expenses on housing subsidies, instantly consumed much of this correction package.

There are furthermore additional risk factors identified by the PEP for this year's budget target. On the expenditure side there is uncertainty concerning the remaining appropriations for budgetary institutions, and the risk of a greater-than-budgeted deficit

of the local government sub-system. A shortfall of tax revenues could pose another risk for the year 2004, due to the possible slippage of the 2003 base on which it is calculated. However, the Hungarian authorities indicated that they would take the necessary measures to correct such a slippage. The increased level of interest rates, on the other hand, does not appear to pose a considerable threat to the budget in the short run, given that Hungarian public debt has an average duration of 3.5 years.

Table 2: Fiscal development (general government, % of GDP)

		PEP framework			
	2002	2003	2004	2005	2006
Receipts	44.5	43.2	44.4	44.2	43.6
Expenditures	53.7	48.0	48.2	47.0	46.1
Net lending	-9.2	-4.8	-3.8	-2.8	-2.5
Primary balance	-5.5	-1.2	-0.4	0.4	0.4
Gross debt level	56.3	57.5	57.2	55.3	54.0

Source: PEP, if not otherwise indicated

The plans for fiscal consolidation in 2004 are based on raising revenues, mainly through a tax reform, while maintaining the size of expenditures[6]. The targeted deficit rate is approximately 3.8%, as compared to the 3% deficit indicated in the 2002 PEP for that year. Details about the envisaged tax reform have not been specified in the PEP, as the debate about the new tax regime were still going on at the time of the transmission of the PEP[7]. A mere revenue-side consolidation of the budget without a reduction of expenditure, based on a comprehensive structural fiscal reform of both the revenue and expenditure side, seems not entirely satisfactory and sustainable, as it entails most likely new corrections in the near future. Another risk of such a revenue-side fiscal consolidation is the already mentioned potential reappearance of inflation expectations, along with undesirable effects on wages. The assumed effects of the planned VAT increases leading to a higher rate of inflation would furthermore very likely produce windfall gains for the 2004 budget.

Regarding the prospects of a fiscal consolidation, the importance of the creation of a smaller and more efficient public sector, with which a significant reduction of expenses could be achieved, should be attached more attention in the economic planning. Especially that Hungary has one of the largest public sectors among OECD countries. Although the PEP mentions in very general terms such intentions, it is not detailed, in which way this should be implemented. Also the figures on the envisaged expenditures of collective consumption seem very less ambitious, as there is only an envisaged improvement of 0.1 percentage points each year, from the estimated present level of 7.8% of GDP. More concrete commitments on this issue would have been desirable in the PEP, including details about priority and non-priority areas, the ways in which the

[6] The new budgetary framework – adopted by the government in late September – maintains the size of both expenditure and revenue side, though its internal composition changes in favour of public investment in the tune of 0.4 percentage points of GDP compared to the original figure in the PEP.

[7] The following changes in the internal composition of tax revenues are envisaged: due to an increase of VAT rates, VAT income is estimated to grow by 0.5 percentage point of GDP as indicated in the PEP, whereas the reduction of the personal income tax is expected to reduce revenues. In order to improve competitiveness, corporate income tax was reduced and is expected to reduce revenues by 0.1 percentage points of GDP compared to the figure originally indicated in the PEP.

authorities intend to reduce the public staff headcount, what kind of complementary budgetary measures such a reform would entail and what would be the envisaged target date of such a thorough public sector restructuring.

The targeted general government budget deficits for 2005 and 2006 are 2.8% and 2.5% of GDP. There are though no details about concrete measures to reduce the budget deficit to the targeted level, only that the improving economic environment is expected to contribute to a reduction in general government expenditures and the financing of priority expenses would be facilitated through the inflow of EU funding. However, as pointed out correctly in the PEP, transfers between the EU and Hungary will not directly improve the general government balance. Therefore, it is not quite comprehensible how the facilitation of the financing should be achieved, especially, as there are no such estimations provided in the PEP.

The general government gross debt to GDP ratio, which raised again after the high budget deficit ratio of last year and reached the level of 56.3% to GDP, is envisaged by the PEP to fall again as from 2004 onwards, and reaching a level of approximately 54% of GDP. The declining trend of the debt rate is expected trough the reduction of deficit and a surplus in the primary balance again after 2005.

It is very much to be appreciated that the 2003 PEP contains for the first time estimates about the output gap and the cyclically adjusted (structural) general government balance. In the calculations the so called Hodrick-Prescott filter was used. For the application of the production function method used by most EU Member States, long term time series of the capital stock would have been needed, which are difficult to approximate. According to the calculations, the potential growth rate of the Hungarian economy is around 4% for the whole PEP period. The data of the estimates on structural budgetary developments point to a deficit correction in the cyclically-adjusted balance from –4.6% of GDP in 2003 to –2.4% in 2006, which means an annual correction of about 1 percentage points. However, in 2006 a less ambitious correction of only 0.1 percentage points is envisaged. The cyclically adjusted primary balance would be in equilibrium in 2004, whereas in 2005 and 2006 it would already be in surplus. However, due to the uncertainties mentioned also by the PEP concerning the calculations, the results of this first estimations should be treated with caution. A 4% potential output seems a rather conservative estimate for the case of a rapidly catching up economy like Hungary.

5.2. Public debt management and deficit financing

Hungary’s debt management strategy has undergone a considerable modernisation since 2001, starting with the establishment of the State Debt Management Centre (ÁKK). The agency’s strategy aims at providing the financing requirement of the budget in the long term and at acceptable risk levels. The medium-term goal of the authorities is to reduce gradually the share of debt denominated in foreign currency in order to improve the predictability of debt management, through the elimination of the exchange rate risk. Debt management is becoming indeed more predictable, it might have though, in the short- or medium-term, detrimental effects on the interest rate burden for the budget, as a consequence of the considerable interest rate spreads. Nonetheless, in 2003 considerable amounts of public debt are issued in Eurobonds.

5.3. Fiscal risks

The transparency of government accounts has been considerably improved since 2002, in particular through the integration of extra-budgetary items and a considerable number of quasi-fiscal activities into the accounts of the central government. Thus, contingent liabilities have been made more visible as compared to previous years. As announced by the last PEP, the quasi-fiscal functions of the Hungarian Development Bank (MFB) were removed at the end of 2002. As a consequence, GFS based headline budget figures are by now more or less in line with accruals based ESA95 figures.

6. STRUCTURAL REFORMS

The structural part in the PEP 2003 is being kept in rather general terms. Reference is made to the PEP 2002, which presented the key objectives, and only the changes are presented in the PEP of this year. As in previous years, budgetary implications are broadly left out. It should be noted, furthermore, that the Hungarian authorities are preparing a study on structural reform with a view to the Lisbon strategy within the framework of the Cardiff process.

6.1. The enterprise sector

Corresponding with the growing importance of SMEs, both in terms of GDP contributions and employment, the government adopted a number of further measures to enhance the economic environment for SMEs. A promising element is a redesigned credit-programme for SMEs, aiming to provide small and micro companies with access to credit combined with business advice, according to their special (financing) needs. The envisaged new business-credit model should in the medium term work in a self-sustaining way, and rely more on money market than on budgetary funding sources. As with most items discussed in this chapter of the PEP, any reference to short-term budgetary implications is missing. The need for an increasingly predictable and stable environment for enterprises through gradually diminishing the tax and administrative burdens is underlined in the PEP. It appears that EVA, the low-rate flat tax scheme that was introduced in early 2003, proved quite popular.

6.2. The financial sector

The PEP reports about the continued process of the alignment of the financial sector's legislation to the EU relevant legal framework and standards. Several amendments were i.e. made in the act on credit institutions, furthermore a new insurance act and an act on the prevention and impeding of monetary laundering was adopted by parliament in 2003.

6.3. The labour market

With regard to the relatively low labour market participation rates in Hungary, last year's developments were rather disappointing. 2002 was marked by a decline in the number of persons employed in the business sector, and an increase in the number of employment in the public sector. This effect was not least due to the significant wage increases in the public sector, whereby a large number of workers, in particular in the underpaid health care sector have been re-attracted. This year's PEP is rather concentrating on measures fighting

poverty and social exclusion, as well as the development of social services. The PEP would have though benefited through details about envisaged measures, improving labour market flexibility, one of the main problems of the Hungarian labour market.

6.4. Additional reform areas

Stabilisation and modernisation of the ailing health care sector was highlighted as a priority area in former PEPs. The government has accordingly implemented several reforms. After a consolidation programme in order to reduce the debt of hospitals in 2002, a new law was adopted in 2003 opening the way for large-scale privatisation of healthcare assets, including hospitals. A privatisation realised in a transparent way, respecting the rule of law, could through the involvement of external capital improve the conditions of the health system. The envisaged steps of the forthcoming years, such as the introduction of an nursing insurance, provisions aiming at self-provision, the admission of Voluntary Health Funds and the introduction of personal health accounts could contribute further from the demand side to an improving of the Hungarian health care sector, which is still characterised by an extremely poor level of service in combination with high budget outflows.

The intention of the government to restore the original conditions for the two-pillar pension system introduced in 1998 is to be welcomed. The rate of contribution payments into the private pension funds increased accordingly from 6% to 7% in 2003, and it will go up to 8% as of 1 January 2004. These transfer payments will of course add to the budgetary strain in the short and medium term, therefore, this part of expenditure (respectively loss in revenue in the size of 0.7-0.9% of GDP) deserves to be recognised in the structure of the general government.

The government is about to streamline its housing subsidy policy. Although it proved to be extremely popular during recent years and it had positive social effects and boosted the construction industry during the present economic slowdown, its burden on the budget became unsustainable. On top, the amount of subsidies requested turned out to be a constant risk factor to the budget since demand for it -proved quite difficult to estimate.

The development of transport infrastructure, identified as the main obstacle to faster economic development of Hungary’s disadvantaged regions, remains a political priority of the government. In the respect of road network, priority will be given to the expansion of the high speed road network facilitating cross-border transportation. The gradually separation of the management of roads and their ownership and supervision is intended. In the respect of the restructuring of the railway system and the Hungarian Railway Company (MÁV) no concrete further steps were done.

As to the ongoing liberalisation, both in the field of electricity and gas, the further opening of the market should be pursued. Moreover, the unbundling of the transmission system needs to be continued.

LATVIA

PRE-ACCESSION ECONOMIC PROGRAMME 2003

ASSESSMENT

1. OVERALL SUMMARY AND ASSESSMENT

The third Latvian Pre-Accession Economic Programme (PEP) provides a medium-term policy framework, covering the period 2003-2006. The PEP updates last year's programme and provides an assessment of recent economic trends. It also reviews the factors contributing to economic growth and compares the actual outcomes of key aggregates with those forecast in the previous PEP. The medium-term objectives of economic policy and structural reforms are clearly stated and estimates of budgetary effects as well as detailed timeframes for implementation of specific commitments for structural reforms are provided. The PEP was prepared by the Ministry of Finance in consultation with the Bank of Latvia and the Ministries of Economy, Transport, Justice, Welfare, Environmental Protection, Regional Development and Local Government Affairs, Agriculture, State Chancellery, and Finance and Capital Market Commissions. The PEP has been approved by the Latvian Cabinet of Ministers, and published subsequently, in August 2003.

The macroeconomic scenario provided in the PEP envisages an annual GDP growth of 6% on average in the period 2003-2006. Compared to 2002, the macroeconomic outlook is more optimistic. Although fiscal policy turned into a more expansionary phase in 2002, it is expected that in the medium-term the fiscal deficit in the state budget will not exceed 3% of GDP. Inflation is expected to stay within 2.5-3% range, yet, a strong growth of domestic demand and private consumption in particular is expected to continue in the medium-term. It is assumed that productivity growth will outpace the growth in real wages. Monetary stability is going to be preserved by keeping the fixed exchange rate regime unchanged until joining ERM II. The programme describes changes in monetary and exchange rate policy that will have to be implemented before Latvia can participate in ERM II. Upon reaching a mutual agreement between the Bank of Latvia and all involved EU institutions, the Bank of Latvia plans that Latvia will join ERM II together with changing the currency peg from the SDR to the euro on January 1, 2005. The PEP also explicitly notes the continuing commitment to adopt the euro as soon as possible after EU accession, in 2008. Despite the bright macroeconomic outlook the labour market situation is not expected to change markedly in the period 2003-2006 emphasising the need for comprehensive labour market reform. The unemployment declines hardly and remains above 10% in 2006. Furthermore, the external trade is expected to expand with exports slightly outpacing imports. Consequently, in the medium-term the current account deficit is expected to remain large at 8-8.5% of GDP.

The assumptions underlying the analysis presented in the PEP are clear and, generally, realistic. The quality of the reform chapters has improved, as estimates of budgetary effects as well as detailed timeframes for implementation of specific commitments for structural reforms are provided. However, the PEP puts the main emphasis on identifying specific tasks instead of focusing on defining priorities and co-ordinating the implementation path of reforms. Therefore, the reform chapters of the PEP lack an integrated view of the structural reforms, which should be bundled into a co-ordinated

policy effort. Furthermore, the PEP is somewhat sparse with providing evaluations of developments concerning the implementation of the reforms. More factually, efforts that have been recently made to promote competition and fair regulation in Latvia are described in details in the PEP. However, more could be said about the independence – especially from a financial perspective – of the competition and regulatory authorities. Likewise, the 2003 PEP is rather silent on whether the formal opening of the telecommunication market to competition has yet delivered effective results. The issue of security of energy supply is also poorly covered in the 2003 PEP.

2. JOINT OPINION

"On 4 November 2003 the ECOFIN MINISTERS OF THE PRESENT MEMBER STATES AND THE ACCEDING COUNTRIES examined the 2003 Pre-Accession Economic Programme of Latvia on the basis of an assessment prepared by the Commission Services with a contribution from the ECB. In accordance with the Conclusions of the High-Level Meeting with the Candidate Countries in Athens (EFC/ECFIN/227/03) Ministers adopted this joint opinion.

The third Pre-Accession Economic Programme provides a medium-term policy framework, covering the period 2003-2006. It includes public finance objectives and structural reform priorities needed for EU accession and prepares further the institutional and analytical capacity necessary to participate in EMU. The Programme was adopted by the government cabinet in August 2003.

…

Opinion

[…], Ministers note Latvia's recent strong macroeconomic performance. The main economic policy objectives such as a sustainable and balanced economic development together with price stability have been broadly attained. However, important challenges remain, in particular, the Latvian current account deficit remains high. Over the medium term vigilance will be required in relation to the level and financing of the current account deficit, to ensure that the external debt ratio is prudently contained. In this connection the authorities are also encouraged to monitor carefully developments in private sector credit growth and explore ways to increase domestic savings. A prudent fiscal policy should also contribute.

Ministers acknowledge that significant progress has been made to consolidate public finances, but warn that the medium-term scenario faces significant risks that could endanger the achievement of the planned fiscal targets. The scenario relies heavily on large increase in tax revenues, yet it is hard to foresee what effect changes in company taxation will have on revenues. Ministers emphasise that the current period of strong economic growth creates favourable conditions for speeding up fiscal consolidation. Moreover, it is recommended to keep government expenditure on target and use extra revenues for deficit reduction. More attention should be paid to the structural budget deficit in order to create room for automatic stabilisers to operate if need be.

Furthermore, the labour market is still characterised by low employment and high unemployment rates, which differ considerably across the regions.

Ministers urge Latvia to pursue vigorously labour market reforms. Most of all, it is important to promote entrepreneurship to create more enterprises and more opportunities for employment."

3. REVIEW OF RECENT ECONOMIC DEVELOPMENTS

Fuelled by stable and high domestic demand GDP continued to grow strongly at 6.1% in 2002 and is expected to increase further at 6.5% in 2003. A high increase in private consumption (7% in constant prices) was mainly determined by growth in real wages and more readily available credit facilities. Along with the domestic demand fixed capital formation was particularly robust and was an important factor contributing to growth. All main sectors of the economy grew rapidly, in particular construction but also manufacturing. Export growth was relatively high and outpaced import growth despite a weak external environment. Nevertheless, the difference between the total value of imports and the total value of exports increased.

Table 1: Economic development

		PEP framework			
	2002	2003	2004	2005	2006
GDP growth at constant market prices	6.1	6.5	6.1	6.0	6.0
Contribution to GDP growth:					
- Final domestic demand	7.5	8.0	7.1	6.5	6.5
- Change in inventories and net acquisition of valuables	-1.7	-0.5	-1.2	-1.0	-1.2
- External balance of goods and services	0.3	-0.9	0.1	0.4	0.7
Investment ratio (% of GDP)	25.7	26.4	26.5	26.3	26.1
GDP per head (PPS, % of EU average) (1)	39.0	40.9	42.5	44.3	45.9
Participation rate (% of 15-64 age group)	68.8	68.8	68.8	68.8	68.8
Unemployment rate (ILO definition)	12.0	11.6	11.0	10.7	10.1
Employment growth	2.8	1.0	1.0	0.5	0.5
Labour productivity growth	3.2	5.4	5.0	5.5	5.4
Average real wage growth	6.6	5.4	5.0	4.7	4.1
CPI inflation (annual average)	1.9	2.6	2.8	3.0	3.0
Exchange rate vis-à-vis EUR (percentage change of annual average)	4.1	0.0	0.0	0.0	0.0
Current account balance (% of GDP)	-7.8	-8.5	-8.5	-8.0	-7.6
Net foreign direct investment (% of GDP)	4.6	4.7	4.6	4.5	4.4
Foreign debt (% of GDP)	76.2	79.3	85.2	89.4	92.3

Source: PEP, if not otherwise indicated

(1) calculated, without demographic or price effects; growth rates: candidate countries: PEPs / EU: 2003-04: Spring 2003 COM forecast; thereafter same as in 2004

Regardless of high private consumption growth, inflation decreased to 1.9% in 2002, as inflation in Latvia's major trading partners was low and lower prices in mobile communication services contributed to attenuate domestic pressures. Inflation is expected to be up to 2.6% in 2003. High growth has contributed to lower unemployment, which decreased from 12.8% in December 2001 to 11.6% in December 2002. The current account deficit decreased to 7.8% of GDP, but remains on a relatively high level. The current account deficit is financed by long-term borrowing and direct

foreign investments; the net direct foreign investment showed strong growth in 2002 and financed about 60% of the deficit. The decreasing path of fiscal consolidation was interrupted in 2002, when the general government deficit increased to 3%. The general government debt remains relatively low at 15.2% of GDP in 2002.

4. MEDIUM-TERM MACROECONOMIC FRAMEWORK

The program describes a macroeconomic scenario for the period 2003–2006, which does not differ significantly from the one in the previous PEP. Growth is envisaged to remain strong and steady at about 6% annually. It is expected that the external economic environment will continue to improve. In addition the strong increase in private consumption, due to a leap in consumer credit, is going to reflect positively on growth.

Main objectives of macroeconomic policy are to achieve sustainable and balanced economic and social development. Therefore, the government is focussing on stable and predictable economic policy and the implementation of structural reforms.

The macroeconomic scenario is based on the assumption that the government will continue to implement strict fiscal and monetary policies. It is also stressed that implementation of the structural reforms will be decisive in ensuring competitiveness of Latvia as well as a real convergence.

The section on risks for implementation of the macroeconomic scenario is brief and does not provide a quantitative scenario that would provide an estimate of the potential impact of these pressures on economy. Some of the main risks mentioned stem from the fact that Latvia is a small open economy, and as such it is particularly sensitive to changes in external demand. A weaker than expected external demand could endanger the envisaged improvement of the current account balance, both in terms of lower real exports and in terms of lower prices; a large share of Latvian exports consists of wood, which might experience sharp price changes.

As Latvia will continue to have a large current account deficit for many years, there will remain a need for significant capital inflows to finance the deficit. The privatisation reform will soon be completed and that might have a negative influence on foreign direct investment. Accordingly, Latvia might have to rely more on debt creating borrowing. Because the savings-investment balance is likely to be under pressure from high private consumption growth and investment requirements, guaranteeing external sustainability in the medium term remains a point of concern.

4.1. Real sector

The envisaged economic development is described both from the production side and from the demand side. Assumptions are in general underpinned by relevant arguments and links between economic development and economic policy are highlighted, as well as links between different sectors. However, the linkages between the external environment assumptions and the domestic growth assumption are not entirely consistent.

Main economic trends remaining similar to those displayed in the previous years. In the medium term, Latvian economic growth will depend on private consumption, investment and exports. Private consumption is expected to grow, fuelled by high wage increases and expanding credit. Although wages are assumed to increase rapidly, they are not expected to grow faster than productivity. A stable macroeconomic environment, further expansion of credit markets and the implementation of business environment reforms, such as tax reductions, will promote investments. It is anticipated that the development of deposit insurance, pension system reforms, as well as the development of the securities market will increase the level of domestic savings. External trade is assumed to continue grow steadily, with exports growing more rapidly than imports. Along with expected productivity growth, exports will be promoted by the economic policy measures of the government. The main objective of these measures is to ensure diversification of the structure of Latvian exports and increasing the share of higher added value goods. Public consumption will be restricted due to the medium-term budget balance goal.

It is likely that food industry, textile industry and chemical industry will continue to expand in the medium term. These branches recently have received considerable investments to modernise production capacities and logistics. Manufacturing in general is also expected to be promoted by different policy measures, such as innovation policy and export promotion. Wood industry and timber production in particular is expected to continue to expand, boosted by a steady increase in construction.

Private services are also envisaged to be one of the fastest growing sectors with expected average growth rate in constant prices at 7.2% per annum. Planned liberalisation of the telecommunications market is expected to increase significantly the volume of communications. Consumer credits will boost further increase in trade.

Agriculture, except forestry, the energy sector and public services are forecast to show more modest growth rates. However, the development of agriculture is influenced by several factors, both political and economical, making it particularly difficult to forecast.

Despite some early signs of improvement, growth of employment is insignificant and such tendency can be expected also in the future. Decrease in population and constantly increasing number of students have been proposed as a main reason for this situation. Continuation of structural reforms in the area of labour force training and regional development will ensure further progress. Furthermore, in the medium term the growth of the average gross real wages (approximately 4.2% per annum) will be lower than the growth of productivity (5-6% per annum).

4.2. Inflation and wages

The main tool used to ensure price stability is the fixed exchange rate between the lat and the SDR. This policy has proved to be successful and inflation has not exceeded 2.4% for the last three years. Thanks to the fixed exchange rate regime and moderate increases in administratively regulated prices an adjustment of the price level to the EU level is expected, but convergence will be slow. The share of administratively regulated prices in the goods and services basket used in 2003 CPI calculations will decrease from 20.7% in 2002 to 16.3%, thus, even though a number of administratively regulated

services are planing to increase their tariffs in 2003, medium-term inflation is expected not to exceed 3%.

4.3. Monetary and exchange rate policy

The lat has been pegged against the SDR since 1994. As monetary policy has been successful in maintaining price stability and supporting macroeconomic stability, no changes of the exchange rate regime before accession to the EU are envisaged. However, the PEP describes changes in monetary and exchange rate policy that will have to be implemented before ERM II participation. Upon reaching a mutual agreement between the Bank of Latvia and all involved EU institutions, the Bank of Latvia plans that Latvia will join ERM II together with changing the currency peg to EUR on January 1, 2005. Moreover, when all the required Maastricht criteria are met and the European Council decides that Latvia is ready to adopt euro, and following a decision concerning the conversion rate, the Bank of Latvia will become a member of the Eurosystem and therefore subject to the monetary policy of the Eurosystem.

4.4. External sector

The large current account deficit is explained by the demand shock following the Russian crisis and large investment needs. In the medium term, the current account deficit is expected to decline slowly. Imports will continue to grow fast but exports are expected to increase even faster. However, given a current tendency for prices of Latvian imports to grow faster then those of Latvian exports, one must be cautious, when assuming that current account deficit will not increase in the coming years. So far the increase of the share of finished goods and higher value added goods in the overall structure of exports has been slow. Finally, the role of transit, which is a very important component in exports of services, is likely to diminish as result that no clear agreements with the Russian government noir oil transportation company – monopoly company "Transneftj" have been reached so far.

Although Latvia has had large current account deficits, it has had no problems in financing the deficits, as net inflows of foreign direct investment showed strong growth and financed about 60% of the deficit. In the medium term it is assumed that foreign direct investment and long-term capital will be used to finance the deficit.

5. PUBLIC FINANCE

The programme clearly states the goal with the fiscal policy, as well as intermediate goals. It also mentions achievements made during last year, in line with the priorities of the previous PEP. In addition, a calculation of the structural budget balance is presented. Given the growing positive output gap over the projection period, the government deficit is mainly of a structural nature.

5.1. The medium-term fiscal framework

The overall goal of the fiscal policy is to maintain the fiscal deficit at a level that ensures stable macro-economic growth. To that end the medium-term fiscal policy aims at ensuring a predictable and stable tax system, reducing the tax burden on businesses

and a gradual reduction of the state budget fiscal deficit. The budget deficit targets for the period 2003 – 2006 have been adjusted upwards from those provided in the previous PEP and seem to be attainable. However, the precedent of budget amendments made by the central government at the end of 2002 might undermine the future budgetary discipline.

Regarding the tax policy the main goals of the Latvian government are to ensure stable and predictable tax revenues, diminish the possibilities of tax evasion, ensure harmonisation of the tax system with the requirements of the European Union directives, and finally, to improve the business environment and to increase the living standards of the population. The PEP identifies a large number of so called key tax policy tasks directed towards attainment of these ambitious goals. For some of theses policy tasks an implementation time frame has been provided, whereas others still need to be elaborated. Furthermore, no expected economic implications of these policy measures have been discussed.

A section on expenditure policy of the central government identifies main priority measures aimed at achieving balanced budget in the long term. These priority measures comprise improvements in budgetary procedures, such as effectiveness of budgetary spending and closer to optimal planning. The main principles underlying the priority measures are effectiveness, transparency and flexibility.

Next, a new section that has been added to the 2003 PEP provides an overview of financial flows between the Latvian and EU budget. Under the accession agreements the EU funding available to Latvia could amount to 4.7% of GDP.

Table 2: Fiscal development
(general government, % of GDP)

		PEP framework			
	2002	2003	2004	2005	2006
Receipts	41.9	42.2	42.3	42.2	42.2
Expenditures	44.9	45.1	44.7	44.4	44.2
Net lending	-3.0	-2.9	-2.4	-2.2	-2.0
- Cyclically adj.	-3.1	-2.9	-2.5	-2.4	-2.3
Primary balance	-2.6	-2.3	-1.5	-1.5	-1.3
Gross debt level	14.6	19.1	17.0	17.4	17.4

Source: PEP, if not otherwise indicated

And finally, a sensitivity analysis section identifies the impact of changes in the key macroeconomic indicators given the fiscal position of the state. Two scenarios that assume GDP growth rates 1% above and 1% below the growth rate assumed in the PEP are compares against each other. These scenarios have been developed assuming that the sectoral structure of the national economy and the GDP deflator remain unchanged. The volume of public consumption in all scenarios has been preserved unchanged as well. The results of the sensitivity analysis demonstrate that the impact on expected tax revenues is asymmetrical, thus, if the actual economic performance would fall short in comparison to the expectations, the resulting impact on the tax revenues would be more severe then in the case of the actual performance exceeding expectations. The value added tax revenues would be most severely affected by the drop in GDP growth, since

lower exports growth rates would mainly reduce economic activity in those sectors that are have bigger potential for value-creation. Additionally, the optimistic scenario relays on productivity growth, whereas the pessimistic scenario assumes a drop in real income and loss of jobs. Consequently, the impact on personal income tax and social insurance contributions is more pronounced in the pessimistic scenario case.

5.2. Public debt management and deficit financing

The State Treasury carries out public debt management.

The public debt has seen two large increases recently: in 1999, following the Russian crisis and in 2002. Despite these two large increases, public debt is still relatively low at 15.2% of GDP in 2002. In 2003 the public debt is expected to rise to 19.0% of GDP, however, by the end of the period it is expected to stabilise at 17.0%. The share of the domestic part of the debt was 38% at the end of 2002 but the policy goal is to increase the share in order to reduce the currency risk. To further reduce the currency risk foreign loans are, as much as possible, taken in SDR or currencies contained in the SDR basket. With the aim of achieve stable debt service costs, public debt management policy provides that at least 60% of the debt should be with fixed interest rates.

5.3. Deficit financing

Latvia will mainly try to attract domestic financing, by issuing short- medium- and long-term T-bills. The domestic interest rates are expected to remain stable but with a slight downward trend. Not to create too much volatility on the domestic financial markets, issuing T-bills will take place at several sequential auctions. However, borrowing on international markets will not be totally abolished and it is planned to refinance the Eurobonds, maturing in 2004, with a new issue of bonds.

5.4. Fiscal risks

Issuance of government guarantees constitutes an uncertainty in forecasting public debt. At the end of 2002, the balance of the government guaranteed loans, including indirect commitments of the government, constituted 5.4% of GDP.

6. STRUCTURAL REFORMS

In response to the Commission's suggestion, the information provided foreshadows to a considerable extent the Cardiff report, which Latvia – like all other candidate countries – has been invited to provide in October this year. It will be comprehensively evaluated in the respective assessment, whereas the following will describe the presented reforms only briefly and concentrate on public finance aspects.

The PEP presents a broad overview of on-going and envisaged structural economic reforms, emphasising their importance for macroeconomic stability and growth. Every chapter is systematically divided into two parts: one backward looking and one forward looking. In comparison with the previous PEP the quality of provided information has improved considerably. Both, estimates of budgetary effects as well as detailed timeframes for implementation of specific commitments for structural reforms are

provided. Nevertheless, not always it is easy to make comparisons between actual developments and commitments in the previous PEP.

6.1. Business environment

The area is treated thoroughly, with several sub chapters: privatisation, competition policy, regulation of public services, legislation regulating insolvency procedure, business development policy, and new technology development and innovation policy.

Privatisation is an essential part of creating a favourable business environment. The reform is ongoing and close to completion. What remains to be done is to complete the privatisation of large state companies, of land and of state residential housing, as well as to complete the liquidation of insolvent state companies. The reform is planned to be finalised during 2003 and 2004.

The part on competition policy outlines the implications of changes made in the Law on Competition that took effect in 2002. These implications mainly concern effectiveness of implementation of competition policy. Furthermore, the changes in law and procedures that will be necessary in order to join the EU are noted briefly.

A unified regulator for public utilities in the state sector was established in 2001. The municipalities are themselves responsible for regulation of public utilities at municipal level. New methodologies for calculating tariffs have been developed in 2002. These methodologies are based on a uniform approach using the price ceiling establishment principles, consequently, the maximum tariff will be regularly adjusted in relation to changes in inflation and operational effectiveness of enterprises. Importantly, starting from 2003 the telecommunications market is open to competition.

Regarding the legislation regulating insolvency procedure a number of measures with the purpose of insuring protection of state and community interests have been implemented in 2002. Also, the new regulatory enactment and implementation of the reform measures that have started in 2003 bring Latvian insolvency laws and procedures closer to those currently adopted by the EU. However, the viability of these new procedures will depend on informing all involved parties about the process, as well as ensuring high professional qualifications for insolvency process administrators, which might prove tricky in practice.

The future of Latvian economy depends on development of strong and healthy business environment and the knowledge-based society, therefore, the PEP discusses structural reforms aimed at facilitating entrepreneurship and enterprising in great detail, but it is silent on the financial resources needed to increase these efforts. A lot has been done in this field and the programme mentions the most important achievements that are in line with the pre-ascension commitments.

For a small, open economy like Latvia trade is very important. The programme identifies a number of problems that exporters face today, such as lack of information, lack of financial resources, low competitiveness and export marketing. The programme also recognises that in order to implement earlier policy programmes, the government needs to increase appropriations to export promotion considerably. With the support of the United Nations Development Programme the Ministry of Economy has started work on updating the Latvian National Foreign Trade Programme (LNFTP). The LNFTP integrates and allocates financing to various exports promoting sub-programmes.

Besides strengthening the capacity of existing external economic missions, 9 new missions will be opened. A system of export crediting, guarantees and insurance will be set up and support will be given in the areas of marketing, market research, participation in international fairs etc. Most of these activities are planned to continue until 2005. Some costs estimates for these activities are provided.

6.2. The financial sector

Financial markets are expanding rapidly. In 2002 the establishment of a single supervisory body, the Financial and Capital Market Commission, was fully completed. Regulatory enactments governing the Latvian finance and capital market in all significant aspects have been harmonised with the requirements of the EU directives. The main future developments are expected in areas of securities, insurance companies and investment companies, where new laws and amendments to laws have to be implemented in order to comply fully with the EU legislation.

6.3. The labour market

Labour market is still characterised by low employment and high unemployment rates, which differ considerably across the regions. In 2002 the State Employment Service implemented a number of active employment measures including vocational training, creation of subsidised workplaces for disabled and less competitive, as well as pre-retirement aged job seekers. The National Employment Plan has been drafted in close relationship to the joint declaration of the European Commission and Latvian government (signed on February 6, 2003). This plan envisages a large number of employment promotion measures and activities as well as provides a budget to finance these measures. It is expected that large share of funding will be obtained via EU structural funds and the European Social Fund.

6.4. Public administration reform

The implementation of the Law on Public Sector agencies and the Law on State Civil Service continued through 2002 and 2003. The Law on Public Administration framework came to effect in the beginning of 2003 and the government has approved the Implementation Plan for the law. The Law on Public Administration framework sets the legal principles to be applied in establishment of democratic and effective public administration. In May 2003 the government approved the first stage in introducing uniform remuneration system for those employed in public administration. In addition, medium-term budget planning will be implemented and the system of internal audit will be further developed. The implementation of the medium-term budget planning and the remuneration system will continue until 2006.

6.5. Agriculture

The chapter gives a brief, but informative, description of the current situation and clearly points out existing problems. It describes policy commitments in relation to the above mentioned problems. It also gives tentative estimates of budgetary effects.

Agriculture has gone through several structural changes during the last decade. Production has gone down dramatically, whereas employment has decreased much less. Average age of those employed in the sector is high and a majority of those people do not have sufficient management skills to compete in the market. As a result of the land reform, the property structure is fragmented, which makes it more difficult to increase productivity. Low productivity and small farms mean low incomes and difficulties in getting loans for investments. Without significant support, Latvian agriculture will not be able to overcome this circle of low productivity and insufficient investment.

Furthermore, it has been noted that implementation of EU directives regarding veterinary and phitosanitary practice, as well as food safety and hygiene legislation might be problematic. To facilitate access to funds, two programmes have been approved, the Programme for credits to purchase of agricultural land and the Programme for agricultural long-term investment credits. In order to support the creation of alternative, i.e. non-agricultural job opportunities and to support the economic development in general in rural areas, the non-agricultural business development programme has been launched. In 2002 first grants have been disbursed to rural businesses within a framework of Special Accession Programme for Agriculture and Rural Development.

6.6. Additional reform areas

The programme also report about reforms in several other areas: the pension system, the health care system, transports and communications, regional policy and environment.

The pension reform commenced in 1995 and is now completed in terms of legislation. However, implementation of the reform is not completed yet. For example, the retirement age will continue to increase gradually until 2008. Also, since participation in the 2nd tier pension scheme is voluntary for persons 30-49 years of age it is difficult to foresee the volume of contributions and, therefore, it is difficult to foresee how sustainable the state old age pension system is going to be in the next 20 years.

In co-operation with the World Bank, a two-stage health care reform project was launched in 1998. The first stage of the project is completed and a number of improvements have been achieved. The reform will continue with the second stage, which is directed towards developing health care financing and monitoring systems, optimising public health protection activities and providing information to the public on health care developments. In order to ensure the implementation of the strategic tasks established by the government, a Ministry of Health was established in early 2003. The reform is planned to be completed in 2007.

The transport sector is very important in the Latvian economy and is accordingly treated carefully. The programme identifies several areas where the reform has to continue: development of Latvian ports and improvement of competitiveness of the ports, modernisation of railways and roads, development of the system of oil product pipelines and development of a harmonised transport system for cargo and passenger transportation in domestic and international traffic. No detailed commitments are made on how to deal with these questions, only the general direction of the policy, which will continue for many years. Some cost estimates are presented and it is pointed out that the projects are assumed to be co-financed by the Instrument for Structural Policy for Pre-

Accession (ISPA), the European Regional Development Fund ant the Cohesion fund resources.

The sector of telecommunication will be liberalised gradually. The public fixed telecommunications network services have been opened to competition, which is regulated by the Public services regulation commission. A new law on electronic communications has been drafted in order to comply with the new EU directives governing the telecommunications sector. Currently, postal services are provided by one company, therefore, the main objective of the future policy is to liberalise this market. It is likely that after opening the market to private enterprises some services will be eliminated, in particular in rural areas. Therefore, besides abolishing the restrictions on entering the markets, two funds will be established to ensure that a basic telecommunication and postal services are provided to all inhabitants.

A long description is given of the current situation of regional policy, mainly focussing on the administrative structure. No follow-up is provided regarding the policy commitments outlined in 2002 PEP.

The environment chapter has already been provisionally closed, but significant investments are necessary to reach the level of infrastructure stated in the EU directives. Essentially, it consists of development of water treatment plants and water supply and waste management systems. Due to high costs of these investments, Latvia has been given several transition periods in these areas. ISPA funds will provide a notable support to the financing.

LITHUANIA

PRE-ACCESSION ECONOMIC PROGRAMME 2003

ASSESSMENT

1. OVERALL SUMMARY AND ASSESSMENT

The third Pre-Accession Economic Programme (PEP) provides a medium-term policy framework, covering the period 2003-2006. It includes public finance objectives and structural reform priorities needed for EU accession and prepares further the institutional and analytical capacity necessary to participate in EMU. The Programme was adopted by the government and is publicly available, but was not sent to Parliament.

The Lithuanian Pre-accession Economic Program covers in detail recent economic developments. Lithuania showed a strong macroeconomic performance in 2002 and the first months of 2003. GDP grew robustly at 6.7% and 7.7% respectively in 2002 and the first half of 2003, compared to the same period one year earlier. Inflation remained low at 0.3% in 2002, as a result of strong productivity growth, moderate wage inflation and the large appreciation of the Litas. The unemployment rate decreased significantly, although it remains high at 13.8%. Significant structural rigidities related to low mobility of the workforce and a mismatch between supply and demand of skills persist in the labour market. Budgetary consolidation continued in 2002, when the general government deficit fell to 1.7% of GDP. The current account deficit increased to 5.3% of GDP in 2002, reflecting strong growth of domestic demand and a deterioration of the current transfers balance.

The PEP foresees high GDP growth rates at 6% and above per annum up to 2006, underpinned by strong domestic demand and a good export performance. Inflation is set to edge up to a level ranging from 2.5% to 2.8% in 2004-2006, due to tax harmonisation with the EU, wage inflation in the tradable sector spilling over to the low-productivity non-tradable sector and price hikes among the regulated sectors. Unemployment is forecast to decrease to 10.2% by 2006, induced by high output growth and active labour market policies. The general government deficit is forecast to pick up to 2.9% of GDP in 2004, as higher investment will couple with contributions to the EU budget and prepayments of agricultural subsidies, but is foreseen to drop back to 1.8% by 2006. In the face of persistent high domestic demand, the current account deficit is set to increase slightly to 5.6% of GDP by 2006. The Lithuanian authorities seek to enter ERM II while retaining the currency board arrangement.

Structural reforms have moved forward. The PEP depicts an extensive list of structural reform initiatives, some of which will be dealt with under the Cardiff report, which Lithuania has been invited to provide in October this year.

The Programme reiterates the authorities' main goal of maintaining a stable macroeconomic environment, thus creating conditions for sustainable long-term growth. In this respect, the currency board arrangement will remain a cornerstone of the macroeconomic policy. Strong investment in physical and human capital are considered crucial to increase the economy's long-term growth potential and sustain rapid growth rates. Liberalisation of markets and harmonisation of legislation with the EU will also contribute to that end. The PEP covers the main areas where attention should be

focused. Improving the competitiveness of the economy, vis-à-vis Lithuania's trading partners, is key especially under the currency board arrangement. Strong productivity gains, and enduring macroeconomic stability will in turn continue to attract foreign capital, and contribute toward building the country's productive capacity. Structural reforms will increase market flexibility and boost the economy's resilience to external shocks. Privatisation will contribute toward streamlining the public sector, and enhancing the private sector's share in the market.

The medium-term macroeconomic objectives are ambitious, and achieving them will require the maintenance of a sound policy stance and a rapid implementation of structural reforms. The medium-term budgetary scenario is subject to uncertainties, as a number of outstanding fiscal obligations could jeopardise the authorities' targets. Those obligations mainly refer to compensation for rouble savings and real estate restitution commitments, potentially amounting to 6.8% of GDP. The government needs to present a clear scheme to repay those liabilities, so as to ensure the achievability of the present fiscal targets. Other factors also constitute a source of uncertainty for the fiscal projections. A non-mandatory privately funded pillar under the pension reform has been introduced. An assessment of its impact on the long term sustainability of the pension system will have to be made. More far-reaching reforms appear necessary. More in-depth reforms might entail initial costs for the budget that should be integrated in the fiscal scenario. Higher expenditure in the wake of EU accession and revenue losses from recent tax reforms stress the need to enhance tax administration to compensate for those effects. Use of ESA95 methodology remains limited and must be improved in the forthcoming convergence programme.

Although the present levels of the current account deficit and external debt do not raise major concerns, they are not exempted from potential vulnerabilities in the medium-term. Growing investment needs are likely to increase the demand for foreign capital financing flows, which should be safeguarded by maintaining high macroeconomic and financial stability. Rapid credit growth is likely to persist, underpinned by low interest rates and better access to credit, stressing the need to maintain tight banking supervision to dissipate potential risks.

The structural reform plans are generally ambitious. The list of outstanding reforms is extensive, and an effort has been made in providing their estimated budgetary impact. Notwithstanding this, it will be of paramount importance that the authorities keep the momentum and yet accelerate the implementation of some reforms. A more in-depth analysis of the planned structural reforms will be done under the framework of the Cardiff Process.

2. JOINT OPINION

> "On 4 November 2003 the ECOFIN MINISTERS OF THE PRESENT MEMBER STATES AND THE ACCEDING COUNTRIES examined the 2003 Pre-Accession Economic Programme of Lithuania on the basis of an assessment prepared by the Commission Services with a contribution from the ECB. In accordance with the Conclusions of the High-Level Meeting with the Candidate Countries in Athens (EFC/ECFIN/227/03) Ministers adopted this joint opinion.
>
> The third Pre-Accession Economic Programme (PEP) provides a medium-term policy framework, covering the period 2003-2006. It includes public finance

objectives and structural reform priorities needed for EU accession and prepares further the institutional and analytical capacity necessary to participate in EMU. The Programme was adopted by the government and is publicly available, but was not sent to Parliament.

…

<u>Opinion</u>

[…],Ministers welcome Lithuania's strong macroeconomic performance and the progress achieved in economic restructuring. In view of the important challenges lying ahead, the authorities are recommended to continue pursuing the implementation of sound economic policies. Ministers acknowledge the significant progress made to consolidate the public finances, but draw the attention to the fact that the medium-term scenario faces significant risks that could lead to slippages from the planned budgetary targets. Ministers praise Lithuania's efforts to implement structural reforms and point at the need to maintain a fast reform pace. In particular, Lithuania is advised to speed up reforms conductive to employment growth and improving the business environment, so that labour market rigidities are reduced, with particular attention to rural areas."

3. REVIEW OF RECENT ECONOMIC DEVELOPMENTS

The PEP provides a good overview of recent economic developments. Overall, there is no significant change in economic trends in comparison to those envisaged last year, although the main macro-economic indicators performed slightly better in 2002 than foreseen in the previous PEP.

3.1. Real sector

Output growth remained strong at 6.7% in 2002. The trend continued over the first half of 2003, when GDP growth accelerated further to 7.7% year-on-year. Competitive exports, despite the appreciation of the currency, growing domestic and foreign investment and the implementation of structural reforms are stated as main factors behind rapid growth. Labour productivity experienced fast growth, while inflation remained close to zero and wage growth was modest, which positively impinged on the competitiveness of the Lithuanian economy. Both public and private consumption grew below GDP growth in 2002, which is pointed out as a factor contributing to contain import growth. The unemployment rate decreased significantly in 2002, although significant structural rigidities and regional disparities remain.

3.2. Fiscal policy

The fiscal consolidation pace continued in 2002, when the general government deficit decreased to 1.7% of GDP. The deficit was mainly attributed to the central government, as both the municipalities and the social insurance funds registered surpluses. Fiscal policy is highlighted as a major factor that has contributed to reducing external imbalances, attenuating tensions on the current account, allowing for lower interest rates and therefore contributing to higher GDP growth. Fiscal consolidation in the last

years has been primarily the result of expenditure adjustments, as revenues declined due to tax cuts. The loss of tax revenues in a context of high economic growth is a matter of concern. This fact stresses the need to further improve tax administration on the one hand, and to continue with the efforts to control and prioritise expenditure on the other hand. Increasing pressures on expenditure related to EU and NATO membership and the need to face several pending financial obligations might constrain the consolidation of the public finances in the medium-term.

3.3. Inflation

Inflation slowed down to 0.3% in 2002 from 1.3% in 2001. The appreciation of the Litas against the US dollar, following the re-pegging of the Litas to the euro in February 2002, is highlighted as a major factor explaining lower inflation. Other factors, such as lower prices of agricultural products and higher competition are also underlined. Real wages have increased below productivity growth and also played a major role in keeping low inflation and preserving Lithuania's external competitiveness.

3.4. External sector

The document highlights the good Lithuanian export performance in 2002 and early 2003. Export growth was primarily induced by exports of investment and final consumption goods. Such positive performance is seen as a sign of increasing competitiveness and diversification of Lithuanian exports. Import growth was also strong, largely due to high imports of investment goods, and outpaced export growth in nominal terms in 2002 (though not in real terms). These developments, together with a deterioration of the current transfers balance, pushed the current account deficit up to 5.3% of GDP in 2002, from 4.8% in 2001, despite an improvement of the balance of services and the income balance.

Financing of the present levels of the current account deficits is not perceived as problematic by the authorities. Significant growth of foreign direct investment inflows, a high level of international reserves, successful issues of government securities and better international credit ratings of the country are outlined as positive signs pointing to the sustainability of the present deficit levels.

Table 1: Economic development

		PEP framework			
	2002	2003	2004	2005	2006
GDP growth at constant market prices	6.7	6.2	6.5	6.7	6.0
Contribution to GDP growth:					
- Final domestic demand	6.6	5.9	5.9	6.6	6.0
- Change in inventories and net acquisition of valuables	0.0	-0.1	-0.1	0.0	0.3
- External balance of goods and services	0.1	0.9	0.3	-0.2	0.1
Investment ratio (% of GDP)	21.5	21.9	22.1	23.1	23.6
GDP per head (PPS, % of EU average) (1)	35.0	36.8	38.1	39.5	40.9
Participation rate (% of 15-64 age group)	69.3	69.8	69.6	70.4	70.5
Unemployment rate (ILO definition)	14.0	12.9	11.9	10.8	10.2
Employment growth	4.0	0.9	1.1	1.2	0.8
Labour productivity growth	6.8	6.9	5.8	6.1	6.1
Average real wage growth	4.9	5.9	3.3	4.5	4.9
CPI inflation (annual average)	0.3	0.1	2.8	2.5	2.6
Exchange rate vis-à-vis EUR (percentage change of annual average)	-3.4	-0.2	0.0	0.0	0.0
Current account balance (% of GDP)	-5.3	-5.1	-5.2	-5.3	-5.6
Net foreign direct investment (% of GDP)	5.1	3.6	3.2	3.2	3.2
Foreign debt (% of GDP)	40.5	40.1	40.0	39.5	39.1

Source: PEP, if not otherwise indicated

(1) calculated, without demographic or price effects; growth rates: candidate countries: PEPs / EU: 2003-04: Spring 2003 COM forecast; thereafter same as in 2004

4. MEDIUM-TERM MACROECONOMIC FRAMEWORK

4.1. Objectives of economic policy

The PEP outlines a medium-term macroeconomic framework that focuses on improving the country's competitiveness and on reaching rapid and sustainable economic growth. Those targets should allow the country to gradually converge toward the EU average income levels. To achieve those goals the Lithuanian authorities will pursue further the fiscal consolidation strategy, maintain the current monetary arrangement and continue with labour market reforms. The authorities intend to carry out other structural reforms in order to achieve these targets, highlighting as the main ones a reform of the tax and the social security systems, the continuation of the privatisation process, the liberalisation of the telecommunication and energy sectors, the improvement of public expenditure efficiency and improving the business environment.

4.2. Real sector

The information provided states the expected sources of growth in terms of production factors and aggregate demand and allows for an analysis of the cyclical position of the economy.

The PEP envisages a higher medium-term growth rate than reported last year, in a range between 6-6.5%, against a background of slower growth in the EU at about 1.3-2.4%. Growth is expected to be induced by strong investment and consumption growth, supported by the planned structural reforms. Export growth is reported to be robust over the forecast period, offsetting import growth. It is assumed that EU accession positively affects growth. While foreign direct investment is forecast to remain strong, the EU structural and cohesion funds are expected to boost domestic investment. Consequently, gross fixed capital investment will increase markedly.

Assumptions about the external environment are provided. The forecasts are based on a slow GDP growth rate in the EU in 2003 that gradually increases in the subsequent years. Stability of the exchange rate and oil prices are other key external assumptions. In 2004-2006, oil prices are foreseen at USD 23.5 per barrel, while the euro is expected to amount to 1.07 dollars over the same period. Potential risks to the macroeconomic forecast are very briefly mentioned, and no detailed information has been provided to explain the conclusions. The approach appears optimistic and seems to be very much based on past experience. In particular, the expected rather limited impact of a potential further appreciation of the euro on the exporting sectors of the economy might be underestimated.

4.3. Inflation and wages

The PEP foresees an annual average inflation rate close to zero in 2003, picking up to a level ranging from 2.5% to 2.8% in the medium-term. Inflation will be initially influenced by the harmonisation of excise rates on fuel and tobacco products and the elimination of a reduced VAT rate on heating of residential houses. Other factors are expected to add more pressure on prices, such as wage inflation in the tradable sector spilling over to the low-productivity non-tradable sector, price hikes among the regulated sectors and higher prices of public transport. Although the projected inflation rates are feasible, they seem ambitious for a catching-up economy which is expected to experience an investment and consumption surge. Keeping inflation around the foreseen levels will be very much dependant on a rapid implementation of structural reforms that allow Lithuania to maintain the current productivity growth trend. In addition, it will be crucial to maintain wage moderation so as to guarantee that salary increases reflect productivity gains. Furthermore, fiscal policy should be ready to play a role in mitigating inflation pressures through a faster reduction of the general government deficit if necessary.

4.4. Monetary and exchange rate policy

The currency board arrangement is seen as a key element of economic policy ensuring external stability, leading to lower inflation and interest rates and contributing to a stable economic development. The re-pegging of the Litas to the euro in February 2002 proceeded smoothly and is facilitating a faster integration with the EU and other acceding countries. The authorities intend to maintain the main features of the current exchange rate system in the ERM II mechanism. Nothing has been put forward in the PEP with respect to the timing of participation in the euro area.

4.5. External sector

It is envisaged that the current account deficit will gradually widen from 2004 as a result of rising domestic demand. Nevertheless, transfers from the EU and an anticipated increase of domestic savings are expected to keep the deficit below 6% of GDP. The current account deficits are expected to be largely financed by non-debt creating capital flows, with FDI financing about 57% of the deficit by 2006.

Although the projections are feasible, the PEP would have benefited from a detailed analysis of the expected increase of domestic savings. According to the fiscal projections, public savings (in the form of lower deficits) will not increase until 2005, and there are no clear signs pointing to an increase of private savings over the forecast period. Therefore, the capacity of the private sector to generate savings that largely compensate the high expected increase in investment is unclear. This emphasises the need to maintain a prudent fiscal policy that supports the current account and to continue with structural reforms that will increase the export capacity of the economy.

5. PUBLIC FINANCE

The programme presents the government's medium-term fiscal objectives and specifies the factors leading to the choice of objectives. It includes data generally consistent with the ESA 95 methodology. Budgetary and economic measures needed to achieve the objectives are described, and a fairly extensive coverage of their quantitative effects is included. The impact of structural reforms outlined in Part 3 of the report is to a large extent quantified and included in the fiscal calculations. Payments to the EU budget and the impact of the ongoing tax reform are taken into account in the projections. A good presentation of fiscal risks together with their quantification is provided, but several of those risks will represent explicit costs for the budget (e.g. the compensation for rouble savings and the restitution of land and real state ownership rights), and a clear strategy to face them seems to be lacking. Thus, the government needs to present a clear scheme to repay those liabilities, so as to ensure the achievability of the present fiscal targets. Use of ESA95 methodology remains limited and must be improved in the forthcoming convergence programme.

5.1 The medium-term fiscal framework

The general government deficit projections have been revised upwards by 0.7, 1.3 and 0.9 percentage points of GDP respectively for 2003, 2004 and 2005. The revised figures show that the deficit picks up to 2.9% of GDP in 2004 and that fiscal adjustment resumes thereafter until 2006, when the deficit decreases to 1.8%. The revision of the targets is mainly explained by the inclusion in the projections of capital expenditure related to EU accession and the financial package approved in the Copenhagen Summit in 2002. The largest expenditure increases will stem from payments to EU's own resources, pre-financing of direct payments to agriculture and capital expenditure related to EU and NATO integration.

The tax revenue-to-GDP ratio is expected to remain slightly below 20% in the medium-term. Social contributions will decrease very slightly to 8.7% of GDP by 2006. EU grants will progressively increase from 2.6% of GDP in 2004 to 4% in 2006, being the major contributor for an increase of total revenue from 33.4% of GDP in 2003 to 35.8% in 2005, although it is expected to decrease slightly to 35.6% in 2006.

Table 2: Fiscal development

(general government, % of GDP)

		PEP framework			
	2002	2003	2004	2005	2006
Receipts	33.8	33.4	35.2	35.8	35.6
Expenditures	35.6	35.8	38.1	38.3	37.4
Net lending	-1.7	-2.4	-2.9	-2.5	-1.8
- Cyclically adj.	-1.7	-2.6	-3.0	-2.5	-1.6
Primary balance	-0.2	-1.1	-1.6	-1.2	-0.5
Gross debt level	22.7	22.9	22.7	23.2	23.3

Source: PEP, if not otherwise indicated

Total government expenditure will gradually increase and reach a peak at 38.3% of GDP in 2005, dropping back to 37.4% in 2006. The increase will be mainly driven by expenditure related to EU integration. Public spending on gross fixed capital formation will expand notably from 2.9% of GDP in 2003 to 4.2% of GDP in 2006. Higher expenditure in the form of subsidies mostly reflect the implementation of the common agricultural policy. Public spending for collective and individual consumption will increase, partly reflecting higher current expenditure related to EU integration. Due to a favourable age structure and the prolongation of the retirement age, social contributions will progressively decrease, making up savings of about 1% of GDP by 2006 in comparison to 2003. Interest payments as a percentage of GDP are assumed to remain broadly unchanged over the medium-term.

Overall, the medium-term fiscal framework provides a comprehensive view about the authorities' fiscal objectives and the necessary measures to achieve them. The key objective of fiscal policy is to achieve a cyclically adjusted government budget close to balance. The programme is clear in terms of policy direction and necessary reforms to achieve the objectives. It properly reflects key expected structural changes and a notable effort has been made to quantify the budgetary impact of structural reforms as well as the contribution of pre- and post-accession EU funds. However, the non-inclusion of some pending financial obligations in the medium-term fiscal framework denotes a considerable downside risk for the projections. The financial obligations related to compensation for rouble savings (3.7% of GDP) and the restitution of land and real state ownership rights (3.1% of GDP) imply explicit costs which will impinge negative pressures on the budget. Only a minimal part of those liabilities is integrated in the medium-term fiscal scenario[8] and a credible, well defined, strategy to repay outstanding

[8] Annex 3 of the PEP presents an estimation of the amounts pending to be paid as well as the scheduled payment date for savings and real estate restitution plans. The authorities envisage to pay compensations for savings amounting to 0.1% of GDP in 2004, 0.2% in 2005 and 0.2% in 2006. Payments for restitution of real state are planned to take place mostly in the period 2006-2011.

amounts is lacking. The budgetary impact of these –and other- fiscal costs is likely to be considerable and could endanger the authorities' fiscal targets.

The programme would have very much benefited from a sensitivity analysis. In particular, the fall of tax revenue in a scenario of high economic growth is a matter of concern, and raises questions about the budgetary impact of a potential economic slowdown.

The submission of projections of the output gap and structural fiscal deficit is welcome. The estimations of the structural deficit are largely based on past experience and show that the GDP cycle has a little impact on the deficit. This is explained by low elasticity of government revenues and expenditure to GDP fluctuations. Elasticity measures of revenues and expenditure to GDP changes are provided but, as the document rightly outlines, changes in tax laws make the results less reliable. It is projected that, after an initial increase by 0.35 percentage points of GDP in 2004, the cyclically adjusted fiscal deficit will decrease by 0.5 and 0.9 points respectively in 2005 and 2006. Nevertheless, the calculations should be viewed with caution since, as the PEP correctly acknowledges, short time series and structural breaks may lead to ambiguous results.

An estimation of the change in the structural deficit net of the impact of EU financial flows has been done and may provide an idea about the budgetary impact of EU accession over the forecast. It shows that the structural deficit would increase by 0.6 percentage points of GDP in 2003, but would subsequently decrease by 0.7 points in 2004, 0.4 points in 2005 and 1 point in 2006.

5.2. Public debt management and deficit financing

The Ministry of Finance is responsible for central government debt management and borrowing. Central and local governments borrowing is regulated by the Law on Approval of Financial Indicators of the State and Municipal Budgets, which imposes limits on borrowing.

The general government debt is forecast to remain low at about 23.3% of GDP in 2006. Interest and exchange rates are assumed to remain stable in the medium-term. The document focuses on the central government debt, and more information about municipalities and social security funds would have benefited the analysis. The calculation of debt is not yet fully according to ESA 95, which could lead to revised projections at a later stage. Borrowing conditions have improved markedly, partly as a result of fiscal consolidation. About 70% of central government debt is foreign debt, of which 76% from euro-zone countries. For the medium-term, the government plans to keep the debt level below 30% of GDP and not more than 25% of GDP in foreign denominated currency. The debt management strategy outlined in the PEP includes plans to increase the share of domestic borrowing, reducing government liabilities in foreign currencies, and to concentrate its foreign borrowing toward the euro markets. The strategy to finance the budget deficit has not changed, government securities and borrowing from international institutions will remain the main instruments to finance it.

5.3. Fiscal risks

Explicit and implicit liabilities are described and quantified. The major fiscal risks are mainly the restitution of savings and real estate ownership rights, the deposit insurance,

the debt of state owned enterprises, the decommissioning of Ignalina nuclear power plant, budget arrears and government guarantees. The quantified amounts are very sizeable and the materialisation of some of those risks could have a very negative impact on public finances. Several of those fiscal risks are explicit costs, such as savings compensation and real estate restitution. The PEP shows a low share of those costs being repaid during the forecast period. A comprehensive strategy to face those fiscal costs is not established. Annex 3 provides a schedule for the repayment of some of those costs, but it remains very general and makes it difficult to estimate the annual expected impact on the public finances.

6. STRUCTURAL REFORMS

Structural reforms should increase the markets' flexibility and boost the economy's resilience to external shocks. Furthermore, reforms in the labour market are needed to tackle the serious unemployment problem in Lithuania, particularly in rural areas.

The PEP provides an extensive list of reforms that are planned over the medium-term, with the focus set on the labour market, the enterprise sector and the reform of public administration. The reform package is ample and the financing plans seem to be consistent with the overall objective of fiscal policy in the medium-term.

6.1. The enterprise sector

The privatisation program has proceeded at a reasonable pace. The privatisation of the banking sector has been achieved, and progress is being done in the restructuring of the energy sector, where plans to privatise companies and to integrate the sector with EU energy networks should increase economic efficiencies. Nevertheless, important efforts are still needed to open the network industries to competition.

Privatisation receipts have been substantial and the government used significant amounts to repay national debt. The PEP summarises the future privatisation plans. A good overview of the companies to be privatised is given, although an estimation of expected revenues from those transactions up to 2006 would have been useful.

Improvements in bankruptcy rules and procedures have led to a significant increase in the number of bankruptcies. The new rules are also speeding up bankruptcy and liquidation procedures as well as restructuring of the enterprise sector, which should have a positive impact on productivity and long-run growth.

The authorities outline plans for the further development of SMEs. The government's main focus is the development of the financial promotion system, business infrastructure, business incubators and regional business development programmes. Visible results have been achieved in improving access to finance (loan guarantees) and creating business incubation and information centres. The aim is to create favourable conditions for the growth of SMEs, and at the same time promote their integration in the EU and stimulate co-operation of SMEs. The focus of industrial policy on increasing innovation and quality standards and export promotion initiatives is welcome, as it will be crucial in order to maintain high productivity growth and competitiveness in the medium-term.

Overall, financing of the initiatives in the enterprise sector is well detailed in the corresponding matrix of policy commitment.

6.2. The financial sector

The privatisation of the banking sector has been accomplished. The PEP focuses on plans to tighten the supervision of financial institutions, and to promote further consolidation of the supervisory functions in the banking, insurance and securities markets. This focus is welcome. There has been a rapid growth in bank lending and the authorities expect this trend to persist in the medium-term. The portfolio of bank loans grew by 22% in 2002, which largely outpaced the increase in deposits (12.1%). Efforts to improve credit risk management and promoting testing methods in case of potential risks (e.g. interest rate or foreign exchange risks) as well as to increase the publication of information have been significant. Indeed, the attention on supervisory issues is welcome and the authorities must remain vigilant, given the rapid developments in the banking system.

6.3. The labour market

Although the unemployment level persists as one of the main problems in Lithuania, recent developments in the labour market are positive. The unemployment rate, which increased steadily since 1997, has declined in 2002. Recent reforms in the labour market, and active labour market policies seem to be contributing to reduce unemployment. Participation in active labour market policies increased significantly in 2002. The new labour code is seen as a good step that should increase flexibility in the labour market. In particular, we welcome the new provision under the new labour code stating that the government can set different rates of minimal wages for individual branches, regions or employees groups. This should make it easier to maintain wage increases that reflect productivity growth as well as to reduce inflationary pressures stemming from Balassa-Samuelson effects.

There are plans to reform the unemployment insurance system, strengthen active labour market policies, improve the quality and provision of vocational training, promote more flexible forms of employment and to guarantee equal opportunities in the labour market. These are viewed as the essential elements for promoting employment growth and lowering unemployment in Lithuania. In addition, the reforms in the labour market will contribute toward improving flexibility, and hence improve the responsiveness of the Lithuanian economy to adverse economic shocks. The reform of the unemployment insurance system should set the grounds for higher incentives for unemployed to look for jobs and to reduce the leeway for unemployment and poverty traps.

The envisaged decline of the unemployment rate from 14% in 2002 to 10.2% by 2006 is ambitious, but is attainable provided that labour market reforms—and other structural reforms—are pursued forcefully by the authorities. As a difference from the previous PEP, the medium-term program envisages employment growth and an increase in the participation rate over the whole forecast. Wage moderation, structural reforms, and a solid growth performance should foster employment growth and lead to an overall improvement in the labour market. Wage moderation will be particularly important and developments in this area should be closely monitored. The average real wage is forecast to increase at a relatively fast pace in the range of 3.3-5.9%, which emphasises the importance of proceeding with structural reforms and increasing investment in

human and capital stock in order to keep high productivity growth. A matrix of policy commitments showing the expected costs of labour market initiatives has been provided.

6.4. Public administration reform

The reform of the public administration features as an important point on the agenda of the authorities. The aim is to create a more efficient and transparent public administration and to streamline the functions of the central and local governments. The latter is particularly important since it will improve the transparency especially with regard to fiscal management.

The reforms, which envisage providing more financial independence to municipalities, should ensure that mechanisms are in place which guarantee that local authorities public finances are consistent with the overall budgetary framework of the central government. In addition, the proposed introduction of a new remuneration system for the civil servants based on the attached grade is welcome since it will contribute to improve the efficiency of the public sector and set a clearer basis for setting public sector wages.

A matrix of policy commitments has been provided and is welcome, although it could have been completed with estimated costs of the territorial administration reform, especially where establishment of new municipal institutions is envisaged.

6.5. Other areas

Considerable attention is paid to the issue of population ageing in Lithuania. The authorities expect that the demographic trends will pose a significant challenge in the long-term. In the long-run, a slower population growth and a smaller labour force, will be reflected in the growth potential of the economy. These demographic trends are likely to have a major impact on public finances: directly, through the social security system, and indirectly as a result of lower, projected, growth rates and hence revenues in the long-term.

It is therefore welcome that the PEP makes a specific reference to this problem and discusses the plans of the authorities to meet this challenge. The PEP outlines changes in the tax system that will favour bigger and poorer families, while the retirement age is being increased. The government plans to introduce a privately funded pension system in 2004. Participation will not be mandatory. As a result, the PEP foresees a shortage of revenues that will lead to a deficit of the Social Insurance Fund during the first decade ranging from 0.03% to 0.2% of GDP annually. However, the estimations depend on assumptions about the number of people who will join the new pillar, and detailed information about those assumptions is not provided. The incentives to join the new pillar seem low, which raises doubts about the efficiency of the reform. The shortage of revenues is planned to be covered with funds from privatisation transactions, the state budget and other sources, but no further details are provided. Furthermore, the document is unclear about the government's plans to set the retirement age at 65 years.

The document outlines plans for reform in the agriculture sector, which are needed in order to meet the terms of the Common Agricultural Policy (CAP), and customs reforms which are also essential to bring Lithuania's legislation in line with the EU.

The authorities place considerable emphasis on their plans to improve the transport, health and education systems, and protect the environment. These are areas where the state can play an active role and are critical in supporting long-term and sustainable development. Education is key in that regard and the authorities plan to continue investing in Lithuania's education system, and in promoting research and development in the country. The planed reforms in the health-care system should improve its quality and accessibility. Finally, steps have been taken to proceed with the gradual liberalisation of the telecommunications and postal services. This should promote competition, enhance services for the consumer, and attract investment in these sectors.

Given the large regional disparities existing in the country, regional policy is a crucial area where reforms are important. The PEP correctly outlines that the process of planning, assessing and monitoring public investments needs to be strengthened. A rapid development in this area and in developing the administrative capacity is crucial to reap the full benefits of the EU structural funds.

In general, very clear aims of each reform are described, although the means to implement the reforms lack detail in some cases. A matrix of policy commitments quantifying the budgetary impact of the reforms has been provided for most reforms and is very well received. Structural reforms will be analysed more in depth in the framework of the Cardiff process.

MALTA

PRE-ACCESSION ECONOMIC PROGRAMME 2003

ASSESSMENT

1. OVERALL SUMMARY AND ASSESSMENT

The third Pre-Accession Economic Program 2002-2006 presented by Malta was compiled by the Ministry of Finance and Economic Affairs, and both the Central Bank of Malta and the National Statistics Office have also provided important inputs. The document was sent with some delay.

This year's PEP builds on the previous one and it is the basis for policy formulation and evaluation serving as a framework for maintaining progress in the three key medium-term objectives: to attain real convergence with the EU economy through achieving sustainable economic growth and a high level of employment, to restore fiscal balances to sustainable levels in the medium term and ensuring stability in the external sector. The PEP also contains a report on observations on the output gap for Malta, but fails to provide estimations on cyclically adjusted balance. Further refinements have been made in the application of the ESA 95 methodology, in particular for the compilation of general government total receipts and total expenditures, but additional steps are needed.

In comparison with last year's PEP, the most notable difference is a more cautious approach to the performance of the main macroeconomic variables for the whole period. According to the authorities, these revisions were mainly due to the persistent deterioration of the external environment since 2001, leading to a lower starting point and a more careful stance. The Maltese economy recovered in 2002 from the 2001 slowdown, GDP growing by 1.2%, far below the 3.3% estimated by the economic authorities in the last PEP, but is expected to gradually resume growth to attain 3.6% in 2006. The two main engines for recovery will be private consumption and exports, while investment will be supportive in 2004 and 2005. The increase in high value manufactured exports will progressively improve the current account deficit from 5% of GDP in 2001 to 4.4% in 2006. Labor supply shrunk in 2002 by 0.3%, due to the implementation of voluntary early retirement schemes in private and, mostly, in public enterprises, implying that a high rate of those who decided to retire remained economically inactive. Despite the output recovery in 2002, the registered unemployment rate stood at 5.2%, but it is estimated to fall down to 4.9% by the end of the period. The inflation rate slowed down remarkably in 2002, falling to 2.2% in December from 2.9% a year earlier, and is expected to remain below 2% the next two years. In 2002, the general government deficit fell down to 6.2% of GDP (from 6.8% in the previous year), but the last submission projected an improvement to a deficit of 5.2% of GDP. Lower than expected economic growth in 2002 resulted in reduced tax revenues whilst government expenditure went beyond PEP-2002 expectations. The third Maltese PEP provides estimations for the general government deficit to 7.4% of GDP in 2003, as compared to 4.6% projected last year. In connection with developments in the general government deficit, the debt ratio is expected to increase from 66.6% of GDP in 2002 to 68.4% of GDP in 2006, provided that assumptions for the public deficit path remain as expected by the government. Malta's authorities declare their willingness to join ERM II and eventually to participate in the euro area.

It is not excluded that the general government deficit increases above the level of 7.4% planned for 2003. This deterioration is attributed to weaker tax revenue linked to slower economic growth, large public expenditure related to the new Mater Dei Hospital and downwards rigidity of government expenditure. The government plans to bring the public deficit down to 3.4% in 2006, which seems somewhat difficult to achieve. The document reflects the government's commitment to macroeconomic stability and fiscal sustainability, but it does not offer a comprehensive and specific approach for needed public finance reform. The current baseline scenario does not look easily attainable, unless the authorities undertake a more decisive action to put public finances on a sound footing. The reduction of the deficit could be possible by amending policies encompassing mandatory and quasi mandatory expenditures to improve budgetary flexibility and by continuing efforts to curtail abuse in the welfare system. An appraisal of the budgetary impact of ageing population and initiatives to ensure the long-term viability of the pension and healthcare system should also be provided. Concerning the structural reforms in Malta, some progress has been made, notably concerning state monopolies that have been dismantled and open to international bidding. Labor markets seem to be sufficiently flexible to deal with the economy's volatility without generating long periods of high unemployment. In the banking sector some controls by the Central Bank remain, especially for short term operations, but efforts will have to be taken to face the liberalization of capital movement. Concerning the non-performing loans, rules have changed and the share of these loans will be reduced in the future.

2. JOINT OPINION

"On 4 November 2003 the ECOFIN MINISTERS OF THE PRESENT MEMBER STATES AND THE ACCEDING COUNTRIES examined the 2003 Pre-Accession Economic Programme of Malta on the basis of an assessment prepared by the Commission Services with a contribution from the ECB. In accordance with the Conclusions of the High-Level Meeting with the Candidate Countries in Athens (EFC/ECFIN/227/03) Ministers adopted this joint opinion.

The third Pre-Accession Economic Programme (PEP) provides a medium-term policy framework, covering the period 2003-2006. It includes public finance objectives and structural reform priorities needed for EU accession and prepares further the institutional and analytical capacity necessary to participate in EMU. The Ministry of Finance and Economic Affairs compiled this document.

…

Opinion

[…], Ministers note that developments in the international economy are likely to temper the pace of the recovery because of their impact on tourism and semi-conductor manufacturing, Malta's main economic sectors. The weak fiscal position could undermine Malta's achievements. Ministers urge the Maltese authorities to vigorously implement the necessary reforms to put the public finances on a sound footing, to enhance efficiency in public enterprises, to diminish subsidies and to replace the use of extra-budgetary funds with a strict and transparent process ensuring their exceptional use. In line with this, Ministers recommend Malta to target without delay a rapid decrease in the general government deficit to a close to balance position in the medium term, as well as prompt a downturn in gross debt level. In this context, Ministers call for

> changes to the welfare and pension systems to reduce their pressure on public finances and on the cost of employment, while taking into account the impact of ageing to ensure the long term sustainability of public finances. Ministers underline the necessary coherence of the budgetary strategy with the objective of the Maltese authorities to join the euro.
>
> Ministers invite Malta to pursue the privatization process to significantly reduce the public sector's involvement in the economy, contributing to a more efficient deployment of resources, specially by cutting public sector employment to the advantage of the private sector to boost economic efficiency and be a factor to lasting economic growth."

3. REVIEW OF RECENT ECONOMIC DEVELOPMENTS

The Maltese Economy recovered in 2002 from the 2001 slowdown, GDP growing by 1.2%, far below the 3.3% estimated by the economic authorities in the last PEP. In the absence of a recovery of the international economy, Maltese economic growth was mainly supported by private and public consumption and, to a lesser extent, by a fragile export performance.

Both private and public consumption expenditure grew by 2.5% in 2002, above the figures presented in the PEP-2002. Private consumption increased at the expense of a further decline in the savings ratio as, despite favorable interest rates, the domestic credit growth slowed down to 3.3% in 2002, from 6.6% in 2001. The sharp plunge of the gross fixed capital formation in 2001 softened in 2002, contracting by 4%, mostly due to high activity in the construction sector. The external sector remained heavily influenced by the unsatisfactory international environment. Exports experienced a slight increase of 0.2% (recovering from a 4.9% drop in 2001) , due to re-exports, operations in the fish farming industry and some manufactures which counteracted the poor results of the electrical machinery sector. Imports fell by 2.2% in 2002, as a reflection of the adverse situation in the electronics and manufacturing sectors and a continued run-down of inventories of industrial supplies. As a result, the current account deficit slightly improved in 2002 to 4.7% of GDP, from 5% of GDP in 2001.

Labor supply shrunk in 2002 by 0.3%, due to the implementation of voluntary early retirement schemes in private and, mostly, in public enterprises, implying that a high rate of those who decided to retire remained economically inactive. Despite the output recovery in 2002, the registered unemployment rate stood at 5.2%. The combined effect of output increase and reduction in the labor force led productivity to grow by 1.1% in 2002.

The inflation rate slowed down remarkably in 2002, falling to 2.2% in December from 2.9 a year earlier, owing to the improvement of the food sub-index, affected by the reduction of food import levies and as past disturbing elements in 2001 in the supply side improved and others were of a one-off nature.

Table 1: Economic development

		PEP framework			
	2002	2003	2004	2005	2006
GDP growth at constant market prices	1.2	1.3	2.5	3.2	3.6
Contribution to GDP growth:					
- Final domestic demand	1.1	3.6	2.0	2.0	1.9
- Change in inventories and net acquisition of valuables	-2.1	0.6	0.3	0.7	1.1
- External balance of goods and services	2.2	-2.8	0.2	0.5	0.7
Investment ratio (% of GDP)	23.2	25.0	25.7	25.7	25.1
GDP per head (PPS, % of EU average) (1)	:	:	:	:	:
Participation rate (% of 15-64 age group)	56.8	57.1	57.4	57.7	58.0
Unemployment rate (ILO definition)	5.2	5.3	5.5	5.3	4.9
Employment growth	-0.5	0.7	0.6	1.0	1.2
Labour productivity growth	1.6	0.6	1.9	2.1	2.4
Average real wage growth	-	-	-	-	-
CPI inflation (annual average)	2.2	1.6	1.8	1.9	2.0
Exchange rate vis-à-vis EUR (percentage change of annual average)	1.4	0.0	0.0	0.0	0.0
Current account balance (% of GDP)	-4.7	-5.5	-5.4	-4.9	-4.4
Net foreign direct investment (% of GDP)	-10.0	2.5	2.5	2.5	2.5
Foreign debt (% of GDP)	27.5	27.3	27.8	28.2	28.0

Source: PEP, if not otherwise indicated

(1) calculated, without demographic or price effects; growth rates: candidate countries: PEPs / EU: 2003-04: Spring 2003 COM forecast; thereafter same as in 2004

In 2002, the general government deficit felt down to 6.2% of GDP (from 6.8% in the previous year), but the last submission projected an improvement to a deficit of 5.2% of GDP. Lower than expected economic growth in 2002 resulted in reduced tax revenues whilst government expenditure went beyond PEP-2002 expectations. Furthermore, it is relevant to mention that the last PEP projections related to the general government budgetary performance were widely exceeded.

4. MEDIUM-TERM MACROECONOMIC FRAMEWORK

The Program provides a coherent and consistent macroeconomic framework, identifies the main targets of macroeconomic policy with the correspondent intermediate objectives, but further attention should be paid to the right economic policy mix supporting the envisaged macroeconomic developments.

The government broadly maintains the same three objectives as in the previous Program: i) to attain real convergence with the EU economy through achieving sustainable economic growth and a high level of employment, ii) to restore fiscal balances to sustainable levels in the medium term which, in turn, should ascertain that levels of Government debt grow at a slower rate than economic growth, and iii) ensuring stability in the external sector. In comparison with last year’s Program, the second objective gives up any quantitative target, but inserts a new mention on Government debt growth, the anticipated deterioration of this variable being given.

The current Program presents a baseline macroeconomic scenario that reflects the authorities' estimate on the evolution of the economy up to 2006. Contrary to what was done last year, the PEP-2003 does not present data neither on cyclical developments nor on long-term sustainability of public finances.

In the Program's period (2004), Malta will enter the EU. The bulk of reforms linked to the Cardiff process will be already carried out and the immersion in a highly competitive area will come true. Accordingly, all these phenomena have been taken into account in the baseline scenario, having an impact on productivity gains which are sizable in 2005 and 2006. The net and direct budgetary impact of these policy measures are well reflected in the Matrix of Policy Commitments annexed to the document. Two additional scenarios are introduced, allowing for a sensitivity analysis of the influence of two key external variables on the performance of the extremely open Maltese economy. The Scenario I takes on board the different rates of economic growth in the country's major trading partners. The Scenario II builds on price developments in the same Malta's main trading partners. Both Scenarios present "strong" and "slow" assumptions.

4.1. Real sector

After the negative impact that the international demand slowdown had on the Maltese economy in 2001, real GDP growth recovered in 2002. The Program expects this recovery to be sustained over its time horizon with acceleration in the last two years of the period. In 2003, the effect of the depreciation of the dollar on the earnings of the semiconductor industry, which accounts for about a quarter of the total manufacturing value added, and the decrease in receipts from tourism due to the war in Iraq turn the expectations for recovery modest (1.3% of GDP in 2003). This will make economic activity to rely only on government expenditure. However, the 2003 first quarter contraction of GDP makes the growth prediction somewhat optimistic. From 2004 onwards, economic growth will gradually increase led by brighter external sector performance, investment and private consumption, whilst government expenditure is expected to be lower. Compared to the previous submission, the expected growth rates for the period 2003-2004 are fairly smaller, reflecting the weaker and delayed international economic recovery and the need to bring down government expenditure to consolidate public finances. The baseline scenario predicts real growth rates of 2.5% in 2004, 3.2% in 2005 and 3.6% in 2006.

As regards 2002 Program, in this submission private consumption is expected to increase more moderately in 2004 and 2005, stemming from a worse performance in the labor market and smaller improvements in labor productivity. Private consumption is expected to recover in 2005 and 2006 underpinned by a strengthening of the labor market as well as labor productivity increases. Private consumption estimates seem conservative as they remain below their recorded historical trend. Government consumption, after the 2003 spike, is expected to run at a slower pace.

Gross fixed capital formation and exports, coupled with sustained private consumption, are forecast to be the main engines for growth, but in a more balanced way than in the 2002 submission. Indeed, external demand is expected to increase steadily from 2004 to attain a growth rate of about 4.3% in 2006. While gross fixed capital formation is projected to stay high in 2003 (6.7%) and 2004 (3.5%), it will slowdown in 2005 and 2006. However, the sharp fall in capital formation by 2006, should be explained as it

does not seem consistent with expanding external demand and sound private consumption.

Despite recovery in economic activity, a somewhat negative evolution in the labor market appears in the years 2003-2005, due to the restructuring measures undertaken to trim public sector entities to allow for higher competitiveness and efficiency of the domestic economy. By the end of the period, demand for labor is projected to increase faster than the growth of labor force, owing to the strengthening of the international economy and falling unit labor costs generated by expected labor productivity improvements. Accordingly, private sector wage will increase in line with labor market tightness, entailing an acceleration in unit labor cost to around 1.6% in 2006.

After a significant decline in 2001 and 2002, investment as a share of GDP is anticipated to increase to 25% in 2003, led by government capital expenditure, and to 26% in 2004 in response to higher external demand, mainly linked to the electronics industry. Over the period, investment will remain around 25% of GDP. Savings-to-GDP ratio is expected to increase gradually from 2004, to attain 20% of GDP in 2006, stemming from the reduction of the public deficit which will counteract a further decline in private sector saving.

The document provides an assessment of the effects on the growth rate of the two alternative scenarios presented.

4.2. Inflation and wages

The rate of inflation is measured by the percentage change in the Retail Price Index (RPI). The Program assumes a steady increase in prices over the period as economic activity gathers momentum and conditions in the labor market become tighter. Thus, the authorities believe that the rate of inflation will move from 1.3% in 2003 to 2% in 2006, converging to the rate of inflation in Malta's main trading partners. This development is also explained by the removal of import levies on agricultural and food products. However, effects on the RPI arising from the structural reforms undertaken by the authorities are not taken into account by the PEP.

4.3. Monetary and exchange rate policy

In view of the domestic and international economic developments and in absence of inflation risk, the Central Bank of Malta cut official interest rates by 25 basis points in May 2003 and again in June, bringing it down to 3.25%. The Central Bank is managing interest rate policy mirroring policy carried out by the Eurosystem. The Maltese lira peg to a basket of currencies where the euro weight reaches 70% and the forthcoming EU membership instilled additional exchange rate and price stability.

The document states the government intention to joint ERM II and the adoption of the euro as soon as economic convergence allows it. The authorities estimate that the Maltese lira should not stay more than 2 years in the Mechanism and that the lira should fluctuate within a narrow band. The PEP-2003 does not provide any indication on eventual changes in the exchange rate regime in the light of the medium-term sustainability of the current arrangement and of the authorities' timetable for future EMU membership.

4.4. External sector

The external goods and services deficit is expected to remain high over the period, what is consistent with the need to accelerate catching up. The deficit is predicted to hit the highest level in 2003 to 6.6% of GDP, due to sizeable government expenditure with a high component of imported goods. After this year, the deficit will steadily diminish to 5% of GDP in 2006, as recovery of the international economy will strengthen external demand and public finances will get back on track.

The negative balance of the goods and services account will be partly offset by repatriation of foreign investment by Maltese residents and privatization receipts. The PEP foresees an increase in foreign reserves over the period. As a result, the current account deficit will gradually diminish over the period to, 4.4% of GDP in 2006.

5. PUBLIC FINANCE

The Program is conscious that public finances in the medium term are not sustainable, endangering future macroeconomic stability. However, the authorities seem somewhat passive to tailor a comprehensive plan to definitively reverse the deterioration of public finances.

The general government deficit attained 6.2% of GDP in 2002, 0.6 percentage points lower than the one registered in 2001, but worse than the PEP-2002 target. This escalation is mainly entrenched in a shortfall in tax revenue stemming from lower economic growth and, to a great extent, to rigidities in the expenditure side.

Table 2: Fiscal development
(general government, % of GDP)

		PEP framework			
	2002	2003	2004	2005	2006
Receipts	43.8	44.3	45.0	45.0	43.2
Expenditures	50.0	51.7	50.9	49.1	46.6
Net lending	-6.2	-7.4	-5.8	-4.1	-3.4
- Cyclically adj.	n/a	n/a	n/a	n/a	n/a
Primary balance	-1.4	-2.8	-1.0	0.6	1.5
Gross debt level	66.6	71.7	72.2	70.6	68.4

Source: PEP, if not otherwise indicated

The current estimations for the 2003 general government deficit point to 7.4% of GDP in 2003, as compared to 4.6% projected last year. This strong deterioration in public finances is again attributed to weaker tax revenue linked to slower economic growth, large public expenditure related to the new Mater Dei Hospital and downwards rigidity of government expenditure.

The document outlines the government willingness to bring public finances under control, but it fails to provide a clear set of measures to attain this aim.

5.1. The medium-term fiscal framework

The government foresees an important deterioration of the general government deficit, reaching 7.4% of GDP, from 6.2% in 2002. In 2004, as the ratio of total expenditure to GDP is forecast to diminish and the ratio of total receipts to increase, the public deficit is expected to fall to 5.8%. In the following years, the fall of the total expenditure ratio to GDP is predicted to outpace the slight decrease in the total receipts ratio, leading public deficit to fall to 3.4% of GDP in 2006.

The document underlines the fact that the streamlined application of ESA 95 methodology makes receipts and expenditure data presented in the current PEP not directly comparable with the data presented in the previous Program, but this does not significantly affects the calculation of the general government balance. It is also relevant to indicate that the current fiscal framework takes on board the effects of structural reforms announced in the document.

A sensitivity analysis is provided to determine the impact on general government deficit and gross government debt to a change in the rate of inflation of 0.5 percentage points compared with the rate forecast in the baseline scenario. However, the analysis is not extended to assess the impact of changes in interest rates and exchange rates, what would be specially relevant for the Maltese economy.

Under the assumption of a rate of inflation 0.5 percentage points higher than that predicted in the baseline scenario, the general government deficit improves by 0.2 percentage points in 2004. This effect increases over the period, improving to 0.6 percentage points in 2006. The transmission mechanism operates through increases in government revenue as the nominal tax base expands. Government expenditure also rises, but less.

Lower general government deficit caused by higher inflation rate would shrink government’s financial needs and gross government debt to GDP ratio would fall down as well. The improvement in the gross government debt ratio increases along the period. Thus in 2004, the ratio is 0.7 percentage points lower than that of the baseline scenario, while in 2006 this improvement attains 2.3 percentage points.

The PEP-2003 does not make available estimations about the cyclically-adjusted balance that enables to assess the fiscal and monetary policy mix.

5.2. Public debt management and deficit financing

The government does not communicate any new institutional arrangement for the management of public and publicly guaranteed, domestic and external, debt. Foreign consultants have been engaged to strengthen debt management. The debt is mainly denominated in Maltese lira, hence without exposure to exchange rate fluctuations.

The finance authorities intend to maintain a high share of domestic borrowing to finance the general government deficit in other to avoid exposure to exchange rate risk. The foreign denominated debt currently provides around 6% of total financing.

As a consequence of the extremely negative performance of public finances, the debt-to-GDP ratio is expected to deteriorate up to 72.2% of GDP in 2004. Thereafter, higher

primary balance, stronger growth and privatization receipts should support a gradual reduction of the debt-to-GDP ratio to around 68% of GDP in 2006.

In 2003, the gross government debt-to-GDP ratio is planned to be negatively influenced by the primary balance, by 2.9 percentage points of GDP and by interest payments, amounting to 4.7 percentage points of GDP. The primary balance is predicted to turn positive as of 2005, reflecting the commitment of the Maltese authorities to bring public finances under control. Interest payments are expected to remain on the average level of 5% of GDP. Nominal growth rate contribution to reduce the debt-to-GDP ratio will increase steadily, as economic recovery gathers momentum, from 2.1 percentage points of GDP in 2003 to 3.8 percentage points in 2006.

5.3. Fiscal risks

Government guarantees reached 22% of GDP at the end of 2002, of which 90% are issued to public entities. In the medium term framework, the repayment on credit facilities and the contention in the issuance of new guaranties will bring the current level to 15% of GDP in 2006.

The PEP does not provide an explicit analysis of the long term sustainability of public finance in the light of envisaged trends in pension and health care expenditures. Reform of the welfare system remains one of the main objectives of the government, but its impact on budget is not appraised.

6. STRUCTURAL REFORMS

The government correctly integrates the links between structural reforms, the EU accession and macroeconomic growth and stability.

6.1. The enterprise sector

The document extensively states reforms in the enterprise sector focussing on the restructuring of industry, business environment, price controls, privatization, liberalization and regulatory reform in the sectors of telecommunications, postal services, airline groundhandling services and other national monopolies with exclusive or special rights and competition policy and State aid.

On the side of industry restructuring two main policies have been implemented: trade liberalization and support to enterprises. The government successfully removed the remaining import tariffs on industrial products. In March 2003, the government launched the National Industrial Policy aiming at streamlining productive resource allocation and redefining the role of the State as to provide the legal, educational, physical and institutional infrastructure that allows the private sector to operate in an efficient market economy. The Business Promotion Act encourages investment in the key manufacturing sector, providing incentives for greater investment and productivity across the industry. To speed up R&D the Malta Council for Sciences and Technology has been established to assist companies in quest of innovative technology.

Preferential tax treatment to SMEs and self-employed has been carried out and changes in the bankruptcy law have been made in order to allow companies in distress to continue its activity under Court supervision instead of falling into liquidation.

Amendments to the Supplies and Services Act has been passed by the Parliament to align the Maltese legislation in the area of price controls.

Privatization seems to progress somewhat hesitantly, to some extent due to weak international environment. The Public Lotto Department sale is its final stages and the Administration is working in the privatization of the Mediterranean Offshore Bunkering Company Limited (MOBC) and the Malta Freeport Terminals Limited. The privatization activity net direct budgetary impact is likely to provide revenues amounting to 0.1% of GDP in 2003, and is expected to increase around to 0.25% of GDP in the following years, what will not decisively contribute to bring the debt to GDP ration back into shape.

An array of measures have been undertaken to broaden liberalization and competition in the sectors of telecommunications (opening up to competition of international data gateway services and fixed telephony services), postal services (participation of a foreign operator in the 35% of the national postal services), liberalization of the groundhandling services at the Malta International Airport (allowing the entry of a second operator) and the streamlining of competition policy and State aid (amendments in the Competition Act, concentration and subsidiary legislation on State aid).

6.2. The financial sector

The financial sector legislation continued the process of alignment to the EU relevant legal framework and standards. Legislation governing retirement schemes and funds, coupled with amendments to legislation on trading in securities was passed. In the banking sector, secondary legislation to set up a deposit guarantee scheme was enforced and the netting of financial transactions is permitted by the new bankruptcy procedures. The Malta Financial Services Authority further widened its regulatory power, by regulating stockbrokers activity and some aspects of the securities market, previously under the Malta Stock Exchange supervision. The quality of the banks' assets and the reduction of non performing loans (NPL) have been operated, but more needs to be done as the level of NPLs is still worrying. The number of institutions conducting international banking operations shrunk as a result of institutional changes. The document acknowledges that the progress achieved in the capital account liberalization and the high levels of competition in the financial sector allows the authorities to be confident regarding the impact of EU accession.

6.3. The labour market

The increase in the participation rate of both females and disabled persons remains one of the key priorities of the Maltese authorities, together with higher levels of qualification of the work force. Measures aiming at supporting families to send their children to child day care centers and the enactment of the Equality for Man and Women Act have been carried out in 2003. The opening, in 2003, of three new institutes to provide training in the areas of mechanical engineering, agribusiness and community services are designed to strengthen vocational education and skills of labor force. It is relevant to mention the enforcement of the Employment and Industrial Relation Act and

its subsidiary legislation regulating parental leave entitlement, part time jobs, collective redundancies, contracts of service for a fixed term, posting of workers in Malta, information procedures, the setting up of a guarantee fund to protect wages from business insolvency and regulation to make employers to inform workers in case of transfer of business.

6.4. Administrative reform

Government is pursuing a widespread modernization of the administrative services delivered to the private sector and to population, focussing on the enhancement of the e-government and the utilization of public-private partnerships. The PEP comments the new collective agreement for public service employees for the years 2002-20004. The agreement aims at improving productivity in the public sector but contains a clause which allows the inclusion of any future cost of living adjustment, introducing also the possibility of early retirement schemes. In the absence of deeper information on those last two issues, it is difficult to assess whether this would increase the burden on public finances.

6.5. Agriculture and fisheries

The challenge posed by EU accession led the government to undertake a policy reform containing measures to liberalize agricultural trade, re-orient farm support and introduce price liberalization. Preliminary results indicate that some targets are being attained. In the fisheries sector, the government is modernizing the fleet by replacing the old trawlers.

6.6. Additional reform areas

To restore the economic viability of the shipyards in the long term is the objective of a seven year plan launched by the government in 2002, involving a cost of 10% of 2003 GDP, of which 70% will consist of a write-off of past debt. The first early retirement scheme was successfully accomplished and reduced the work force by around 700 workers. A new collective agreement is about to be negotiated to increase efficiency and productivity. Another important step has been the partnership with an international yacht fitter and builder which will open a new line of business in a high value added segment of the market.

A slight reference to the welfare system reform is done in the document. The National Commission for Welfare Reform is expected to deliver a report on this crucial issue by the end of 2003. Other initiatives in the filed of the knowledge –based society and ICT and on social and environmental sustainability are reported, showing a high degree of the authorities awareness to these issues.

POLAND

PRE-ACCESSION ECONOMIC PROGRAMME 2003

ASSESSMENT

1. OVERALL SUMMARY AND ASSESSMENT

The 2003 PEP pre-accession economic programme (PEP), which was adopted by the Council of Ministers, updates last year's programme and reflects an overall economic policy strategy oriented towards achieving strong economic growth and complying with the conditions for euro area membership. The whole programme is built around the general objective of preparing Poland to adopt the euro in 2008 at the earliest. The macroeconomic framework projects an acceleration of growth from 1.4% in 2002 to 5% in 2004-2005 and to 5.6% in 2006. Thus, the Polish economy would grow above potential, as estimated in the PEP, for the last three years of the programme. The programme expects domestic demand to be the main engine of growth, while the contribution of net exports to growth will turn negative from 2004 onwards. In parallel with the acceleration of growth, the programme projects a widening of the current account deficit from 3.0% of GDP in 2003 to 5.1% in 2006. Registered unemployment is expected to start declining from 2004, in line with the return of Poland to a strong growth path, while inflation is projected to increase gradually from the very low level of 0.8% on average in 2003 to 2.9% in 2006. The programme sees the zloty on a slight appreciating trend vis-à-vis the euro over the forecast period. No change to the existing monetary and exchange rate arrangements, i.e. a direct inflation targeting strategy combined with a floating exchange rate regime, is foreseen until joining ERM II. The programme does not specify the authorities' timetable for entry into ERM II but indicates that Poland envisages a participation of the zloty within the 15% fluctuation band for two years.

The general government deficit is expected to increase from 4.1% of GDP in 2003 to 5.0% in 2004. It would then start decreasing to reach 3.4% of GDP in 2006. A reduction in the cyclically-adjusted deficit of 1 percentage point of GDP is foreseen over 2005 and 2006. According to estimates of structural budgetary developments, the major fiscal adjustment would take place in 2005 and amount to 0.7 percentage points of GDP. In 2006, the adjustment effort in structural terms is expected to be lower than 0.5 percentage points of GDP. The general government gross debt ratio in ESA 95 terms would increase from 44.3% of GDP in 2003 to 49.1% in 2006.

The PEP presents a broad overview of ongoing and envisaged structural reforms, and foreshadows to a substantial degree the Cardiff report, which Poland – like all the other acceding countries – has been invited to provide in October this year. The overall structural reform package is based on and complements the *2003-2004 Pro-Growth Action Plan,* which is an update of the Entrepreneurship-Development-Work programme adopted by the government in January 2002 and presented in last year's PEP.

The third Polish PEP provides an adequate assessment of recent economic developments and a consistent and, to some extent, credible medium-term macroeconomic framework. However, the macroeconomic scenario appears to be on the optimistic side, especially for the years 2004-2006. It crucially hinges on an expected

strong rebound in investment from 2004. The pickup in investment is likely to be more moderate and gradual than forecast in the programme, notably due to the still difficult access of firms to finance. Overall, the appropriateness of the growth scenario is difficult to assess as the programme does not show the linkages between the macroeconomic framework and planned budgetary and structural policy developments.

The budgetary plan presented in the programme is insufficiently ambitious as the adjustment effort in structural terms is postponed till 2005 and would amount to only 1% of GDP over the last two years of the programme. In addition, the path of fiscal consolidation lacks credibility, as the PEP does not provide any details about the adjustment measures envisaged and remains imprecise about the origin of consolidation. The need to restructure public expenditures, and in particular to reform the system of disability payments and early retirement benefits, as well as the special farmers' social insurance scheme, has not been stressed adequately. The exchange rate policy is to be assessed according to the common criteria agreed in May 2003 at the High-Level Meeting in Athens.

The document does not examine the impact of Poland's accession to the EU on the general government sector. The 2003 PEP contains very little quantified information on the budgetary implications of the measures and reforms taken or envisaged and provides no sensitivity analysis of changes to the macroeconomic assumptions. The assessment of the programme is hampered by the extensive reference to several definitions of the government deficit (national concepts), while deficit figures and projections on an ESA 95 basis are little commented upon. There is scope to further improve the quality of the programme

2. JOINT OPINION

"On 4 November 2003 the ECOFIN MINISTERS OF THE PRESENT MEMBER STATES AND THE ACCEDING COUNTRIES examined the 2003 Pre-Accession Economic Programme of Poland on the basis of an assessment prepared by the Commission Services with a contribution from the ECB. In accordance with the Conclusions of the High-Level Meeting with the Candidate Countries in Athens (EFC/ECFIN/227/03) Ministers adopted this joint opinion.

The third Pre-Accession Economic Programme provides a medium-term policy framework, covering the period 2003-2006. It includes public finance objectives and structural reform priorities needed for EU accession and prepares further the institutional and analytical capacity necessary to participate in EMU. The Programme was adopted by the Polish Council of Ministers.

…

<u>Opinion</u>

[…], Ministers commend the authorities for progress made in reforming the Polish economy and in reducing its macroeconomic imbalances. They highlight the rapid fall in inflation and the stabilisation of inflationary expectations at a low level, the marked improvement of Poland's external position and the increasing competitiveness of Polish companies. They emphasise that the

current recovery creates favourable conditions for accelerating structural reforms and addressing Poland's fiscal problems.

Ministers note that the new draft budgetary law has brought some changes to the policy framework presented in the PEP. They express strong concerns about the significant widening of the budget deficit in 2004 in parallel with the acceleration of growth and stress that a more front-loaded and substantial fiscal adjustment than envisaged in the programme is needed in order to reverse the unfavourable public debt dynamics, to further improve the policy mix and prepare Poland's public finances for accession. In this regard, Ministers consider that public expenditure reforms are key to consolidating public finances and increasing the flexibility of the budget. In particular, they consider that the bulk of adjustment efforts should come from a rationalisation of, and reductions in, social spending. Ministers call for stronger efforts to restructure the remaining state-controlled industries and to speed up the privatisation process, steps that will contribute to strengthening Poland's competitiveness. They also urge Poland to pursue vigorously reforms in the labour and product markets, as they are crucial to enhance the growth potential and accelerate the convergence process. They welcome the recent changes to the Labour Code but emphasise that, in light of Poland's high unemployment, further reforms are needed to improve the functioning of the labour market, in particular to reduce disincentives to work. Ministers note the measures in favour of the development of the private sector but stress that there is a need for additional action to improve the investment climate.

Finally, Ministers note that Poland has made some progress since last year towards developing the institutional and analytical capacity required to participate in EMU. However, they urge Poland to intensify its efforts to ensure that the forthcoming convergence programme will provide adequate information on budgetary developments measured according to the ESA 95 system of integrated economic accounts taking into account the new fiscal policy framework and measures announced after the submission of the 2003 PEP."

2. REVIEW OF RECENT ECONOMIC DEVELOPMENTS

After a sharp slowdown in 2001, Poland experienced a modest recovery in 2002. Real GDP grew by only 1.4% compared with 1% in 2001 and 5.1% on average in the period 1996-2000. Growth gained momentum over the course of the year 2002, with GDP growth accelerating from 0.5% year-on-year in the first quarter to 2.2% in the last quarter. Private consumption and net exports were the main motors of growth, while fixed investment contracted sharply (-6.8%) for the second consecutive year.

On the external side, export growth was robust last year despite weak growth in Poland's main trading partners. The competitiveness of Polish exports was in part strengthened by the 10% depreciation of the real effective value of the zloty. The strong export performance, together with the economic slowdown, resulted in a reduction of the current account deficit to 3.5% of GDP compared with a deficit of 7.5% in 1999. Inflation continued to decline sharply in 2002. The PEP attributes the fall in inflation to supply factors ("a drop in the average annual food prices by 0.6%") and domestic demand conditions. The situation on the labour market deteriorated, with the unemployment rate (ILO definition) almost reaching 20% at the end of the year.

The state budget deficit on a cash basis rose to 5.1% of GDP last year from 4.3% in 2001. The sharp deterioration of fiscal accounts is attributed to strong expenditure growth combined with the high share of fixed and quasi-fixed expenditures (66.7%). But the programme is silent on the reasons behind the high spending growth. Also, the programme does not comment on the data on the general government accounts based on ESA95 provided in its annex. The increased deficit, together with low privatisation proceeds, resulted in an increase of the debt ratio (national definition) to 47.4% of GDP against 41.5% in 2001.

Recent economic data point to a gradual economic recovery in 2003. The programme reviews short-term indicators signalling acceleration in activity and underpinning the forecast of 3% growth this year. Industrial production growth exceeded expectations in the first half of the year, while retail sales recorded a strong increase. The improvement of firms' profitability and the start of the recovery in the construction sector are encouraging signs for investment prospects.

Unfortunately, the PEP does not discuss the main differences between actual outcomes and the macroeconomic scenario presented in last year's programme. In addition, this section could have highlighted the evolution of the policy mix over the period under review, notably the substantial loosening of monetary policy, and examined its implications for growth.

3. MEDIUM-TERM MACROECONOMIC FRAMEWORK

The PEP provides data and projections for the key macroeconomic variables for the period 2002 – 2006. The projections for 2004 are in line with the main macroeconomic assumptions underlying the 2004 draft budget adopted by the Council of Ministers in June. Although not stated explicitly, it appears that the main objectives of economic policy over the programme's period are: to achieve 5% growth in 2004-2005, to decrease unemployment and to meet the Maastricht convergence criteria in 2007 so as to be able to join the euro zone in 2008 or 2009.

The forecast for 2003 is largely in line with the Commission forecast, while the projections for the subsequent years seem optimistic. The appropriateness of the growth scenario is difficult to assess because the programme does not show the relationships between planned fiscal and structural policy measures and the macroeconomic framework. Also, it does not discuss the expected effects of EU accession. Although figures on growth potential are provided, there is no discussion of the cyclical position of the Polish economy. Most importantly, the programme is silent on the issue of the policy mix, and particularly on the need for fiscal consolidation. Neither a risk analysis nor alternative scenarios are presented.

3.1. Real sector

The PEP projects an acceleration of growth over the forecast horizon from 1.4% in 2002 to 5.6% in 2006. In particular, GDP growth is expected to reach 5% in 2004, which is in line with the growth objective set by the Polish government in the 2003-2004 Pro-Growth Action Plan, that updates its medium-term economic strategy "Entrepreneurship-Development-Work " of January 2002. The programme expects domestic demand to be the main engine of growth over the forecast horizon, while the contribution of net exports to growth will turn negative from 2004 onwards.

The growth projections appear to be on the optimistic side. They crucially depend on an expected sharp rebound in the growth rate of investment from 2.2% in 2003 to around 12.0% in 2004-2006. However, a more moderate and gradual increase in investment is likely, notably because of the still difficult access of firms to finance. In this regard, the programme does not discuss the expected impact on investment of the 8% cut in corporate income tax to be introduced in 2004. Also, the programme is silent on the effect of the rising government deficit on the savings-investment balance.

Overall, the information provided by the PEP is insufficient to assess the appropriateness of the projected growth profile. The programme does not examine the impact on growth of Poland's accession to the EU and could have better integrated

Table 1: Economic development

		PEP framework			
	2002	2003	2004	2005	2006
GDP growth at constant market prices	1.4	3.0	5.0	5.0	5.6
Contribution to GDP growth:					
- Final domestic demand	0.9	2.6	5.1	5.4	6.1
- Change in inventories and net acquisition of valuables	0.0	0.0	0.0	0.0	0.0
- External balance of goods and services	0.5	0.4	-0.2	-0.4	-0.5
Investment ratio (% of GDP)	19.1	19.0	20.3	21.6	23.0
GDP per head (PPS, % of EU average) (1)	39.0	39.7	40.7	41.7	43.0
Participation rate (% of 15-64 age group)	76.4	76.1	76.1	76.1	76.1
Unemployment rate (ILO definition)	19.7	n/a	n/a	n/a	n/a
Employment growth	-3.0	-1.5	1.0	2.1	2.3
Labour productivity growth	4.5	4.6	4.0	2.8	3.2
Average real wage growth	2.4	2.2	1.5	1.8	2.2
CPI inflation (annual average)	1.9	0.8	2.2	2.8	2.9
Exchange rate vis-à-vis EUR (percentage change of annual average)	5.1	11.9	-1.6	-1.2	0.0
Current account balance (% of GDP)	-3.5	-3.0	-3.7	-4.2	-5.1
Net foreign direct investment (% of GDP)	2.0	2.1	2.3	2.7	3.5
Foreign debt (% of GDP)	39.5	n/a	n/a	n/a	n/a

Source: PEP, if not otherwise indicated
(1) calculated, without demographic or price effects; growth rates: candidate countries: PEPs / EU: 2003-04: Spring 2003 COM forecast; thereafter same as in 2004

envisaged fiscal and structural policy measures into the macroeconomic framework. In particular, more attention could have been given to the impact on growth of the loosening of fiscal stance planned in 2004.

The PEP gives in annex estimates of potential output, but regrettably, does not analyse the implications of the data for macroeconomic and fiscal developments. Potential output is estimated to decline slightly from 3.5% in 2002 to 3.2% in 2006. This deterioration of the potential growth rate is consistent with the fall in investment levels recorded in 2001 and 2002 and the forecast of a slow increase in the investment ratio over 2004-2006, as well as the persistence of high unemployment. It is also consistent with the absence of major reforms of labour and product markets over the programme's period. Thus, in the PEP's scenario, the large negative output gap will start to decrease in 2004 and turn into a sizeable positive one in 2006. The PEP does not develop the

reasons why the Polish economy would be able to grow above potential for three consecutive years.

The labour market situation is forecast to improve from 2004 onwards, in line with the return of Poland to a strong growth path. Like last year, the PEP provides forecasts for the registered unemployment rate rather than the unemployment rate according to the ILO definition. The programme reviews briefly the various factors influencing labour market developments, such as enterprise restructuring, privatisation, capital inflows, demographic factors and policy measures, but does not indicate the magnitude of their respective impact.

The scenario is based on the Commission's main external assumptions, except for the euro-dollar exchange rate. The PEP sees the zloty on a slight appreciating trend vis-à-vis the euro.

3.2. Inflation and wages

The PEP foresees a gradual increase in inflation from the very low level of 0.8% in 2003 to 2.2% and around 3% on average in 2004 and in 2005-2006, respectively. While inflation will likely undershoot the year-end inflation target for 2003, it will remain within the target range set by the Monetary Policy Council for the period beyond 2003 (see below). The programme indicates that the main factors driving inflation developments over the forecast period will be the recovery in domestic demand, low inflationary expectations and the continuing alignment of price levels in Poland to those observed in current Member States.

The inflation projections for the period 2004-2006 appear optimistic given the growth scenario, with GDP growth exceeding potential and falling unemployment. In addition, the PEP does not provide a breakdown of the contributions within the CPI basket showing the impact of oil and food prices, although these two factors continue to play a key role. Among other factors driving inflation, the programme could have mentioned the expected pass-through of the depreciation of the zloty onto prices and the harmonisation of indirect taxes with the EU, which will impact on inflation next year.

3.3. Monetary and exchange rate policy

In February 2003, the Monetary Policy Council adopted a new medium-term strategy of monetary policy for the period beyond 2003. While the previous strategy was geared towards the reduction of inflation, the new strategy identifies the stabilisation of inflation at a low level and Poland's preparation for euro area membership at the earliest date possible as the main tasks of monetary policy for the coming years. As from 2004, annual inflation targets will be replaced by a continuous, medium-term, inflation target of 2.5% with a permissible band of +/- 1 percentage point either side of the target. The PEP emphasises that this target is consistent with strong growth and should contribute to the fulfilment of the Maastricht inflation criterion, but without discussing this issue further. The programme makes no reference to the need to further improve the policy mix.

The main change to the monetary policy instruments implemented since last year's PEP is the shortening from 28 to 14 days of the duration of the NBP bills regularly issued every week. The PEP notes that further harmonisation of monetary policy instruments of the NBP with the European Central Bank standards is envisaged but will depend on market conditions, especially the banking sector liquidity.

The PEP states that the objective of the Polish authorities is to comply with the Maastricht criteria in 2007 in order to join the euro zone in 2008 or 2009. The programme does not set explicitly a target date for entry into ERM II but indicates that Poland envisages a participation of the zloty within the largest allowed fluctuation band (±15%) during the required period of two years. In this regard, it should be noted that merely respecting the 15% fluctuation band will not be sufficient to meet the Maastricht exchange rate criterion. No change to the existing monetary and exchange rate arrangements, i.e. a direct inflation targeting strategy combined with a floating exchange rate regime, is foreseen until joining ERM II. The PEP acknowledges that setting the central rate will be one of the main challenges for the Polish authorities. In this context, it may be recalled that decisions on the central rate are to be taken in line with the common procedure. Overall, the PEP remains vague on the authorities' strategy towards euro adoption.

3.4. External sector

The programme projects a widening of the current account deficit from 3.0% of GDP in 2003 to 5.1% of GDP in 2006. This sharp deterioration of external accounts is expected not to pose a threat to macroeconomic stability. The programme assumes that accession to the EU and the development of domestic financial markets will lead to an increase in inflows of foreign direct and portfolio investments. Thus the current account deficit will continue to be easily financed by non debt-creating capital flows. Foreign direct investment is expected to cover on average around two thirds of external financing needs over the programme's period.

The current account profile is consistent with the projected acceleration of growth. However, the sustainability of the external deficit hinges crucially on the assumption of a growing interest of foreign investors in the Polish market. In this regard, it should be noted that the programme does not provide information on the measures envisaged to further liberalise capital movements in accordance with the *acquis communautaire*. Also, the programme could have presented the forecast for foreign debt.

4. PUBLIC FINANCE ASSESSMENT

4.1. The medium term fiscal framework

The conditions of fiscal policy in the years 2003-2006 presented in the 2003 PEP have not changed since the previous year. The challenges remain the reduction of the deficit through the expenditure restructuring and revenue increases while ensuring the conditions for growth.

The Polish programme forecasts an **expansionary fiscal policy** for 2003 and 2004, with a peak level of the ESA 95 deficit reaching 5% of GDP in 2004 from 4.1% in 2003 and gradually falling to 3.4% by 2006[9]. The authorities provide in the annex tentative estimates of structural budgetary developments, which point to a total deficit correction in the cyclically-adjusted balance of 0.96 percentage points of GDP between 2004 and 2006. The major fiscal adjustement of 0.73 percentage points is expected for 2005. In

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[9] It has to be noted that the new 2004 draft budgetary law has brought some changes to the policy framework presented in the PEP. Strong concerns are to be expressed regarding the significant widening of the budget deficit in 2004 in parallel with the acceleration of growth.

2006, the adjustment effort in structural terms is lower than 0.5 percentage points of GDP.

The PEP does not contain any sensitivity analysis of the impact of changes to main economic assumptions (in particular interest rates and exchange rates) on the fiscal position. The path of fiscal consolidation lacks credibility, as it is not clear whether the fiscal adjustment will come mainly from an increase in revenues boosted by strong growth or by the suggested discretionary tax increases or from significant spending cuts.

The PEP still juggles with several categories of fiscal data relating to the state budget or the public finance sector (national definition) and the fiscal projections on an ESA 95 basis. These numbers include within the general government sector the open pension funds, even though this is a budgetary classification decision that remains under review.

The fiscal framework in the PEP foresees a steady decline of the **overall fiscal burden** in ESA 95 terms over the programme horizon from 43.1% of GDP in 2003 to 42.1% in 2006[10]. The programme contains projections for various broad categories of general government revenues, which are said to be based on the macroeconomic assumptions and on parametrical changes that have been adopted or announced.

The programme indicates that the **revenues to GDP ratio** will be increasing in 2004-2006 reversing the gradual decline over 1995-2002 and that this rise will be to a major extent attributable to the inflow of EU funds, contrary to what has been stated in the previous programme. The rise of this ratio announced in 2002 resulted mainly from government actions supporting growth of the public sector's revenues.

As far as the **personal income tax** (PIT) is concerned, the announced reform path consists of the abolishment of most tax reductions and exemptions, simplification of the tax levying rules and cuts in the overall tax level. The draft amendment of the PIT adopted by the Council of Ministers in June 2003 goes in that direction and provides for a broadening of the taxation base (by means of liquidation of selected subjective exemptions and tax concessions), for easing the tax burden (by an increase in the tax-free amount) and for changes in the regulations pertaining to capital gain taxes. The government intends to align the rate of various taxes on income from capital gains to 19% in 2004. The assumption from the previous PEP that these tax reforms will improve the competitiveness of Polish companies and contribute to FDI inflows remains valid.

The projections of revenues from the **corporate income tax** (CIT) in 2004-2006 take into account the scheduled tax reduction from 27% to 19% in 2004 and the phasing out of tax concessions, exemptions and grants. The authorities announced in the PEP the application of the CIT system to small economic activities and self-employed that have so far been subject to PIT.

Yet the assessment of the revenue projections is hampered by the fact that the breakdown of revenue sources is not based on ESA 95 figures but on national data. The PEP is unfortunately silent on the fiscal effects of the measures described. The

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[10] The previous PEP announced a contrary trend going from 42.8% of GDP in 2002 to 41.5% of GDP in 2004 and 42.2% in 2005.

document would have been more informative if the status of the measures described was provided, i.e. adopted by the government, discussed in the Tri-Partite Commission, submitted to the Parliamentary Committees and foreseen date of their entry into force. The document does not analyse the factors affecting cyclical developments of the budget. The fall of revenues in the period of high growth is a matter of concern, and raises questions about the effectiveness of the tax reforms.

The PEP is silent on the impact of the Revised Tax Code that entered into force on January 1, 2003 and that introduced inter alia, a number of changes with a view to increasing the tax collection, reducing the tax system permeability and the size of the "hidden economy".

The strategy on the **expenditure side** has abandoned the implementation of the expenditure norm (annual growth in expenditure at central government level by forecasted CPI inflation +1%). At the same time there is no reference anymore to a package of structural expenditure reform with a set of clear objectives. The PEP lists a series of measures/laws forwarded recently by the government to the Parliament on family benefits, on social insurance for farmers and on new indexation rules for retirement-disability payments to be implemented for the first time in 2004. The programme does not provide, however, estimates on the quantitative net impact of those measures on the budget. Some of them, although presented as leading to the reduction of expenditures, might induce additional expenses. This implies that the government's priority would be to restructure expenditures and change their composition before reducing them[11].

The PEP refers to **a reform of the local government finances.** The reform is planned to enter into force in January 2004 and consists of a gradual transfer of revenues from the PIT and CIT to local authorities and a simultaneous reduction of subsidies from the State budget. Unfortunately, the assessment of its impact on the general government finance is not possible due to lack of data provided. Although considered as one of the most important basis for the draft budget 2004, it has not been given sufficient attention in the PEP.

The PEP foresees that the highest level of public expenditure as percentage of GDP will be reached in 2004 due to additional **costs related to Poland's accession to EU** (contribution payments and pre- and co-financing of structural funds). The programme contains a table with projected financial flows between Poland and the European Union leading to the conclusion of Poland being a net recipient of funds to the Polish budget. The draft amendment of the Public Finance Act, which will enter into force on 1 January 2004, places financial flows with the EU in the public finance system. Reporting and audit procedures are specified.

The document could have contained a quantitative assessment of the direct and immediate budgetary implications of the EU accession. It would have benefited from a sensitivity analysis of different budgetary positions depending on Poland's absorption capacity of EU structural funds. The PEP does not discuss the effects of accession on the various levels of the general government sector.

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[11] After the submission of the 2003 PEP, the Polish government presented a comprehensive public finance reform package (the so-called Hausner's plan) that foresees a gradual fiscal consolidation over 2005-2007. The measures announced have been sent to social partners for negotiations.

4.2. Deficit financing

The PEP contains a very short, qualitative description of the current structure of and approach to the financing of government deficit. In contrast to the previous PEP, it is noted that although the financing of the deficit is covered mostly through the domestic market, the importance of foreign financing is increasing. In addition, the coverage of borrowing requirements by privatisation receipts is expected to decline. It is anticipated that a similar trend will be observed in the years 2004-2005, but no quantitative information is provided.

4.3. Public debt management

The document contains a description of the goals included in the Strategy for the public finance sector debt management in the years 2003-2005, which are:

- maintaining the public debt at the safe level; and
- minimising of debt servicing cost in the long-term perspective.

It is clearly stated that the condition for implementation of the first goal is the effective reform of public finances, mainly the expenditure side. Public sector debt is mainly a consequence of the high state deficit, which has an impact not only on the current year but also, due to debt servicing and refinancing, on the future debt level. The basic strategy for the years 2004-2006 will keep the goals for debt management unchanged. The programme rightly highlights that now, as the accession of Poland to the European Union has been decided, the major risk factors will be related to challenges arising from public finance reforms.

The **general government debt** (ESA 95) is expected to increase from 41.8% of GDP in 2002 to 49.1% of GDP in 2006. According to the national definition, the level of the state public debt will reach 50.8% of GDP in 2003 and exceed 55% in 2005.

The PEP does not discuss the eventual prudence procedures embedded in the Public Finance Act, which constrains the Council of Ministers in drafting the budget when the 50% and 55% debt ratio levels are reached. The risk of breaching the 55% threshold already in 2004 increases in case the zloty depreciates further.

It would have been useful if in addition to the quantification of the impact of the interest rates changes on the debt, a projection of implications of exchange rates movements was included. The document does not provide any analysis of the holders' structure, maturity composition and currency denomination. The PEP does not discuss the debt-related issues at the local government level, especially in the context of pre- and co-financing EU structural funds.

4.4. Fiscal risks

The PEP identifies in a comprehensive way and in some cases quantifies over the programming period a number of fiscal risks relating to debt, expenditure commitments and contingent liabilities as well as the revenue side. The document does not analyse the long term sustainability and efficiency of public finances.

The risks identified have not changed since the previous PEP. The foreign exchange rate risk remains notwithstanding the significant achievements to date in terms of

reducing the foreign currency component of public debt (from 49% in 1999 to 33.1% in 2002).

As last year, the programme lists as sources of **risk on the spending side** (1) the implementation of restructuring programmes, notably railways and the rejection by the parliament of the law on local governments public finance and (2) the potential liabilities associated with the "re-privatisation" issue (the potential value of the claims has been revised upward from PLN 34bn, or close to 5% GDP to PLN 46.1bn or 6% of GDP). The PEP updates the 2002 PEP forecast for potential calls on guarantees (only those extended by the State Treasury) based on an increase of the historical ratio of calls on guarantees (from 6.9% in 2001 to 8.5% in 2002). The programme also provides some elements to assess the impact of population ageing on public finances.

On the **revenue side**, the PEP contains recognition of threats connected to the effectiveness of the tax collection. Unfortunately, contrary to last year, the programme does not contain any forecast ofs the level of tax arrears.

5. STRUCTURAL REFORMS

The document, as in the previous year, contains a complete sector-by-sector description of ongoing reform efforts. It foreshadows to a substantial degree the Cardiff report, which Poland – like all other acceding countries – has been invited to provide in October this year.

The overall structural reform package is based on and complements *the 2003-2004 Pro-Growth Action Plan,* and its main components. Reference is also made to sector specific strategies that are being continued since the last year. The PEP, in the matrix of policy commitments, contains estimates of the costs of the main programmes of reforms, at least in terms of their fiscal costs. Unfortunately, the linkage between the structural reform part of the document and the macroeconomic and fiscal frameworks, on the other hand, remains minimal. The document would have also benefited from an overview of the progress achieved so far and some indication of whether the commitments set previously have been achieved or specific reasons for delay.

5.1. Enterprise sector

The recognition of barriers restraining business was made in the document *Entrepreneurship in Poland* adopted by the government in June 2003. This has been reflected in the PEP that commits the Polish authorities to improve enterprises' legal environment, to elaborate a new law on economic freedom aiming at reducing procedural barriers for business activities and to stimulate financial support to SME. An increase in SME participation in the public procurements is foreseen through a new law aiming mainly at simplifying the procedures. Access for investment capital builds primarily upon the promotion of public-private partnerships, planned activation of partnership for EU funds absorption (also through operational programmes aiming at improving competitiveness of enterprises) and an amendment to the law on financial support for investments. Finally, the document details the main principles of the Insolvency Law adopted by the Parliament in February 2003.

The programme refers to solutions to contain structural unemployment through public procurements. It excludes, however, from this regulatory framework research and development units, which might go against the EU policy on public procurement.

Alongside business stimulation, the Polish programme outlines on-going progress in the privatisation, restructuring and consolidation of industry. New strategy documents have been adopted on the restructuring of sensitive heavy industries: in the coal mining, iron and steel metallurgy over the years 2003-2006. A Strategy for electronic industry until 2010 was also adopted. The target for privatisation has not changed since the last year and is for a reduction of state ownership in the economy to around 10-15% of GDP, though the end date of the main privatisation programmes has been extended from 2005 to 2006. The programme specifies sectors, in which the privatisation has only been initiated and its continuation strictly depends on restructuring process: mining, gas industry, heavy chemicals and defence industry. The PEP stands by initial 2003 projections for privatisation receipts of PLN 9.1bn (even though this target appears now overly optimistic). The PEP states that postal services would remain within the domain of public property, which seems to be incompatible with the introduction of competition into postal services in the current member states.

Table 2: Fiscal development
(general government, % of GDP)

		PEP framework			
	2002	2003	2004	2005	2006
Receipts	42.1	43.1	42.9	42.2	42.1
Expenditures	45.9	47.2	47.9	46.2	45.5
Net lending	-3.8	-4.1	-5.0	-4.0	-3.4
- Cyclically adj.	-3.4	-3.6	-4.7	-4.0	-3.8
Primary balance	-1.0	-1.1	-2.3	-1.5	-0.8
Gross debt level	41.8	44.3	46.9	49.2	49.1

Source: PEP, if not otherwise indicated

The section on **regional policy** and on the closing preparations for effective use of EU structural funds summarises the main points of the National Development Plan 2004-2006 that has been agreed with the European Commission and that will be implemented through the Community Support Framework. The preparation for use of financial resources from structural and Cohesion funds has been identified as priority task of the Ministry of Economy, Labour and Social Policy. An establishment of the Fund for Communal Investment Development (Fundusz Rozwoju Inwestycji Komunalnych) located in the state-owned Bank Gospodarstwa Krajowego is foreseen to facilitate pre-financing of costs incurred by local governments in relation to the application for and use of structural funds. The document would have benefited from more details on this Fund as well as from a discussion of the absorption capacities at various level of the public sector.

5.2. Financial sector

As in the previous year, the PEP acknowledges a number of structural weaknesses and challenges in the financial sector, in particular banking. These include a further increase in bad loans and lower profits. Significant improvements in the quality of risk management in the Polish banks are expected following the introduction of the New Capital Agreement. However, important organisational and financial effort by the banks are still required. The PEP makes an update on the process of adjustment of the Polish

legislation to the acquis in the area of the payment system, on the situation of economic agents on the capital market, insurance and pension funds sector.

5.3. Labour market

The Polish PEP strongly emphasises the need for reform in the functioning of labour markets and updates information provided in the previous PEP. The National Strategy for Employment and Human Resources Development 2000-2006 orientates reforms in the labour market in three directions: increase in labour market flexibility, improvement in the institutional support for the labour market and preparation for the implementation of the European Social Fund. The PEP makes a clear link between the Strategy and the realisation of tasks specified in the National Development Plan. Next steps announced should lead to Poland's full participation in the European Employment Strategy.

The target of stimulating employment has also been described under the "Enterprise sector" heading, but in relation to the objective of **poverty reduction**. The national employment strategy for 2000-2006 recognises the importance of actions in the area of income generation, and improving the effectiveness of the assistance to vulnerable social groups (in the framework of the Joint Inclusion Memorandum to be signed between the EC and the government at the end of 2003).

5.4. Administrative reforms

The PEP updates recent developments in reforming **public administration** especially in the area of new anticorruption measures (Anticorruption Strategy adopted by the government in September 2002) and the qualitative reinforcement of public administration. The document provides information on activities related to the Civil Service and to strengthening its capacity.

5.5. Agriculture

Like in the previous year, the section in the PEP on **agriculture** is mostly focused on the legal and technical preparation of Polish administrative structures to EU membership and implementation of the CAP. The document contains in particular a short update of the state of play of the development of the integrated and administration control system (IACS). The programme outlines elements of the current strategy for rural development, making a distinction between measures implemented through domestic means (assistance from the Agency of Restructuring and Modernisation of Agriculture) and measures to kick-in under the SAPARD programme.

5.6. Additional reform areas

The 2003 PEP is forward looking with regards to **infrastructure** (quantified targets are provided for the use of ISPA funds) and for housing. The section on the restructuring of railways PKP distinguishes between measures to be financed through domestic sources (primarily guarantees from the State) and the medium term contribution from ISPA and the cohesion funds. No update is provided this year on the debt owed to the open pension funds (OFE). The documents also discussed the state of play of reforms in the areas of telecommunication, regional policy, environment, and education. The document does not discuss the costs of new reforms in the health sector, i.e. of the

winding up of the kasy chorych and the establishment of the National Health Fund. For unknown reasons, the section on information society has been removed from the PEP.

SLOVAK REPUBLIC

PRE-ACCESSION ECONOMIC PROGRAMME 2003

ASSESSMENT

1. OVERALL SUMMARY AND ASSESSMENT

The third Pre-Accession Economic Programme (PEP) provides a medium-term policy framework, covering the period 2003-2006. It includes public finance objectives and structural reform priorities needed for EU accession and prepares further the institutional and analytical capacity necessary to participate in EMU. The PEP has again been prepared under the aegis of the Slovak Ministry of Finance, co-ordinated with other ministries and government agencies as well as social partners, and then formally adopted by government.

The PEP describes recent economic developments and outlines a medium-term macroeconomic scenario. Slovakia's real GDP growth amounted to 4.4% in 2002 and, after a moderate growth slowdown to 4% in 2003, is foreseen to further accelerate to 4.8% by 2006. The unemployment rate has been falling from 18.5% in 2002 but remained high at 17.7% in the first half of 2003. A further slow reduction to around 16% is predicted over the PEP horizon. Core inflation remains low, although headline inflation has surged back to over 8% in 2003, reflecting increases in administered prices and indirect taxes. A rapid disinflation is projected for 2005 and 2006 when the major administered price adjustments will have been completed. The current account deficit has been narrowing substantially from more than 8% of GDP in 2002 to below 5% of GDP in the first half of 2003. A level of 3.3% of GDP is projected by 2006. The PEP states the year 2006 as the earliest possible date for the fulfilment of the Maastricht criteria and envisages Slovakia's adoption of the euro for the period 2008-2009, after a stay of two years in the ERM II and an unchanged managed float regime before ERM II entry.

The medium-term budgetary framework targets a reduction of the general government deficit from 7.2% of GDP in the election year 2002 to 2.9% of GDP in 2006 – with roughly half of the adjustment being implemented in 2003, for which the deficit target is 5% of GDP. Based on tentative estimates by the authorities, the structural deficit would remain at 3.7% of GDP by 2006. The reported general government gross debt level amounted to 44.3% of GDP at the end of 2002 and the PEP projects an increase to 48.5% of GDP in 2006.

The PEP also presents a broad overview of on-going and envisaged structural reforms, and foreshadows to a substantial degree the Cardiff report, which Slovakia – like all other candidate countries – has been invited to provide in October this year. The PEP stresses the new government's commitment to speed up necessary reforms.

Slovakia's macroeconomic performance has been improving considerably since last year's PEP-submission, although some imbalances remain significant. The medium-term macroeconomic scenario presented in the PEP is broadly realistic. However, containment of second-round effects from the on-going administrative price and tax hikes is crucial to attain the envisaged rapid disinflation. Furthermore, although the

current account deficit is likely to narrow further, the projected level for 2006 seems to be somewhat too optimistic, given the predicted import-intensive investment growth.

The envisaged fiscal consolidation scenario is subject to downside risks as it depends on several elements. First, the foreseen reduction of the general government deficit strongly relies on Slovakia's prospectively robust growth performance. Second, the planned composition of the adjustment in the following years – expected to lead to a deficit of 2.9% of GDP in 2006 – raises uncertainties and poses significant challenges. On the one hand, the government foresees a significant reduction in the (tax) revenue-to-GDP ratio over the PEP horizon and has already decided on the introduction of far-reaching tax reforms in 2004, which make any revenue estimate highly uncertain. On the other hand, it remains unclear how the correspondingly necessary reduction in the expenditure-to-GDP ratio will be achieved as many reforms on the expenditure side are not yet spelt out in sufficient detail on substance and sequencing. To contain these risks, the swift implementation of structural public expenditure reforms is crucial, in particular in the health and social protection areas, public employment and with respect to subsidies. Also, based on the authorities' own very tentative calculations, the structural deficit will, at 3.7% of GDP, still be high even in 2006, thus rendering Slovakia's general government deficit vulnerable to any cyclical downturn.

In comparison to previous editions, the coherence of the macroeconomic and public finance sections of the document has improved and the public finance discussion is now couched in ESA95-terms. Nevertheless, the budget data are likely to be subject to adjustments as the Slovak authorities continue to improve the application of the ESA95 economic accounting principles with respect to tax accruals and the introduction of the second pillar of the pension reform. Furthermore, the methodology for budgeting and medium-term fiscal planning needs to be further improved.

2. JOINT OPINION

"On 4 November 2003 the ECOFIN MINISTERS OF THE PRESENT MEMBER STATES AND THE ACCEDING COUNTRIES examined the 2003 Pre-Accession Economic Programme of Slovakia on the basis of an assessment prepared by the Commission Services with a contribution from the ECB. In accordance with the Conclusions of the High-Level Meeting with the Candidate Countries in Athens (EFC/ECFIN/227/03) Ministers adopted this joint opinion.

The third Pre-Accession Economic Programme (PEP) provides a medium-term policy framework, covering the period 2003-2006. It includes public finance objectives and structural reform priorities needed for EU accession and prepares further the institutional and analytical capacity necessary to participate in EMU. The PEP has again been prepared under the aegis of the Slovak Ministry of Finance, co-ordinated with other ministries and government agencies as well as social partners, and then formally adopted by government.

…

<u>Opinion</u>

[…],Ministers take note of the medium-term macroeconomic scenario presented in the PEP. However, Ministers point out that in particular the planned

reductions in the current account deficit and the inflation rate will be facilitated by a strict adherence to fiscal consolidation and by the implementation of further structural reforms.

Taking into account the substantial fiscal slippage in the election year 2002, Ministers welcome the new Slovak government's fiscal consolidation intentions but note that there are risks to the consolidation scenario outlined in the PEP, which are in particular due to the sequencing of tax reforms, on the one hand, and expenditure reforms, on the other hand. They urge the Slovak government to continue with public expenditure reforms so as to curtail public expenditures to a degree which is compatible with the envisaged reduction of the deficit and of the revenue-to-GDP ratio implied by the already passed tax reforms. Further and well specified reforms are in particular necessary in the health and social protection areas and with respect to public employment and subsidies. The binding character of this framework in the budgetary process should be strengthened and it should incorporate contingency measures for the case of materialising budgetary risks. The authorities are urged to swiftly continue the elaboration of their medium-term fiscal framework and the solution of still outstanding methodological and presentational issues so as to be properly prepared for the submission of their first Convergence Programme.

Ministers commend the Slovak authorities for the progress made on structural reforms over the recent year. They advise the government to continue in its efforts to tackle the deep-seated structural unemployment problem and to further improve the performance labour market. In particular, reforms of the health and social protection system, including a continued thorough review of social assistance benefits, should help to strengthen incentives for job creation and job acceptance. Furthermore, the authorities need to maintain close financial sector supervision to safeguard the expanding financial sector against stability risks. Finally, the improvement of the legal framework will contribute to a sound business environment."

3. REVIEW OF RECENT ECONOMIC DEVELOPMENTS

Slovakia's real GDP growth has accelerated steadily from 1.3% in 1999, when unsustainable external and fiscal imbalances prompted austerity measures, to 4.4% in 2002. In the first half of 2003, it amounted to 3.9%. While growth was driven by net exports in 1999 and 2000, domestic demand became the dominant contributor in 2001 and 2002. In 2003, the growth composition seems to turn around again: In the first six months, the expansion of private and public consumption was dampened by restrictive fiscal policy and administered price adjustment measures to 1.2% and a negative 1.1%, respectively. Fixed investment also contracted by 1.1%. On the other hand, exports picked up sharply and grew by almost 23%, thus outpacing import growth of 15.8%.

Unemployment fell to an average 17.7% (ILO-definition) in the first half of 2003 from 19% in the same period of last year. The still high unemployment is the consequence of accelerated enterprise restructuring and of major structural shortcomings in the labour market.

Consumer price headline inflation has re-surged in 2003 to levels above 8% as a result of resumed administered price adjustments and of indirect tax increases. Core inflation,

which excludes these influences, hovers around 3%. In the election year 2002, headline inflation had reached a record low of 3.3%, consequential to a virtual halt of administered price hikes.

The current account deficit has rapidly narrowed from its 2002 level of 8.2% of GDP to slightly below 5% of GDP in June 2003 (on a 12-month moving average basis). As indicated, this has resulted mainly from improvements in the trade balance.

Table 1: Economic development

		PEP framework			
	2002	2003	2004	2005	2006
GDP growth at constant market prices	4.4	4.0	4.1	4.4	4.8
Contribution to GDP growth:					
- Final domestic demand	3.3	0.9	3.0	3.7	4.3
- Change in inventories and net acquisition of valuables	0.8	-0.5	1.0	0.2	-0.3
- External balance of goods and services	0.3	3.7	0.1	0.4	0.8
Investment ratio (% of GDP)	28.8	28.5	29.0	29.6	30.0
GDP per head (PPS, % of EU average) (1)	47.0	47.8	48.5	49.3	50.3
Participation rate (% of 15-64 age group)	70.0	70.3	70.3	70.3	70.3
Unemployment rate (ILO definition)	18.5	17.5	17.0	16.5	16.1
Employment growth	0.1	0.6	0.7	0.9	1.0
Labour productivity growth	4.3	3.4	3.3	3.4	3.8
Average real wage growth	5.8	-1.9	-0.6	2.0	3.0
CPI inflation (annual average)	3.3	8.6	8.1	4.3	3.0
Exchange rate vis-à-vis EUR (percentage change of annual average)	-1.4	-2.8	0.0	0.0	0.0
Current account balance (% of GDP)	-8.2	-4.6	-4.6	-4.2	-3.3
Net foreign direct investment (% of GDP)	16.7	3.7	3.3	2.9	2.0
Foreign debt (% of GDP)	50.4	45.1	39.6	35.4	33.1

Source: PEP, if not otherwise indicated
(1) calculated, without demographic or price effects; growth rates: candidate countries: PEPs / EU: 2003-04: Spring 2003 COM forecast; thereafter same as in 2004

The NBS, which targets inflation benchmarks and combines this with a managed float, has been steering a broadly adequate course between containing capital inflows and appreciation pressures, on the one hand, and reining in inflation and excessive fiscal stimulus, on the other hand. To fend off a post-election surge of capital inflows and of the Slovak crown, the NBS lowered its key policy interest rate by 1½ percentage points in November 2002 to 6.5%. With effect from 26 September 2003, the key policy interest rate was lowered further to 6.25%. In addition, the NBS intervened repeatedly in the market. Nevertheless, the Slovak crown appreciated from levels around 44 SKK per euro before the elections in September 2002 to a range of mostly between 41 and 42 SKK afterwards.

After a pro-cyclical expansionary fiscal policy in the last two years – with a 2002 general government deficit of 7.2% of GDP – the new Slovak government has returned to fiscal restraint. For 2003, the authorities target a deficit of 5% of GDP. The government has reacted to the risk of a considerable fiscal slippage by advancing increases in various excise taxes from the beginning of next year to 1 August 2003. In

addition, the authorities seem to be prepared to take further measures if necessary. The more restrictive fiscal policy stance contributes to a more balanced policy mix, allowed the NBS to lower interest rates, and supports a narrowing of the current account deficit.

The PEP presents the recent economic developments correctly and explains the major divergences between 2002 outcomes and PEP 2002 projections. This concerns mainly the substantial fiscal slippage in 2002, which was driven by the political cycle coupled with the availability of ample privatisation revenues.

4. MEDIUM-TERM MACROECONOMIC FRAMEWORK

The medium-term macroeconomic framework in the PEP 2003 is moderately optimistic and broadly realistic. However, it critically hinges on a forceful and comprehensive implementation of the macroeconomic and structural economic policy stance envisaged in the programme, in particular on strict compliance with the general government deficit targets for 2003 and the following years and the swift implementation of the associated structural public expenditure reforms.

This is acknowledged in the PEP, which discusses the macroeconomic policy mix and emphasizes the importance of structural reforms. Against the backdrop of Slovakia's accelerating growth, the programme notes that continued fiscal consolidation is a pre-condition for broadening the scope for any further monetary easing and for ensuring a sustainable current account deficit.

The PEP rightly mentions downside risks to the outlined scenario: prolonged weakness in major export markets, currency appreciation, slippages in reform implementation, and underperforming FDI inflows. Sensitivity analyses are provided for the former two risks as well as for a positive labour productivity shock. The authorities are encouraged to expand their work on sensitivity analyses so as to fully cover the range of potential macroeconomic and financial vulnerabilities, e.g. related to current account developments, the composition of foreign capital inflows, foreign debt dynamics and credit growth.

4.1. Real sector

The PEP expects 4.0% real GDP growth in 2003 and a steady acceleration to 4.8% in 2006. It thus features somewhat more conservative projections than last year's submission and explains this mainly with a substantially more moderate growth of private and public consumption.[12]

The PEP assumes that, in a strong turn-around from this year's growth composition, domestic demand will become the main driving force behind growth starting in 2004 again – with the growth contribution of net exports dropping close to zero in 2004 and only slowly recovering afterwards. Unemployment is predicted to fall only slowly to 16% in 2006.

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[12] The PEP reports on calculations of potential growth in the range of 3.5% to 4.0% – with structural reform induced TFP-growth, supported by FDI-inflows, being the main explanatory variable. This would imply an increasingly reversed output gap towards the end of the programme horizon.

Whereas the aggregate growth profile is broadly realistic, the shift in the growth composition between 2003 and 2004 would appear slightly too accentuated. Continued fiscal consolidation, higher excise taxes and administered prices, and falling real wages are likely to keep a lid on the expansion of public and private consumption in 2004 as well. Furthermore, investment might already pick up again in the second half of 2003, entailing a less accentuated investment increase in 2004 than assumed in the PEP. And, finally, export growth might well stay strong and keep the external growth contribution significant.

4.2. Inflation and wages

After CPI headline inflation levels of over 8 % in 2003 and 2004, the PEP assumes a rapid disinflation to 3% in 2006, Slovakia's target year for the fulfilment of the Maastricht criteria. Core inflation is expected to peak in 2004 at around 3½ % and to be reduced to below 2½ % by 2006. After exceptionally high real wage hikes in 2002, further increases are not expected before 2005 and are assumed to remain below productivity growth.

The PEP may be somewhat too sanguine on disinflation prospects. These are in particular subject to the risk of second-round effects from the on-going administrative price and tax hikes. In any case, the realisation of the envisaged rapid disinflation path will require a very skilful mix of macroeconomic and structural policies, ensuring especially the implementation of the planned fiscal consolidation and, indeed, sufficient wage moderation.[13]

4.3. Monetary and exchange rate policy

The NBS intends to further pursue its monetary policy strategy, which consists of annual inflation benchmarking combined with a managed float against the euro. Concerning the latter, the goal is to dampen excessive, capital flow induced, exchange rate oscillations, while not leaning against fundamentally justified exchange rate trends. The PEP stresses the importance of fiscal consolidation for broadening the scope for any monetary policy easing.

The PEP states that "the year 2006 can be the earliest possible date for the fulfilment of the Maastricht criteria and that the euro can probably be adopted in 2008-2009", while pointing out that the euro adoption strategy is still under discussion and refinement. In addition, "the Slovak Republic does not intend to prolong the minimum two-year participation period in the ERM2 regime."

4.4. External Sector

The PEP projects a reduction of the current account deficit from 8.2% of GDP in 2002 to 3.3% of GDP by 2006. This seems to be somewhat too optimistic and not entirely consistent with the predicted, import-intensive, investment growth, although further improvements in the trade and current account balances are likely as Slovakia expands its export capacity. In any case, a continued narrowing of the current account deficit will crucially depend on three main factors: first, the implementation of the fiscal

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[13] This is in particular true against the backdrop of the assumed increasingly reversed output gap (see previous footnote).

consolidation plans; second, wage moderation; and third, structural reforms fostering the competitiveness of domestic enterprises and diminishing the import-intensity of production and consumption. Risks may also arise from the prospective high export concentration in one sector.

For the first time, the Slovak PEP projects developments in the composition of capital inflows. In particular, it foresees a reduction of the FDI-coverage of the current account deficit from around 80% in 2003 to around 60% in 2006, with privatisation-related FDI assumed at zero. Furthermore, external debt is projected to decrease over the forecast horizon from its reported 2002 level of roughly 50 % of GDP to around 33% of GDP by 2006. At present, one third of external debt is reported to be short-term and one quarter to be foreign-currency denominated. There is no further discussion on the maturity and currency composition of external debt and no related vulnerability analysis, for instance with respect to exchange rate shocks. Other potential external vulnerability issues are also not discussed. Evidently, the realisation of the assumed benign scenario of stable capital flows is again contingent on strict macroeconomic and structural policy discipline successfully maintaining investor confidence.

5. PUBLIC FINANCE

5.1. The medium-term fiscal framework

The medium-term fiscal framework is based on the macroeconomic scenario assessed in section 3. Key figures of the framework are reproduced in table 2. Improving on last year's presentation, figures and discussion in the text have now been based on ESA95-concepts.[14]

The framework envisages a reduction of the **general government deficit** from 7.2% of GDP in 2002 to 2.9% of GDP in 2006, with approximately half of the reduction being implemented in 2003, for which the deficit target is 5.0% of GDP. Concerning 2003, the authorities have already reacted to budget execution risks, which stem predominantly from lower than planned tax revenues, by advancing excise tax increases from the beginning of next year to August 2003. They seem to be prepared to take further measures and are urged to do so, if these should become necessary to achieve the deficit target.[15]

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[14] The PEP also contains an exposition on the budgetary relations of Slovakia to the European Union, calculating a positive net balance of financial flows to Slovakia of around 1.3% of GDP per annum in the period 2004 to 2006. However, the way in which the public finance impact of EU-accession is presented tends to convey a spurious impression on the extent to which "EU-related" expenditures (and their deficit-increasing effects) are pre-determined or automatic. In reality, the expenditures listed depend very much on domestic policy decisions (for example on the level of agricultural "top-up payments") and on the degree to which the provision of co-financing is compensated by reducing other expenditures. In addition, some of the figures presented need further clarification.

[15] Expenditures in the election year 2002 were driven by the political cycle and the availability of extraordinarily high privatisation revenues (around 15% of GDP), of which, according to Slovakia's spring notification, 2.4% of GDP were used for current expenditure (including for called-on state guarantees).

Assuming that the general government deficit target for 2003 will be broadly reached, the remaining headline deficit reduction amounts to roughly 2% of GDP until 2006, i.e. to 0.7% of GDP per annum. The adjustment path is front-loaded and foresees a further narrowing of the deficit by 1.1% of GDP in 2004. *Prima facie*, the adjustment path appears to be quite feasible, in particular as it is strongly supported by Slovakia's prospectively robust growth performance. However, the planned composition of the adjustment poses significant challenges and subjects it to considerable risks: On the one hand, the government foresees a significant reduction in the (tax) revenue-to-GDP ratio and has already decided on the introduction of far-reaching tax reforms in 2004. On the other hand, many of the correspondingly higher necessary expenditure reductions still need to be specified and implemented. In addition, the planned introduction of a mandatory funded pension pillar, which is now discussed for the beginning of 2005, is not yet included in the medium-term fiscal scenario. According to the authorities' projections, it is estimated to lead to an additional total adjustment need of roughly 1% of GDP if the deficit target for 2006 is to be maintained.

Table 2: Fiscal development
(general government, % of GDP)

		PEP framework			
	2002	2003	2004	2005	2006
Receipts	41.8	39.7	38.9	38.6	38.3
Expenditures	49.0	44.7	42.8	42.0	41.2
Net lending	-7.2	-5.0	-3.9	-3.4	-2.9
- Cyclically adj.	-7.2	-5.1	-4.1	-4.2	-3.7
Primary balance	-3.5	-2.1	-1.4	-1.1	-0.6
Gross debt level[1]	44.3	45.0	45.7	47.4	48.5

1 These figures are not sufficiently explained in the PEP (see section 4.2)
Source: PEP, if not otherwise indicated

Furthermore, with regard to the cyclically adjusted deficit, the authorities' tentative estimates[16] suggest a cumulative improvement of 1.4 percentage points in the period 2003 to 2006, i.e. by roughly ½ percentage point per year. Nevertheless, based on these estimates, Slovakia would still have a structural deficit of 3.7% of GDP by 2006, thus rendering Slovakia's general government deficit vulnerable to any cyclical downturn.[17]

As regards the total **revenue**-to-GDP ratio, the authorities envisage a reduction by around 1½ percentage points between 2003 and 2006. Both tax revenues and social security contributions are supposed to decrease by 1% of GDP, respectively, and non-tax revenues are planned to increase by ½ % of GDP.

The PEP describes the government's far-reaching tax reforms which will come into effect at the beginning of 2004. The reforms embrace a major shift from direct to indirect taxation and contain the following main elements: Introduction of a flat rate for the individual and the corporate income tax of 19% and abolition of tax exemptions;

[16] These estimates are presented in table 8 of the PEP.

[17] In table 8 of the PEP, the authorities also provide tentative estimates for the cyclically-adjusted primary deficit, which is envisaged to narrow by 2.1% of GDP between 2002 and 2006 and by 0.9% of GDP between 2003 and 2006, i.e. by 0.3 percentage points per annum.

introduction of a single VAT tax rate of 19%; and increase of various excise taxes, which has partly been advanced to 1 August 2003 (as mentioned above). The PEP also reports on reductions in social security contributions which are coupled with changes in the assessment bases and are planned to take effect at the beginning of 2004 as well. The budgetary impact of these important revenue measures should have been explained in a more systematic and detailed way.[18]

The tax reforms are commendable and should be growth enhancing as they increase the transparency of the tax system and foster the incentives for investment, job creation and job acceptance. However, although estimates indicate that these reforms could overall be broadly revenue-neutral, the far-reaching nature of the changes makes any revenue forecast highly uncertain, thus posing a high risk for budget execution.

Deficit and revenue reduction plans lead to a required decrease of the **expenditure-**to-GDP ratio from 44.7% of GDP in 2003 to 41.2% of GDP in 2006, i.e. by a total of 3.5 percentage points. Thereof, lower interest outlays are assumed to account for around ½ percentage point.[19] Consequently, the projected overall adjustment in primary expenditures amounts to roughly 3% of GDP in total or to an average 1% of GDP per year.

To achieve this goal, it is of vital importance that the government swiftly continues its structural expenditure reforms and accelerates the specification of the still missing details of its comprehensive reform agenda. Further reforms are in particular necessary in the health and social protection areas, including in the pay-as-you-go pillar of the pension system (e.g. further increases of the retirement age), and with respect to public employment and subsidies, especially to railways and agriculture. The specific measures need to be well sequenced and embedded into the multi-annual fiscal framework, thereby enhancing its credibility. The fiscal framework should serve as a commitment device in the budgeting process and its binding character should be substantially further strengthened. The framework should add contingency plans in case budgetary risks, in particular the risks on the tax revenue side indicated above, should materialise. Additional structural expenditure cuts should be prepared for this case so as not to endanger the 2006 deficit objective.

In an improvement on last year's edition, the PEP already makes a first step towards further necessary specifications by splitting the total expenditure reduction over the planning horizon over a comprehensive range of spending categories. Major contributions are indeed foreseen to come from reductions in health and social expenditures. However, a truly systematically quantified, sufficiently detailed, and well sequenced year-to-year exposition of underlying reform measures is missing and the links to the structural reforms described in part 4 of the PEP are rather sporadic. In addition, the PEP does not furnish any sensitivity analyses with respect to revenue, expenditure and reform implementation risks.

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[18] Also, on the revenue side, the split of the year-to-year profile of the non-tax revenue-to-GDP ratio into its different components could have been better explained. In particular in 2004, there remains a sizeable share of "other" non-tax revenues of 1.1% of GDP, which is not sufficiently specified in the PEP.

[19] The PEP assumes a drop in the implicit interest rate on government debt from 8.0% in 2002 to 5.3% in 2006, which is broadly in line with the underlying convergence scenario.

5.2. Debt management

In 2002, Slovakia's general government gross debt ratio fell by 5.5 percentage points to 44.3% of GDP, as a major part of that year's high privatisation revenues was used for debt retirement. The ratio is assumed to rise back to 48.5 % of GDP over the PEP horizon. This projection is not sufficiently explained in the PEP.[20] Furthermore, the projection is conservative in so far as it assumes that there will be no further revenues from sales of the still major stakes the government holds in some already privatised enterprises, e.g. in the Slovak gas company. The envisaged fiscal consolidation and the use of these potentially still forthcoming revenues for debt reduction should help keeping debt levels in check.

The PEP reports that almost all of the general government debt is owed by central government and that debt limitations for regional and local government levels are planned to be tightened further. Further detailed information on the structure of the public debt stock, for instance on its maturity and currency composition, is not given. Also, sensitivity tests, e.g. to foreign exchange and interest rate shocks, are not provided, although it is mentioned that the increasing reliance on debt issues in domestic currency will diminish the significance of any exchange rate risk.

The PEP mentions that a "Debt and Liquidity Management Agency" has been set up and is getting operational.

5.3. Deficit financing

The PEP indicates that deficit financing will mostly take place on the domestic market and that any foreign debt issues will primarily be euro-denominated. Further details are not specified.

5.4. Fiscal risks

In a step to further augmenting fiscal transparency, the Slovak authorities have been reassessing the stock of government guarantees. The PEP reports that around 57% of the currently extended guarantees in the amount of 99.7 billion SKK (principal) are estimated to be called on in future.[21] Together with the accrued interest, this amounts to a liability of roughly 7% of Slovakia's 2002 GDP.[22] The authorities have taken measures to restrict the issuance of new guarantees.

Further fiscal risks mentioned in the PEP relate to legal disputes, health care and the pension system. Long-term fiscal sustainability issues beyond the PEP horizon are not explicitly quantified or discussed. Potential further risks stemming from the electricity and railway sector are not quantified either.

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[20] In particular, the debt dynamics presented in table 5 of the PEP are not consistent. Based on the projections made in the macroeconomic and fiscal scenario, the debt ratio would remain at levels of around roughly 45% of GDP over the PEP horizon. Furthermore, the starting base for the gross debt-to-GDP ratio in 2002 (and 2001) has been revised upwards by 1.7 percentage points from Slovakia's 2003 spring notification. However, overall, these discrepancies do not change the major thrust of the assessment. The authorities have been invited to provide further clarification.

[21] The PEP does not clarify to what extent this estimate is subject to exchange rate risks.

[22] Although some details of the treatment of these guarantees with respect to the effect on net lending and gross debt will still need to be clarified in the context of Slovakia's next fiscal notifications, this does by no means lessen the laudability of the authorities' efforts to make these liabilities explicit.

6. STRUCTURAL REFORMS

The PEP presents a broad overview of on-going and envisaged structural economic reforms, emphasising their importance for macroeconomic stability and growth. The PEP stresses the new government's commitment to accelerated reform speed. It also points to the increasing weight of post-transition reforms related to the *acquis communautaire*, the Lisbon Strategy and the Maastricht criteria.

In response to the Commission's suggestion, the information provided foreshadows to a considerable extent the Cardiff report, which Slovakia – like all other candidate countries – has been invited to provide in October this year. It will be comprehensively evaluated in the respective assessment, whereas the following will describe the presented reforms only briefly and concentrate on public finance aspects.

6.1. The enterprise sector

Already by the time of the last PEP-submission, Slovakia's main state-owned enterprises had fully or at least partly been privatised, including utilities and other network industries. Nevertheless, the government needs to further create an enabling environment for the restructuring of, in particular domestically owned, enterprises so as to strengthen their adaptability to on-going changes in demand conditions. As an example, the implementation effectiveness of the legal and administrative framework and bankruptcy rules need further strengthening.

The PEP adequately describes recent developments in the enterprise sector, correctly diagnoses shortcomings, and lists a multitude of reform efforts (including in sections 4.6.1 and 4.6.2), including for instance further measures to strengthen the business environment, to foster small and medium-sized enterprises, and to liberalise markets. From a public finance viewpoint, it will be especially relevant to what extent the government sells its still remaining stakes in former public enterprises, in particular in the Slovak gas company. The PEP states that a final decision on this issue has not yet been taken.

6.2. The financial sector

The restructuring and privatisation of the Slovak banking sector has basically been completed and foreign ownership reaches more than 85%. The banking sector is now much better placed to expand its intermediation role and has indeed started to do so – with annual nominal credit growth to the private sector currently hovering above 10%. Steps have also been taken to foster the, so far relatively insignificant, intermediation role of the non-bank financial sector.

The PEP pictures the state of play broadly accurately. It also reports on progress and ongoing efforts in strengthening financial sector supervision and informs about the authorities' intention to unify the related activities within the NBS by 2006. Continuous expansion of supervisory capacity is a pre-condition for safeguarding the stability of a quantitatively and qualitatively expanding, increasingly competitive and potentially more risk-prone financial sector. In this context, the authorities are encouraged to consider an expansion of their surveillance capacity on macroeconomic and financial stability issues.

6.3. The labour market

The functioning of the Slovak labour market suffers from numerous structural problems. The PEP reports on the more decisive stance of the new government to tackle them. Noteworthy are in particular: amendments to the labour code which took effect in July 2003 and introduce important elements of flexibility; and envisaged reforms in the health and social protection systems, which include a reduction in social contribution rates to strengthen the incentives for job creation and acceptance. To this end, a continued thorough review of social assistance benefits is also crucial. The PEP presents increased expenditures for active labour market policies as a success. However, no evidence on the effectiveness of these measures is provided. To ensure an efficient use of public resources, the pertinent programmes should be continuously screened for their targeting effectiveness and efficiency. The government should forcefully continue in its efforts to tackle the deep-seated structural unemployment problems and to increase labour market flexibility.

6.4. Administrative reforms

The PEP elaborates on further progress in public finance management reforms.[23] Important elements described are, *inter alia*: the already completed abolition of almost all extra-budgetary funds; changes in budgeting procedures and in budget classification; further progress in the methodology for medium-term and programme budgeting; gradual build-up of a treasury, which needs to be well co-ordinated; new legislation on auditing and financial control; and fiscal decentralisation.

The PEP reflects awareness of the challenge to ensure compliance with the general government deficit target in a decentralised fiscal structure. A short systematic overview of current and targeted fiscal relations between the different government levels and of the fiscal implications of the decentralisation process would have added value to the text.

6.5. Agriculture

The PEP elaborates on agricultural reforms in the context of EU accession but neglects important challenges (e.g. the need for further restructuring) and does not furnish sufficient expenditure quantifications.[24] It is necessary that the authorities strengthen their restructuring efforts to ensure an efficient use of EU support. Given the minor role which agriculture will play in Slovakia's further development, the authorities are also encouraged to reconsider their general priority setting.

6.6. Additional reform areas

In its section 4.6, the PEP provides information on reforms in the health, social and pension systems. Lasting reforms in these areas are key to the sustainability of the planned fiscal consolidation. Slovakia has already started the necessary reforms, but the bulk of the measures lies still ahead.

The PEP presents the elements of the new government's comprehensive health reform concept and includes an attempt to quantify some fiscal consequences and risks. Health

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[23] Most of the relevant information is presented in section 3.4. of the PEP.

[24] Regional policy is treated in section 4.6.11 of the PEP.

expenditures in Slovakia remain comparatively high and the sector is still far from being financially sound. The swift and effective implementation of further reform measures is indeed of utmost importance.

After a brief exposition of the reform principles for social assistance and social benefits, the PEP concentrates almost exclusively on reforms to child allowances. Although this is an important area, a more systematic and comprehensive treatment of all relevant reforms, expounding on their sequencing and embedding them into the multi-annual fiscal framework, would have been desirable. This holds in particular for the necessary reforms in the social benefits area.

The PEP also reports on the new government's revised pension reform concept. A new Social Insurance Act foresees important PAYG-pillar reforms, in particular an increase in the retirement age to 62. However, the latter target is not ambitious enough and the government should consider further steps to improve the financial situation of the PAYG-pillar, thereby reducing the general government deficit and freeing potential further privatisation revenues for debt retirement. The PEP announces that the planned introduction of a funded pension pillar will be specified in the second half of 2003.

Additional reform areas briefly described in the PEP are: (1) education (2) science, technology and information society; (3) transport policy, which includes only a short discussion of the costly and challenging reforms of Slovak Railways; (4) post and telecommunication reforms; (5) and environmental policy.

SLOVENIA

PRE-ACCESSION ECONOMIC PROGRAMME 2003

ASSESSMENT

1. OVERALL SUMMARY AND ASSESSMENT

The third Pre-Accession Economic Programme (PEP) provides a medium-term policy framework, covering the period 2003-2006. It includes public finance objectives and structural reform priorities needed for EU accession and prepares further the institutional and analytical capacity necessary to participate in EMU. The Programme was adopted by the government.

The PEP bases its medium-term policy agenda on the grounds of a relatively robust macroeconomic performance. The framework contains a comprehensive plan on the development path of the main macroeconomic aggregates, which has been revised downwards in the light of the current climate. Compared to the previous PEP the new path anticipates a more moderate GDP growth; the rates stand at around 4% throughout the medium-term, close to potential output growth. Growth is assumed to be kindled by foreign demand, and subsequently fuelled by domestic demand. In fact, investment growth has now been put on a faster track compared to the previous trajectory. In step with strengthened investment, imports are to rise while growth in exports is expected to pick up through an upturn in international economic environment. These trade development assumptions should keep the current account position in surplus at about 1% of GDP throughout the programme's period. However, the lower GDP growth has undermined the path of gradual elimination of the fiscal deficit. The new projections anticipate that the government deficit will decline only marginally to close at 1.3% of GDP in 2006. At the same time, the comparatively small cyclically adjusted deficit is on a slowly decreasing trajectory to level off at slightly above 1% of GDP by the end of period. Although on a trend decline, inflation remains persistently high – amounting to 6.3% in August 2003 – and is forecast to stand at 3.7% by end 2006. Inflationary pressure is fed by lack of competition in various sectors, inflexible labour markets, and still widespread – but diminishing – indexation mechanisms.

The PEP is geared towards the strategic objective of a balanced increase in welfare, which is assumed to stem from stable economic growth provided for within the transition to the knowledge-based society. The mechanisms seen to lever this development strategy, akin to the Lisbon Strategy, are lower inflation, fiscal consolidation, and intensified investment boosting the restructuring process. An anti-inflationary policy attitude, in particular, is expected to effectively accommodate successful integration in the EU and entry into ERM-II, the government's paramount goals to be accomplished in the next two years. Progress on the structural reform path will require an in-depth consideration by the national authorities in the Cardiff report to be submitted for the Commission services' evaluation in October this year.

The PEP now sets up a solid and coherent framework to give support to sustainable development in the future. A broadly consistent macroeconomic scenario projects an appropriate growth path to which the government has selected medium-term measures accordingly. In particular, it has explicitly recognised that cutting inflation is instrumental in creating conditions for joining ERM-II, now set for the first half of 2005. Still, the PEP addresses this issue somewhat vaguely by laying down a rather

noncommittal objective of "gradually" lowering inflation to an "acceptable" level at "about" 4% in 2004. The policy outline for bringing down inflation is rather unambitious. Government attempts to move toward general de-indexation of the economy and a re-balanced fiscal stance, while welcome and necessary, are not sufficient to achieve the desired low level of inflation and need to be complemented by a more determined monetary policy stance. Also, the new PEP properly recognises that further liberalisation and privatisation is necessary for a sustained disinflation and an improved economic performance in the future.

The PEP reveals the low pace of the restructuring process but fails to deliver a comprehensive plan on how to speed it up although a more swift implementation of reforms has already been called for. Admittedly, some progress has been made. A complete set of reform laws on public administration has now been adopted, allowing further implementation of priority measures such as the rationalisation of employment and the salary system in the public sector.

Adjusting the Slovene economic structure and legislation is deemed necessary also in view of the financial implications of accession to the EU. The programme identifies opportunities and threats in this regard. Financial inflows from the EU budget are conditional on the creation of independent regulatory agencies, many of which are not yet operational but should become so in the near future. On the outflow side, the government foresees additional financial obligations, exerting further pressures on the budget. Public finance policy therefore aims at implementing fiscal reforms to keep general government expenditure under control by improving its structure; at the moment, the budget continues to be characterised by a high share of fixed commitments. Here, the PEP formulates a number of measures whereby a marginal reduction of the small cyclically adjusted deficit is envisaged. The PEP justifies this only gradual decline with fiscal pressures resulting from the integration processes while it estimates the net budgetary effect of accession to EU to be positive of around 0.3% of GDP throughout the medium-term. Despite some uncertainty, the medium-term fiscal path appears reasonable. In general, the fiscal policy of gradually diminishing the structural deficit and aiming at budgetary balance is reflects Slovenia's objectives of participation in ERM-II and meeting conditions to adopt the euro.

2. JOINT OPINION

"On 4 November 2003 the ECOFIN MINISTERS OF THE PRESENT MEMBER STATES AND THE ACCEDING COUNTRIES examined the 2003 Pre-Accession Economic Programme of Slovenia on the basis of an assessment prepared by the Commission Services with a contribution from the ECB. In accordance with the Conclusions of the High-Level Meeting with the Candidate Countries in Athens (EFC/ECFIN/227/03) Ministers adopted this joint opinion.

The third Pre-Accession Economic Programme (PEP) provides a medium-term policy framework, covering the period 2003-2006. It includes public finance objectives and structural reform priorities needed for EU accession and prepares further the institutional and analytical capacity necessary to participate in EMU. The Programme was adopted by the government.

…

Opinion

> […], Ministers consider a relatively high inflation an issue of some concern. A forceful implementation of an anti-inflationary policy mix is called for. Ministers welcome Slovenia's intention to move towards a generalised de-indexation of the economy and the steps taken in that direction so far. In addition, the stabilisation of the tolar, which remains on a continuous depreciation path, is a key element in a broadly based set of policies to lower inflation in a sustained manner.
>
> In this context, Ministers also consider it important to enhance the competitiveness and flexibility of markets through an accelerated restructuring process. Slovenia is encouraged to implement speedily the privatisation and liberalisation programmes in companies under state ownership, as well as to apply other structural reforms, including the final liquidation of the Slovene Development Corporation.
>
> Finally, Ministers recommend Slovenia to apply without further delay the necessary public finance measures to achieve the programme's budgetary targets. Ministers encourage policy efforts geared to increasing budgetary flexibility and reducing rigid budget spending and regard positively the reform plan aimed at restructuring general government expenditure and revenue."

3. REVIEW OF RECENT ECONOMIC DEVELOPMENTS

Slovenia has performed well in macroeconomic terms; following a period of a short transition recession GDP growth picked up in 1993 and thereafter remained steady at 3-5%. In 2002, growth reached 3.2%. It accelerated slightly compared to the previous year with a main push coming from domestic demand which was mostly fed by the revived investment activity, while household and government consumption stayed subdued. Stronger domestic demand growth in turn boosted import growth. The net external demand contribution to economic growth declined as, simultaneously, depressed EU markets, the main trade area for Slovenia by far, brought real export expansion to a further deceleration. Nevertheless, relatively high export growth was sustained owing to a continued market creation outside the EU, in particular in Central and Eastern Europe and the Balkans.

Robust real export growth combined with improved terms of trade - neither of them anticipated in the previous PEP forecast - led to the sharp improvement in the trade- and current account. Therefore, 2002 saw a turn into the current account surplus at 1.7% of GDP, the highest level achieved since 1994. Also, inward foreign direct investment (FDI) reached record levels again, mostly linked to privatisation in the banking and pharmaceutical sectors, and constituted the main part of the capital inflows in 2002. However, the stimulus seems to have faded; FDI inflows have now returned to the low levels of previous years.

Influenced by poor business expectations, employment fell marginally in 2002, quite contrary to projections of a positive growth in the PEP 2001. The unemployment rate, on the other hand, was stable at 6.4% as anticipated.

Inflation has been declining but still remains persistently high. For 2002, the average annual inflation rate stood at 7.5%, down from 8.4% in 2001. Increases in taxes, administered prices, and energy prices contributed most to a rise of consumer prices. Inflationary pressure is fed by lack of competition in various sectors, structural imbalances in the labour market, and still widespread indexation mechanisms. An accommodating monetary policy and a managed float exchange rate system further add to inflation inertia. Although on a trend decline, inflation continues to raise major concerns.

Table 1: Economic development

		PEP framework			
	2002	2003	2004	2005	2006
GDP growth at constant market prices	3,2	3,1	3,9	4,0	4,4
Contribution to GDP growth:					
- Final domestic demand	2,4	2,4	4,1	4,2	4,0
- Change in inventories and net acquisition of valuables	0,2	0,1	0,3	0,2	0,3
- External balance of goods and services	0,6	0,5	-0,5	-0,4	0,1
Investment ratio (% of GDP)	22,9	22,8	23,5	24,1	24,4
GDP per head (PPS, % of EU average) (1)	74,0	76,0	77,2	78,7	80,6
Participation rate (% of 15-64 age group)	67,8	67,8	67,9	68,2	68,3
Unemployment rate (ILO definition)	6,4	6,3	5,9	5,5	5,0
Employment growth	-0,1	0,2	0,8	0,8	0,8
Labour productivity growth	3,3	2,8	3,1	3,2	3,6
Average real wage growth	2,0	2,0	2,0	2,2	2,5
CPI inflation (annual average)	7,5	5,5	4,3	4,2	3,7
Exchange rate vis-à-vis EUR (percentage change of annual average)	3,8	2,8	0,6	0,2	0,0
Current account balance (% of GDP)	1,7	1,5	1,3	1,0	1,1
Net foreign direct investment (% of GDP)	8,3	2,0	3,0	3,0	3,0
Foreign debt (% of GDP)	36,2	36,9	36,6	36,3	35,8

Source: PEP, if not otherwise indicated
(1) calculated, without demographic or price effects; growth rates: candidate countries: PEPs / EU: 2003-04: Spring 2003 COM forecast; thereafter same as in 2004

In 2002, the budget deficit rose to 2.4% of GDP, more than expected. This discrepancy from the PEP 2002 forecasts is supposedly the result of the overly optimistic domestic growth and inflation assumptions prompting economic policy to trigger fiscal stabilisers. However, timely adjustments are heavily strained by structural inefficiency built in; the budget continues to be characterised by a high share of fixed commitments. The primary balance, on the other hand, recorded only a small deficit owing to the relatively moderate indebtedness of the government. The general government gross debt ratio in 2002 further increased to 27.9% of GDP, following a gentle upward trend since 1994.

4. Medium-term macroeconomic framework

Macroeconomic aggregates are projected in line with the scenario set out in the Strategy for Economic Development of Slovenia; the forecasts in the new PEP span the period from 2003 to 2006. The framework contains a comprehensive plan on the development

path of the main macroeconomic aggregates, based on the national accounts system and economic policy guidelines up to 2006. It also comprises detailed projections of fiscal aggregates complemented by a sensitivity analysis, which has been re-iterated to quantitatively determine a number of uncertainties regarding revenues and expenditures. The new exercise revealed that the budget deficit faces the worst deterioration with increased employment in state administration.

The framework is set up on the premises of liberalisation, privatisation and restructuring. These reform processes are assumed to run continuously throughout the period under review since further structural adjustments have been conferred essential role in stimulating growth, attracting more FDI, curbing inflation, and improving the fiscal stance through higher growth, increased flexibility in budget expenditures and greater efficiency in revenues. Given the slow progress on the reform agenda so far, the projected course and pace of development demand immediate policy action.

4.1. Real Sector

Slovenia's performance crucially depends on the economic situation abroad. Given the grim growth outlook world-wide, the new PEP anticipates a more moderate growth path compared to the previous one. Domestic growth is to gain momentum with the recovery of foreign markets; the rates stand at around 4% throughout the mid-term. However, weaker growth has also been foreseen allowing for the pessimistic assumption of delayed upturn in the main trade partners.[25] Growth is assumed to be kindled by foreign demand, and subsequently fuelled by domestic demand with consumption and investment rallying. In fact, investment growth has now been put on a faster track compared to previous trajectory.

4.2. Inflation and wages

In the run-up to EU accession, a relatively high and persistent inflation has been recognised as the main policy challenge. Still, the PEP addresses this issue rather vaguely by laying down a rather noncommittal objective of "gradually" lowering inflation to an "acceptable" level at "about" 4% in 2004. Equally unpersuasive is the Bank of Slovenia in its goal of reducing inflation to a level "between 3-4%" before ERM-II entry", a goal that had been recently postponed until the first half of 2005. Projections presuppose that inflation inertia will be eliminated in the ongoing process of economic restructuring and with the co-ordinated operation of macroeconomic policies. However, the poor inflation record, the slow pace of structural reforms, and the monetary authorities' seeming lack of effort has raised doubts about the plans to durably bring down inflation over the mid-term. Structural reforms should lower inflation expectations through releasing indexation schemes, enhancing price liberalisation, bolstering competition in the financial markets, and increasing flexibility of labour markets. An anti-inflationary policy mix, on the other hand, should frustrate price growth by including more direct – monetary measures, like the slowdown of the tolar's depreciation.

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[25] 0.4% and 0.5% points lower GDP growth rates appear in the alternative macroeconomic scenario for 2003 and 2004, respectively.

Lowering inflation is the underlying objective of the Social Agreement for 2003-2005, concluded by the social partners in April 2003. It stipulates a new wage policy, which should dispense with direct backward-looking indexation while keeping real wages from increasing more than productivity. A new wage adjustment method for 2004-2005 – which will take into account consumer price movements in Slovenia, average inflation in the EU, and the euro/tolar exchange rate – has already been introduced in the public sector.[26] For the private sector, such a policy yet needs to be negotiated between the social partners. In addition, government urges them to formulate profit sharing schemes so as to put off a part of pay to future payments. Pressures to push up wages are now capped by preventing wages in the public sector from rising faster than in the private sector. Wages constitute an important share of the high fixed commitments in general government expenditure and therefore need to be carefully controlled. A positive step toward containing nominal wage increases in the public sector is the agreement to replace the adjustment of the basic wage, set for August 2003, with a pension insurance premium.

4.3. Monetary and exchange rate policy

The PEP states that the Bank of Slovenia (BoS) is committed to price stability. In line with its long-term strategy of lowering inflation in a way to comply with the Maastricht criteria -without referring to any potential dates for euro area membership- monetary policy will first be moderately restrictive and then – after joining ERM-II – slightly expansionary. This implies that achieving effective price stabilisation in the mid-term is important for successful integration into ERM-II. Therefore, the mid-term goal is to direct monetary policy to a gradual decrease of foreign exchange rate depreciation with a corresponding adjustment of interest rates.[27] The PEP does not clearly indicate whether the Bank of Slovenia will continue to operate the managed floating foreign exchange rate system, which in its present form is incompatible with ERM-II. This intensifies the need to actively pursue anti-inflationary economic policies. The authorities have agreed to co-ordinate their activities in tackling inflation. The government advanced further in a move toward generalised de-indexation of the economy, with full indexation now eliminated for interest rates, public sector wages, and financial contracts prepared by the government. However, by focusing on protection of the real exchange rate, monetary policy, in fact, contributes to inflation. It therefore remains to be seen whether inflation can be subdued in a timely manner.

4.4. External sector

Export and import growth forecasts largely reflect consensus assumptions of economic developments in the main trade partners. After decelerating again in 2003 due to weak foreign markets, growth in exports is expected to pick up through improved growth in international markets. In particular, trade policy will aim at regional dispersion within the EU. Consequently, imports of goods and services is expected to rise, in step with strengthened investment as the private sector will need to expand its production capacity in order to fully satisfy foreign demand. Trade developments should keep the

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26 Recently the government and the non-corporate sector trade unions have agreed on the new indexation system; the wages in the public sector would be indexed in July, accounting for 52% of the Slovene inflation, 38% of the European inflation, and 10% of the increase of the €/SIT ER (in 2004) / 52% of the Slovene inflation and 48% of the European inflation (in 2005).

27 The Bank of Slovenia has argued it adheres to the uncovered interest rate parity principle in its policy.

current account surplus at a level of about 1% of GDP throughout the mid-term period. The surplus will be facilitated by a relatively modest external debt relieving the interest rate payments. Moreover, reserve levels are expected to improve, also as a result of positive net financial inflows once Slovenia becomes fully integrated in international capital markets. Capital inflows are to increase because of higher foreign direct investment (FDI). However, the preliminary figures for 2003 show a sharp drop from 2001 and 2002 record levels to (even below) the historically low volumes. The PEP relates the large inflows to privatisation in the banking and pharmaceutical sectors and itself renders any further exceptional inward FDI doubtful considering a limited business scope for cross-boarder corporate acquisitions. Furthermore, the PEP ignores the role of FDI in restructuring industries and their potential contribution to promoting competitiveness. The attitude toward FDI among various actors in Slovenia is still somewhat mixed, as the cases of bank privatisation and the take-over in the brewery sector have shown. On the other hand, capital outflows will be further motivated by integrating into the internal EU market. With a gradual opening up of the domestic financial sector and a decrease in domestic interest rates, corporate and government sectors should therefore increasingly recur to domestic lending rather than borrowing externally.

5. PUBLIC FINANCE

5.1. The medium-term fiscal framework

The macroeconomic framework underpins the fiscal scenario of a gradual move toward structural balance. Despite the mid-term goal of achieving a stable public finance stance, the projections anticipate that deficit reduction will decelerate to come in at 1.3% of GDP by the end of the forecast period. Against the background of an unfavourable macroeconomic environment, fiscal policy will allow automatic stabilisers to operate so as to mitigate the negative effects of the economic cycle. This would lead to a deviation from the targets as provided here. In addition, the PEP sees the EU and NATO membership as potentially exerting further pressure on the Slovene public finance. The high share of fixed commitments gives little room for any new financial obligations (e.g., setting up the Schengen border, professionalisation of the Slovene Army) within the existing budget. This may provoke a short-term deterioration of economic results should legal order and economic structure not be suitably adjusted. The PEP underlines the powers of fiscal policy in maintaining macroeconomic stability

Table 2: Fiscal development
(general government, % of GDP)

		PEP framework			
	2002	2003	2004	2005	2006
Receipts	41.5	41.6	42.2	42.5	41.7
Expenditures	43.9	43.6	43.8	44.1	43.0
Net lending	-2.4	-2.0	-1.6	-1.6	-1.3
- Cyclically adj.	-2.2	-1.4	-1.1	-1.1	-1.1
Primary balance	-0.2	-0.5	-0.1	-0.1	0.0
Gross debt level	27.8	27.8	27.7	26.9	25.9

Source: PEP, if not otherwise indicated

and stimulating economic growth, which will be further intensified after the entry into

ERM-II when exchange rate policy – currently operated under the managed float regime – becomes unviable.

The PEP projects a precise path on the gradual elimination of the fiscal deficit. This year, the projections of public finance aggregates have been set up in a new macro-fiscal framework for the period 2004-2007 which again drew a slowly declining trajectory for deficit reduction. However, government deficit forecasts have been revised upward by 0.6-0.8% points compared to the path in the previous PEP as a result of the gloomy economic situation world-wide driving domestic growth below the initial forecast. With the upward revision of the government deficit trend, the credibility of the mid-term fiscal consolidation programme has been further weakened but may still be assessed as broadly sustainable. While the government retains the possibility of increasing the cyclical deficit should the global economic conditions deteriorate, it is unlikely that it will allow the automatic stabilisers to fully play against the adverse external effect on the deficit development. On the other hand, the scenario projects a smooth downward trend line on the cyclically adjusted deficit, levelling off at slightly above 1% of GDP at the end of the mid-term. Given the solid economic fundamentals, this slow path is rather disappointing. According to the text, a sharper improvement is hindered by the fiscal pressures related to financial obligations of the membership in the EU and NATO. Nevertheless, the PEP anticipates positive budgetary effects of accession to the EU over the mod-term – with the net position of financial flows in terms of GDP amounting to 0.4% in 2004 and 0.3% for 2005 and 2006 – provided that the absorption capacity is further strengthened. In addition, the announced restructuring of government revenues and expenditures needs to be implemented without delay.

With reference to the goal of improving flexibility and effectiveness of public finance in the mid-term the PEP announces a number of measures aimed at restructuring general government expenditure and revenue. On the revenue side, tax restructuring – such to increase the tax capacity while maintaining the present tax burden on the economy – is pending. The reform plans give priority to changes in direct taxes: the simplification of personal income tax, the modification of corporate income tax, and the introduction of a real estate tax. So far, policy efforts have focused on restructuring the public sector expenditure. The government has redesigned the reform package to finally proceed with cutting the high fixed share of spending commitments, one of the most critical points highlighted in the last year's evaluation. It laid down explicit measures for a better management of public sector wages, e.g. the wage policy agreement, which will help limit wage growth, as noted earlier.

In the future, more funds will be channelled to financing development priorities. The projections of the main fiscal aggregates anticipate that planned structural reforms or any other measures bolstering competitiveness will not incur cost on public finance. Quite the contrary, the sale of state property generates revenue which is subsequently used to reduce government debt, thereby exerting a positive effect on the level of debt servicing. In 2002, considerable revenue accrued from partial privatisation of the largest Slovene bank (NLB). The sale of a part of a state's share has already produced beneficial impact since a part of privatisation proceeds was instantly transferred to early debt repayment. The government adopted a programme on the gradual use of the proceeds to retire the public debt. Still, the revenues were not explicitly accounted for in the quantitative scenarios of public debt management. It is rather puzzling why the government decided to exercise such a prudent approach in projecting the debt positions. In the coming years, further revenue from selling government financial assets has been envisaged. Yet, the PEP remains silent on the privatisation plan: what state-

owned equity is to be sold when. Rather, it is outspoken in admitting that the government will carry out, postpone, or halt the planned sales “depending on the financial market conditions”. While it is acceptable to stall privatisation of the state property due to unfavourable international economic situation, a gradualist and uncommitted approach to restructuring of the economy, on the other hand, may add to the uncertainty about future developments.

The updated PEP contains a sensitivity analysis that explores the potential impact of the changes in key economic variables on general government expenditure and revenue and the overall government deficit. It is, however, difficult to comparatively assess how the Slovene deficit responds to shocks given the atypical approach used for measuring the effects. Changing the respective variable by 1% to calculate the impact on the budget balance, the analysis produces oddly insignificant results. For example, a 1% increase in GDP growth pushed by a boom in private consumption lowers the deficit by a negligible 0.01% point in terms of the share in GDP. In addition, the analysis of the responsiveness of the budget deficit to the changes in inflation and exchange rates reveals only a minor impact on the debt servicing cost, reflecting a (gradual but constant) decline in inflation and a shift in the government debt management.

The gradual reduction of the government deficit, in conjunction with lower interest rates and slower tolar’s depreciation, and assuming a sustained economic growth is expected to push the general government gross debt to GDP ratio down to 25.9% in 2006.

5.2. Public debt management

The PEP gives a clear overview of the strategy in managing the public debt. The government has been replacing external borrowing with borrowing in domestic financial markets with the aim to minimise the cost of debt over the long term. Since the final goal is the effective integration in EMU it has already started adjusting the debt structure in foreign currencies by increasing the share of Euro-nominated debt. In recent years, a shift away from index-linked financial instruments and towards fixed-rate bonds has been stimulated in order to diminish interest risks for the budget. This shall significantly contribute to the formation of yield curves for government securities and the promotion of transparent market prices. Furthermore, the market will eventually establish a long-term interest rate thereby allowing a quantification of the compliance with the convergence criteria for entering the EMU.

The ample liquidity in the domestic financial markets enhances the orientation toward internal borrowing under nominal fixed rate terms, which will provide important stimulus for generalised de-indexation in the economy and for the development of a rather thin domestic financial market.

5.3. Deficit financing

The strategy of long-term borrowing and incremental short-term borrowing to finance the budget deficit encourages the Slovene government to maintain a comparatively low deficit. As the domestic financial market deepens, it is motivated to finance the entire budget domestically. Short term borrowing is mostly executed through short-term treasury bills while a variety of medium-to-long term bonds is used for borrowing long-term. The policy decision to shift gradually to borrowing by market interest rate instruments has now finally reached the long-term segment of the market. In 2002, the

first medium-term (three-year) nominal fixed rate securities were released on the domestic market to replace the issues of bonds of equal maturity with variable interest rates. Further activities – the extension of nominalism to other tolar-nominated bonds – remain necessary in 2003 to facilitate the assessment of the cost of financing and to accelerate a decrease of interest rates and of cost of debt servicing over the mid-term, thereby contributing to a slow down of autonomous debt growth resulting largely from indexation in an inflationary environment.

5.4. Fiscal risks

The PEP briefly discusses fiscal risks related to government guarantees and long-term sustainability of public finances in the context of population ageing with additional reference to the assessment of debt sustainability.

Currently, the fiscal stance is not facing major threats. The state does issue guarantees – mainly related to financing of public utilities – but its intervention seems unproblematic, considering that the debt covered by government guarantees was stagnant at 6.6% of GDP in 2002. However, given the present situation in the rail transport sector the state may incur considerable financial burdens. Most likely to put more pressure on the longer-term future fiscal position is the demographic evolution. A preliminary analysis of the long-term budgetary impact of population ageing showed that pension and health care expenditures will mount up to 20% and 10% of GDP, respectively, by 2040. The importance of (further) reform of pension insurance and compulsory health care seems to be well acknowledged among policy makers. While the pension reforms are being introduced gradually, the health reform process has only started. The PEP reports on the draft paper of proposed health care reform, which will need to be elaborated on further.

A short discussion on debt sustainability reveals that several factors – including inflation and exchange rate developments – will significantly affect the debt level over the mid-term. Still, in the 2004-2007 period economic growth appears to sustain the level of interest payments in a way that the primary balance required to stabilise the debt/GDP ratio can become negative. Economic circumstances should therefore facilitate the stabilisation of the primary debt.

6. STRUCTURAL REFORMS

The PEP provides a detailed report on the mid-term development guidelines and implementation of announced structural reforms, noting duly any departure from the plans. As the execution of measures and programmes has not been uniform across the areas, the government was prompted to adopt a side Programme for Effective Integration into the EU to which the 2002 PEP extensively refers. It lays down specific short-term measures to be implemented in the most critical areas before the accession to the EU and ERM-II. Although some of the proposed measures can hardly be executed in a very short time, the Programme can nevertheless prove a useful document as it abets the government's willingness to root out the inefficiencies of the economy.

Structural reforms plan, as set out in the previous PEPs, corresponds to the mid-term development strategy[28] urging the improvement of welfare defined in terms of a balance between the economic, social and environmental components of development. This objective is to be realised through policies that accelerate the transition to a knowledge-based society, bolster economic competitiveness, improve state efficiency, strengthen institution building, and secure balanced social and environmental development.

The creation of a knowledge-based and information society, a paramount measure of enhancing future growth and development in line with the Lisbon strategy, is considered a policy priority and several actions have already been launched in this field; the introduction of e-government, in particular, is well underway. However, the shift to a knowledge-based society is retarded by the insufficient progress in the field of education, R&D investment and corporate innovation and information technology, as the PEP critically notes. Further, promoting competitiveness in the corporate sector is seriously hindered by the low pace of restructuring and introducing corporate governance, as well as a mixed attitude to foreign direct investment, which keeps most of the structural rigidities in place. On the other hand, economic development could be stimulated by the improved state's efficiency. Important progress has been achieved in the judiciary and public administration, while serious problems remain with the state involvement in the economy as far as concerns its adverse effects on national competitiveness. Here, many reforms are pending and require urgent execution.

Policy priorities now include measures to rationalise and modernise public administration, lift administrative barriers, increase the flexibility of general government expenditure, and eliminate the main structural imbalances so as to enhance efficiency and competitiveness of the economy, in particular, concerning further liberalisation and privatisation of telecommunications, post, electricity, steel, banking and insurance sectors.

6.1. The enterprise sector

The PEP notes recent reform of the public utilities; important initial activities have been undertaken towards liberalisation of electricity markets, e.g. by allowing large consumers a free choice of supplier, and telecommunications services. However, a number of measures still need to be phased in since the market structures in the utilities do not yet fully support effective competition. Referring to bad market conditions, the government has ultimately renounced to sell its majority stakes in the Slovenian Steelworks while the privatisation of the incumbent telecommunications operator has been postponed. The government is therefore urged to implement speedily the privatisation and liberalisation programmes in companies under state ownership, as well as to apply other structural reforms, including the final liquidation of the Slovene Development Corporation, originally foreseen for end of 2001. The commitment to close it down has proven very difficult to put into practice and is now expected to be completed in 2004. However, the government again refrained from committing to a firm timetable in the PEP although concerns about the constant delay(s) had been repeatedly expressed in previous evaluations.

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[28] Strategy for Economic Development of Slovenia (IMAD, July 2001).

6.2. The financial sector

The new PEP indicates that the financial sector is one of the least developed segments of the economy. It does note some progress of privatisation process of the two largest Slovene banks NLB and NKBM in 2002. The privatisation of NLB finally went ahead under altered conditions – introduced by the government during the privatisation process, allowing only a minority sale privatisation –, and is now completed, with the state holding – directly or indirectly – a 45% stake. The privatisation of NKBM was initiated in September 2001 and although foreign strategic investors expressed interest, the government interrupted the privatisation process and the sale was halted due to political resistance. The PEP reports that the management board of the NKBM has put forward a plan proposing a merger with the state-owned Postal Bank but it remains unclear whether (part of) the bank will be offered for sale to private (foreign) investors at any time in the near future.

The PEP only briefly addresses the (lack of) progress in the insurance sector, which has remained closed and largely unrestructured, dominated by one state-owned company. The ruling of the Constitutional Court on the implementation of the Law on the Ownership Transformation of Insurance Companies announced in February 2003 has now opened the way for the largest state-owned insurance company Triglav to be privatised. Yet, the government is not actively engaged in the preparation of a privatisation plan nor it has fixed a timetable for restructuring of the industry.

Irresolute or steady handling of the restructuring process erodes government credibility in creating a stable and predictable economic environment. This further complicates the development of the financial markets.

6.3. The labour market

The state’s intervention and management encroach in the labour market which thereby remains to be characterised by some structural rigidities. Development guidelines direct the policy toward greater flexibility. The measures are being implemented in accordance with the goals and deadlines as set in the PEP 2002.

6.4. Administrative reform

In 2002 in 2003, considerable progress in the area of public administration reform was made. All reform laws, i.e. the basic institutional acts have now been adopted. A complete legal framework for the existing system of public administration and public servants allows further implementation of priority measures as laid down in a new strategy for the development of the public sector (adopted in July 2003). The proposed measures envisage, inter alia, a rationalisation of employment and the establishment of a uniform, balanced and flexible salary system in the public sector.

6.5. Additional reform areas

Progress reports on a number of other dimensions including agriculture, education, Information Society, housing policy, social security, healthcare, environment, and regional policy revealed no major discrepancies from the planned dynamics of reforms; broadly, programmes are being implemented according to the schedules set in the 2002 PEP.

BULGARIA
PRE-ACCESSION ECONOMIC PROGRAMME 2003
ASSESSMENT

1. OVERALL SUMMARY AND ASSESSMENT

The Pre-accession Economic Programme (PEP) 2003 is a good basis for economic policy in Bulgaria in the run-up to accession in order to sustain economic growth and further reduce unemployment. It is also broadly consistent, not only in time horizon but also in the macroeconomic and fiscal framework, with the updated National Economic Development Plan (NEDP) 2000-2006 and the multi-annual budget 2004-2006, which the government both adopted almost in parallel to the PEP. The high discipline envisaged by the medium-term fiscal framework, targeting a low budget deficit until 2005 and a balanced budget by 2006, will contribute to a balanced policy mix and to a further reduction of public debt. However, in view of the high cash surplus of about 1.8% of projected GDP in the first half of 2003, the deficit target of –0.8% of GDP in 2003 should be revised towards a lower deficit or a surplus since it would imply a substantial fiscal loosening in the second half of 2003. This could trigger a further widening of the already high current account deficit of about 5.2% of projected GDP in the first of half of 2003.

Compared to the PEP 2002 (and the NEDP), the target of a balanced budget has been postponed to 2006 and results in a higher deficit relative to GDP of 0.2 percentage points in 2004 and of 0.6 percentage points in 2005. While the direct economic impact of these changes should be limited, also in view of the built-in mechanisms of fiscal flexibility, the credibility of the PEP could erode if it were perceived as a general rule that the balance will always be a target for the last year of the PEP period.

The PEP adequately emphasises the importance of continuing structural reforms to complement the macroeconomic conditions for high growth and sound public finance. The flexibility of markets is crucial for an economy whose currency is tied up in a currency board arrangement where the nominal exchange rate is not available to adjust to external shocks. Good progress has been made in several areas, but delays occurred in some areas with fiscal implications, in particular in privatisation and healthcare. On the labour market, there is a strong reliance on active labour market policies whereas little indication is given of envisaged reforms to increase labour market flexibility which could reinforce the reduction of unemployment.

2. JOINT MINISTERIAL CONCLUSIONS

The Economic and Finance ministers of the EU and of the acceding and candidate countries Ministers approved at their meeting of 4 November 2003 the following Joint Conclusions:

"….

Bulgaria

- The macro-economic performance in 2002, with high growth, low inflation and a low government deficit was welcomed. The public finance scenario of the PEP

reflects the government's awareness of the importance of a prudent fiscal policy in a currency board environment.

- It was noted that a currency board regime poses particular challenges to the external viability of the Bulgarian economy. It was welcomed that, although total foreign debt and foreign borrowing remain high, they are projected to fall further, and that the share of public foreign debt is declining.
- The programme also suitably stresses the importance of continuing structural reforms to reinforce the conditions allowing high and sustained economic growth and sound public finance.
- Considerable progress has recently been made in this respect, such as the completion of the privatisation and restructuring of the banking sector. However, delays occurred in areas with important fiscal implications, such as privatisation and healthcare reform.
- As regards labour markets, the programme relies mainly on active labour market policies. It puts limited emphasis on measures aiming to increase the flexibility of labour markets, which could be one of the main tools for further reducing unemployment and enhancing necessary structural change in the economy.

….."

3. REVIEW OF RECENT ECONOMIC DEVELOPMENTS

The programme offers a clear and succinct description of economic developments in 2002, but only occasionally mentions latest developments in 2003. Despite the weak external environment, real GDP growth was high at 4.8% in 2002 and was largely sustained by domestic demand, in particular private consumption and gross fixed capital formation. In contrast to previous years, there was a slight positive contribution from the external sector. Domestic demand is supported by strong credit growth, higher incomes and increasing employment. On the supply side, all sectors of the economy reported a contribution to gross value added (GVA) growth in 2002. Agriculture and the service sector registered the highest growth rates. Unemployment has declined as a result of net job creation in both private sector and active labour market programmes and of lower participation resulting from an ageing society. Inflation has declined further because of low import and food prices which were only partly offset by increases in administered prices. The current account deficit went down from 6.1% of GDP in 2001 to 4.4% of GDP in 2002 due to a lower trade deficit, higher tourism revenues and higher current transfers. Compared to earlier years, net FDI inflows were rather low at 3.1% of GDP in 2002

According to latest available data, trends in 2002 broadly continued in the first half of 2003. Real GDP growth was 4.1% of GDP, based on strong private consumption and investment. However, there was a strong negative contribution from net exports. In the first half of 2003 the current account deficit widened to 5.2% of projected GDP due to higher import than export growth and a higher deficit of the income balance. Compared to 2002, FDI can be expected to be higher in the full year 2003 when inflows were already 2.7% of projected GDP in the first six months only. Inflation declined to very low levels, with an average of 1.3% until August, also because of the depreciation of the US dollar which reduced import prices. Unemployment decreased further to a rate of 13.7% in June 2003 (ILO definition).

Table 1: Economic development					
		PEP framework			
	2002	2003	2004	2005	2006
GDP growth at constant market prices	4.8	5.0	5.3	5.3	5.5
Contribution to GDP growth:					
- Final domestic demand	5.3	5.6	5.4	5.0	5.9
- Change in inventories and net acquisition of valuables	-0.6	-0.3	-0.2	0.1	-0.5
- External balance of goods and services	0.5	-0.8	0.0	0.2	0.1
Investment ratio (% of GDP)	19.7	20.5	21.0	21.5	21.8
GDP per head (PPS, % of EU average) (1)	25.0	25.9	26.6	27.4	28.2
Participation rate (% of 15-64 age group)	53.3	53.7	53.8	54.0	54.4
Unemployment rate (ILO definition)	17.8	15.9	15.1	14.4	14.0
Employment growth	0.8	1.6	1.2	1.2	1.1
Labour productivity growth	3.8	3.0	4.1	3.8	4.4
Average real wage growth	7.1	5.8	4.1	3.7	4.3
CPI inflation (annual average)	5.8	2.5	4.2	3.2	3.9
Exchange rate vis-à-vis EUR (percentage change of annual average)	0.0	0.0	0.0	0.0	0.0
Current account balance (% of GDP)	-4.4	-4.5	-4.3	-4.2	-3.8
Net foreign direct investment (% of GDP)	3.1	4.3	4.3	4.4	4.4
Foreign debt (% of GDP)	63.8	59.9	57.5	56.4	54.6

Source: PEP, if not otherwise indicated

(1) calculated, without demographic or price effects; growth rates: candidate countries: PEPs / EU: 2003-04: Spring 2003 COM forecast; thereafter same as in 2004

4. Medium-term macroeconomic framework

The programme explains that the scenario has been based on the, only slightly modified, model already used for the 2002 PEP and that it drew from external assumptions by the European Commission and the IMF. The medium-term projection of real GDP growth is identical to the one presented in the PEP 2002, suggesting rates of 5.0% in 2003, 5.25% in 2004 and 2005, and 5.5% in 2006. In view of the low income level and the high potential for catching-up, this might not be overly optimistic. However, the programme does not specify the assumed potential growth rate for Bulgaria. The suggested growth figures might be within the range potential growth rates, but their realisation will critically depend on appropriate economic policies over the programme's horizon and a favourable global economy. Trade and current account deficits are projected lower than in the PEP 2002 and assumed to stabilise in nominal terms, but would decline relative to GDP because of further growth.

4.1. Real sector

On the demand side, investment and private consumption are projected to contribute most to economic growth over the period. Growth in government consumption would lag behind GDP growth by 2 percentage points on average, leading to a decrease in the share of government in the economy. Net exports would have a negative contribution to growth in 2003 and a marginally positive contribution in subsequent years. On the supply side, the industry sector (including construction) is expected to keep its share in

gross value added of about 29%, while the agricultural sector and the service sector would keep their shares of 11.5 and about 60% respectively. Labour market trends are projected to continue and to bring down unemployment to a rate of around 14% in 2006. For real wage growth, which was above productivity in 2002 and could again be so in 2003, the assumption is that they move closely together in the years 2004 to 2006.

4.2. Inflation

The biggest projected contribution to inflation in Bulgaria arises from increases in administered prices (such as for household electricity) in the order of 2.3 percentage points (2004), 1.2 percentage points (2005) and 2.0 percentage points (2006). Given that most of the excise duty rates now effective in Bulgaria are lower than the EU minimum rates, an overall contribution to the consumer price inflation of 0.4 percentage point in 2003 and 2005, 1.0 percentage point in 2004 and 0.9 percentage point in 2006 is estimated. On the basis of these estimates, the scenario assumes that consumer price inflation will remain below the rate of 4.2% reached in 2004.

4.3. Monetary and exchange rate policy

The Bulgarian authorities are maintaining a currency board arrangement under which the Bulgarian currency has been fixed to the single European currency (EUR 1 = BGN 1.95583) and where money supply is driven by demand. No change to this system is foreseen by the PEP. The remonetisation of the economy is projected to continue with an increase in money supply and foreign reserves. The positive trends in the financial sector recorded over the last years are expected to continue.

4.4. External sector

Export and import projections are based on the assumption of a rebound of growth in the world economy in 2003. Growth rates of merchandise trade are projected in a corridor of about 4% to 8% per year. The current account deficit is assumed to remain in a band between EUR 800 and 900 million and therefore to decline gradually relative to GDP from 4.5% (2003) to 3.8% (2006). A current account deficit of this order of magnitude might indeed be necessary to finance an investment-to-GDP ratio of above 20%, in spite of an assumed increase in domestic saving, and would be higher if fiscal policy were to become looser. In view of the current account data for the first half of 2003, the projected current account deficit for 2003 of 4.5% of GDP might prove to be rather optimistic. Net inflows of FDI are expected to exceed the current account deficit again in the coming years, reaching over EUR 1 billion in 2006.

5. PUBLIC FINANCE

The public finance scenario of the PEP 2003 reflects the government's awareness of the importance of a prudent fiscal policy in a currency board arrangement. The government is aiming to reduce the tax burden through a decline of the expenditure-to-GDP ratio by more than 3 percentage points until 2006. In order to reduce public debt as well as to avoid any substantial widening of the current account deficit, it is targeting a small general government (cash) deficit between 0.6% and 0.8% of GDP and a balanced budget in 2006, one year later than envisaged in the PEP 2002. However, the projection

for the year 2006 needs to be seen in the perspective that it is beyond the current parliamentary period. Possible fiscal risks arising from differences in interest and exchange rates from those assumed in the programme are expected to be limited by several safety buffers built into the budget.

5.1. The medium-term fiscal framework

On the revenue side, the main objectives are to reduce the tax burden (from 38.6% of GDP in 2003 to 36.1% of GDP in 2006), to stimulate investment and to improve tax collection. There is a gradual shift of taxation from income towards consumption which is introduced through a reduction of the profit tax rate from 23.5% in 2003 and 22% in 2004 to 20% in 2005 while several rates of excise duties will increase in line with commitments in the accession negotiations. Social security, in particular healthcare, is planned to increasingly have to rely on contributions from beneficiaries rather than on allocations from the central budget. Non-tax revenues will see a decline from 6.9% of GDP in 2003 to 4.9% of GDP in 2006 since a major part is related to dividends or privatisation revenues of state-owned enterprises and the privatisation process is scheduled to be finalised in 2005.

Table 2: Fiscal development
(general government, % of GDP)

		PEP framework			
	2002	2003	2004	2005	2006
Receipts	38.7	38.6	37.5	37.1	36.1
Expenditures	39.4	39.4	38.2	37.7	36.1
Net lending	-0.7	-0.8	-0.7	-0.6	0.0
- Cyclically adj.	n/a	n/a	n/a	n/a	n/a
Primary balance	1.5	1.5	1.7	2.1	2.8
Gross debt level	56.2	50.5	45.8	42.7	39.0

Source: PEP, if not otherwise indicated

General government expenditure is envisaged to decline from 39.4% of GDP in 2003 to 36.1% of GDP in 2006. This would be achieved by minor reductions (relative to GDP) in almost all budget items of current non-interest expenditure. However, capital expenditure, which will be partly spent for the co-financing of EU pre-accession funds, is foreseen to remain at about 3.5% of GDP. The main structural change is the shift of hospital funding from the tax-based budget of the Ministry of Health Care to the contribution-based National Health Insurance Fund by 2005. Subsidies are programmed to come down to 0.8% of GDP. Interest expenditure relative to GDP is expected to see an increase of 0.5 percentage point mostly due to the assumption of rising interest rates over the next years. A reserve for allocation increasing from 1.2% of GDP in 2004 to 2.6% of GDP in 2006 is foreseen which gives room for manoeuvre in the context of the three-year programmatic budget framework, which is expressed in constant prices, to cover the differences to the amounts in current prices in the respective budget year.

Compared to the PEP 2002, the target of a balanced budget has been postponed to 2006 and results in a higher deficit of 0.1 percentage point in 2003, 0.2 percentage point in 2004 and 0.6 percentage point in 2005. While the direct economic impact of these changes will be limited, also in view of the built-in flexibility of the budget (see below

under 4.4), there could be a problem of credibility of the medium-term fiscal framework for two reasons. First, it could be perceived as a rule that the balance will always be targeted in the last year of the PEP period, i.e. never be achieved. Second, the year 2006 could be the first full budget year of the new parliament which might feel less bound by this commitment than if the balance had already been achieved in 2005. Due to the lack of a reliable model, no information on the cyclically adjusted deficit is given in the PEP.

For the year 2003, the deficit target of –0.8% is no longer adequate for latest developments and a revision towards a lower deficit or a surplus should be made. A high cash surplus of about 1.8% of projected GDP has accumulated in the first half of 2003 due to revenue overperformance. Hence, the deficit target of –0.8% of GDP for the full year 2003 would imply a substantial fiscal loosening in the second half of 2003, which could trigger a further widening of the already high current account deficit of 5.2% of projected GDP in the first half of the year.

Some modifications in the budget procedure have been introduced in 2003, aiming at more flexibility, efficiency and decentralisation of public spending. As in 2002, the programmatic budgeting approach giving more responsibilities to the line ministries has been further improved and extended. In this context, although not legally binding in a strict sense, the budget 2004 went along with the first three-year budget framework 2004-2006, thus covering the period of the current PEP. Furthermore, the division of tasks between central and local level and their financing has been further clarified.

5.2. Public debt management

The gross debt level of general government (excluding social security and municipalities) has declined to 56.2% of GDP in 2002. This is the result of several factors, among which are strong nominal GDP growth, a primary surplus of 1.5% of GDP, active debt management, privatisation receipts as well as the USD depreciation. It is targeted to decline further to 39% of GDP in 2006 assuming trends to continue with the exceptions of no further effect from exchange rate changes, of an increase in interest rates, and of diminishing privatisation receipts.

To ensure long-run sustainability of public debt, a Government Debt Act has been adopted in September 2002, which defines rules on ceilings and accounting of public debt. This Act also stipulates to define a three-year debt management strategy, which the government adopted in March 2003 and which is to be updated annually. The strategy aims at continuing an active debt management with the objective of reducing risks by gradually shifting from foreign debt denominated in USD towards a denomination in EUR, from short-term to longer-term maturities, from floating into fixed interest rate bonds and from foreign to domestic financing. The latter objective is also pursued in order to bring more savings instruments and liquidity into the domestic capital market. The share of USD denominated debt in total public debt has been brought down to about 50%, and the share of debt with floating interest rates to below 60%.

5.3. Deficit financing

In line with the debt strategy, and with the exception of 2004 when a major loan from the World Bank is expected, external financing of the deficit is foreseen to be negative. Domestic financing will run positive at about 0.7% and 1.0% of GDP in 2005 and 2006.

Revenues from privatisation are expected to become negligible for the financing of the deficit after 2004, but in view of the delays in privatisation in the past it remains to be seen whether this is a realistic assumption.

5.4. Fiscal risks

External risks arising from interest rates, exchange rates, inflation and foreign demand are discussed in the PEP. It is concluded that each of them individually are manageable and that the more serious risk of all of these factors occurring at the same time is rather unlikely, such as for example a simultaneous rise in international interest rates and a slump in foreign demand. With a view to government debt, the changes in its level and structure should indeed have reduced the possible impact of these risks considerably. While no quantification of the magnitude of risks is presented, the PEP is pointing to the risk-reducing effects of three budget buffers which give fiscal policy some flexibility to react to unforeseen events: First, there is a contingency reserve of 0.1% of GDP for natural disasters and of about 0.5% of GDP for structural reforms. Second, an "88%-rule" is applied according to which discretionary spending is limited to 88% of the annual budget in the first three quarters and the rest is only spent if the budget is running according to plan. Third, there is a fiscal reserve account of currently more than 12% of GDP most of which is held at the central bank and only to be used in exceptional cases; limits and purpose of its use will be defined in each year's budget law. Regarding the fiscal reserve account and in the light of on-going discussions about its use, the PEP could have been an occasion to further elaborate on its medium-term orientation.

6. STRUCTURAL REFORMS

The Programme acknowledges fully that the process of structural reforms needs to continue to complement the macroeconomic conditions for high growth and sound public finance. More flexible markets will increase the capacity to adjust in an economy, where the nominal exchange rate is not available to adjust to external shocks, and to improve and maintain competitiveness. The PEP mentions as key priorities of structural reforms the privatisation and restructuring of state-owned enterprises including the network monopolies, the development of the non-banking financial sector, the reduction of unemployment, the modernisation of public administration, land consolidation, and the reduction of subsidies to the pension and healthcare systems. The matrix of policy commitments indicates the intention to conclude most of the reforms in the social security system by 2004 and to phase out subsidies to the energy sector, to the transport sector and to tobacco growers by 2005. Social security and the pension fund will continue to receive subsidies from the central budget until the end of the PEP period.

6.1. The enterprise sector

Laws and implementing procedures and bodies in competition policy are to be brought into line with the *acquis communautaire* in the areas of state aid and anti-trust policies. The PEP explains that privatisation has progressed more slowly than planned, in particular for the telecom and the tobacco monopolies, so that the finalisation of the privatisation process is only expected for 2005. In the financial sector, privatisation has

been completed in October 2003 with the sale of the last major bank. For 2003, the sale of 145 shares of enterprises, 60 detached parts and 900 minority shares of already privatised companies is planned, with expected revenues of EUR 280 million (excluding the telecom and tobacco companies). In line with the energy strategy adopted in 2002, a draft energy law is currently under discussion in the Parliament, which is to gradually liberalise the energy market in line with EU directives until 2007. A three-year schedule to achieve cost recovery levels of household electricity prices and district heating prices until 2005 is on track. The privatisation of the 7 electricity distribution companies is under preparation with the aim of finalisation in 2004. Transport infrastructure is being developed according to the National Economic Development Plan (NEDP) 2000-2006. The most important restructuring objectives in the transport sector are the granting of concession for ports, the financial independence of the railway services operator by 2005, the privatisation of the new national air carrier and the introduction of a road pricing system at the beginning of 2004. In the telecommunication sector, the fixed-line monopoly expired at the end of 2002 but has not yet attracted substantial interest of competitors due to the pending adoption of the regulatory framework. The digitalisation of the fixed-line network is planned to reach 46% of all subscribers at the end of 2005 compared to 25% at the end of 2002. Tourism continues to be among the fastest growing industries in Bulgaria and the government's strategy aims, among others, at the diversification towards higher quality and other forms of tourism than those at the Black Sea.

6.2. The financial sector

Following the privatisation of the second-largest bank in 2003, 97% of the bank assets are privatised and over 80% of them are foreign-owned. There is progress of the banking sector's role in financial intermediation brought about by strong growth in deposits and credit, while this development is so far not accompanied by a significant deterioration of credit performance. A new real time gross settlement system has started operating in June 2003. The programme does not give any detailed indications as regards further development and policies applying to the banking sector except for the general assumption of "maintaining the 3-year sustained growth trend in lending to the private sector" (p.29). However, growth rates of bank lending of 40% and more year-on-year are unlikely to be sustainable over several years and will require close supervision.

In the non-banking sector, pension funds were growing rapidly by 78% year-on-year until the end of 2002 and the PEP expects the trend to continue in the next years. Insurance companies are also expanding, with gross premium income increasing from 1.61% of GDP by end-2001 to 1.90% of GDP by end-2002. The strong growth of life insurance in 2002 of 70% is not expected to continue in 2003 due to changes in tax incentives, but would resume in subsequent years. Non-life insurance is projected to maintain its current growth rates of annually 15% to 20%. The stock exchange is expected to grow strongly in terms of capitalisation and turnover in 2003 and 2004, mostly as a result of privatisation, but also of direct corporate financing. Since January 2003, the financial sector is obliged to apply the international accounting standards. Financial supervision, with the exception of banking supervision remaining with the central bank, has been merged from sector-specific bodies into a single, independent body. As regards the insurance sector, the programme foresees the full harmonisation with the acquis by 2005.

6.3. The labour market

The PEP labour market projection assumes working-age population (aged 15 years and over) and participation rate to remain broadly stable in spite of a decline in population of –0.4% per year. Although public sector employment is set to shrink by more than 6% per year, overall employment is expected to increase by somewhat over 1% per year. The unemployment rate (ILO definition) is projected to continue falling from 15.9% in 2003 to 14.0% in 2006. Real wages increase faster than labour productivity in 2002 and 2003 but are expected to run in parallel from 2004 to 2006. The positive labour market developments are not only expected to come from net job creation in the private sector in spite of on-going restructuring, but also from substantial active labour market policies involving expenditure of EUR 155 million in 2003 and EUR 104 million per year from 2004 to 2006. However, no indications are given in the PEP of plans how to further increase the flexibility of the fairly rigid formal labour market which could speed up the reduction of the rather high unemployment over the medium term.

6.4. Administrative reform

The government's strategy for the modernisation of public administration over the period 2002 to 2005 is gradually implemented. In order to reinforce the capacity of the public service, preparations are under way to introduce open competitions and appraisal-based promotion as well as more systematic training. A law coming into force in December 2003 is to reduce administrative barriers to business by limiting the use of licensing regimes. E-government and one-stop shops will be used to improve administrative procedures. Co-ordination mechanisms have been introduced to ensure the fulfilment of obligations for EU membership. Several measures of the anti-corruption strategy have already been implemented.

6.5. Agriculture

The high fragmentation of land ownership continues to be a main reason for the low productivity in the agricultural sector. Although varying by regions and their main products of cultivation, land consolidation is not progressing significantly because of expected low profits in agriculture and low land prices which goes along with a scattered ownership and its documentation, implying high costs of land transactions. In 2002, there was a 13% increase in the number of land transactions which covered 40% less surface than one year earlier and points to the higher importance of transactions in small land plots. On the other hand, the number of land lease contracts doubled in 2002. The government is preparing measures to support land consolidation and a project to create an electronic unified land registry and cadastre database is continuing. SAPARD funding is playing an increasing role in supporting investment in agriculture and rural development.

6.6. Additional reform areas

The three-pillar pension system is gradually developing. The first pillar is expected to remain in deficit until 2006, and a surplus is only envisaged for 2007/2008. This is in spite of a number of expected positive developments between 2002 and 2006, including a slight decrease of the dependency ratio from 102% to 97%, a decline in the replacement rate from 38% to 37% and a higher contribution compliance from 87% to

88%. The PEP notes that these developments are still insufficient to offset the expected higher expenditure arising from a larger number of pensions and an increase in the average pension benefit.

The reform of the healthcare system has advanced less than planned. The biggest fiscal drain is the over-capacity in hospitals which have 637 hospital beds per 100,000 inhabitants, compared to an EU average of 410, and an average bed occupancy rate of 55%. In 2002, the shift of financial responsibility to the National Health Insurance Fund through a process of accreditation of hospitals has brought about a reduction of beds by 12.7% and of staff by 6%. Due to the delay in reform, the healthcare sector is expected to continue requiring subsidies from the central budget until 2005.

Further reforms mentioned in the PEP are on the judiciary, education and science, regional development, environmental protection and culture.

7. INSTITUTIONAL AND ANALYTICAL CAPACITY

The PEP has been prepared by the Agency for Economic Analysis and Forecasting (AEAF), which is part of the Ministry of Finance, and has been approved by the government on 7 August 2003.[29] The AEAF was also responsible for preparing the updated National Economic Development Plan 2000-2006 which the government adopted in June 2003 to provide a strategy for the use of EU pre-accession funds. Both programmes are fully covering the pre-accession period and special emphasis has been given to their mutual consistency. The PEP is also broadly consistent with the multi-annual budget 2004-2006 as adopted by the government in July 2003. Furthermore, the PEP's orientation corresponds largely to economic policy commitments undertaken in the context of the IMF Stand-by-Arrangement.

As in the PEP 2002, the macroeconomic scenario seems to be in itself consistent since it has been designed on the basis of a model containing major macroeconomic identities and functions. Balance of payments forecasts are used as a point of departure in the model's design. No indication is given of the country's cyclical position because the authorities do not yet dispose of a model to reliably estimate the output gap. A scenario for the long-term sustainability of public finances until 2050, which was requested in the Commission's outline for the PEP 2003, has not been included either.

The indicators of general government debt and deficit for 2002 and 2003 roughly correspond to those submitted in the context of the fiscal notification in April 2003. However, this also implies that they are not yet in full compliance with ESA95 methodology, the main differences being that data are reported on a cash basis instead of an accrual basis and that municipalities and social security are not included in the debt figures. This situation is planned to be changed in the near future.

[29] The document is available at the AEAF's website (http://www.aeaf.minfin.bg)

ROMANIA

PRE-ACCESSION ECONOMIC PROGRAMME 2003

ASSESSMENT

1. OVERALL SUMMARY AND ASSESSMENT

The 2003 Pre-accession Economic Programme (PEP) provides an adequate illustration of past economic trends. Its presentation of planned policy developments appears consistent with that of the other policy documents setting out Romania's priorities on the road to accession. The 2003 document broadly restates most of the macroeconomic projections and policy targets of the 2002 update. There are, however, two notable exceptions. First of all, reflecting ongoing trends, GDP growth is projected to be slightly lower, this year, and more unbalanced throughout the period with a negative contribution from net exports. Rather than declining as under the 2002 framework, the current account deficit is therefore projected to rise, albeit only gently from 2004 onwards. Secondly, the authorities now plan to target a larger fiscal deficit as of next year so as to allow for a temporary increase in expenditures while preserving the goal of reducing the tax burden. Higher outlays, mostly in the form of transfers, are seen as instrumental in completing the authorities' reform agenda as presented in previous submission and broadly restated in the 2003 document. Intending to restructure and privatise public enterprises, improve the business environment and increase investment in human, infrastructural and institutional capital, the planned reforms aim at completing Romania's transition to a functioning market economy capable of coping with competitive pressures and market forces within the European Union.

Under the 2003 PEP framework, a larger fiscal deficit than previously envisaged would neither cause any further significant deterioration in the external accounts nor impair the achievement of the (unchanged) inflation targets thanks to the planned parallel reduction in the quasi-fiscal deficit. The arguments supporting this view, however, are less than fully convincing. This is so because the macroeconomic framework, in fact, seems to underestimate the extent and causes of the ongoing external deterioration. Moreover, despite the provision of seemingly consistent saving and investment balances at the sectoral level and a more open acknowledgement of the linkages between different policy areas, there is still only a very limited quantified analysis of quasi-fiscal issues and planned policy measures. This impairs a comprehensive assessment of the proposed macroeconomic stance.

2. JOINT MINISTERIAL CONCLUSIONS

The Economic and Finance ministers of the EU and of the acceding and candidate countries Ministers approved at their meeting of 4 November 2003 the following Joint Conclusions:

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Romania

- The macroeconomic performance in 2002 with high growth, falling inflation, a decrease in the current account deficit and a moderate government deficit was welcomed. The PEP in general restates the macroeconomic projections and policy

targets of the 2002 programme. However, reflecting ongoing trends, GDP growth for this year is projected to be slightly lower (4.8%) than previously envisaged and less balanced. In contrast to the 2002 PEP, the negative contribution of net exports to growth will imply a widening of the current account deficit. Moreover, the authorities now target a larger government deficit in 2004 so as to allow for a temporary increase in expenditures while preserving the goal of reducing the tax burden.

- The macroeconomic framework is, also in the light of the progress achieved so far, broadly in line with recent economic trends in the country and abroad. However, it should more clearly pay attention to the extent and causes of the ongoing deterioration of the external accounts. Additionally, a larger fiscal deficit might also cause further widening in the external accounts.
- The recent successful disinflation has been welcomed, although the level of inflation is still too high. The authorities' fiscal policy has been supportive in bringing down inflation, but may be less so as of next year when the government deficit is targeted to increase. Furthermore, the recent considerable wage increases might also pose some risk for bringing inflation down further. A further clarification of the current and future framework of monetary and exchange rate policy would be appreciated, especially since the authorities envisage a change of monetary policy towards inflation targeting from 2005 onwards, with an envisaged transition towards a free floating regime of the currency from 2005/2006.
- The PEP is yet to illustrate the full picture of the state of enterprise reforms. It would have benefited from more complete information and an attempt to quantify the impact of planned reforms on issues such as the quasi-fiscal deficit and the volume of arrears. This still needs to be developed. The PEP properly identifies the accumulation of arrears as an important budgetary risk factor, but this is not analysed for its macro-economic impact.

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3. Recent economic developments

Economic recovery entered its fourth year as GDP continued to expand at a sustained pace on the back of accelerating domestic demand. Annual real growth totalled 4.9% in 2002 and 4.4% in the first quarter of 2003. Household consumption growth slowed down to 3% in 2002 but rose to 3.8% in the first quarter of 2003 on the back of booming household credit and sharply accelerating wages, up 9.6% in real net terms in the first quarter of 2003 relative to the same period in 2002. Increasing capital accumulation by the private sector supported investment spending which increased by 8.3% over 2002 and 6.8% in the first quarter of 2003. Contrary to the first two years of the current upswing, since 2002, stock accumulation did not support growth while net exports did. Despite the slowdown in the EU markets, in fact, Romanian exports expanded at an accelerating pace with annual growth equalling 17.6% in the first quarter of 2003. Import growth was relatively lower but picked up over the first quarter of 2003 when it totalled 15%. As a result, the current account deficit began widening again in 2003 after dropping sharply to 3.4% of GDP in 2002. Disinflation, on the other hand, continued in 2003 after progressing more than expected in 2002. Unemployment remained at single-digit levels but methodological changes in its measurement make it difficult to identify the underlying trends.

As in the 2002 update, the presentation of recent economic developments is illustrative but focuses almost exclusively on the real side of the economy. The little attention paid to trends in monetary variables, wages and arrears is reflected in the authorities' sanguine assessment of trends over the first quarter of 2003 when, the demand pressures caused by sharply rising real wages and expanding credit to the private sector began to surface.

Table 1: Economic development

		PEP framework			
	2002	2003	2004	2005	2006
GDP growth at constant market prices	4.9	4.8	5.6	5.2	5.1
Contribution to GDP growth:					
- Final domestic demand	4.2	5.3	6.0	5.6	5.3
- Change in inventories and net acquisition of valuables	0.0	0.2	0.0	-0.1	0.0
- External balance of goods and services	0.7	-0.7	-0.4	-0.3	-0.2
Investment ratio (% of GDP)	21.1	22.5	23.8	24.5	25.3
GDP per head (PPS, % of EU average) (1)	25.0	25.9	26.7	27.4	28.1
Participation rate (% of 15-64 age group)	47.1	45.5	45.9	46.1	46.4
Unemployment rate (ILO definition)	8.4	7.9	7.6	7.1	6.8
Employment growth	-	-	0.7	0.6	0.5
Labour productivity growth	-	-	4.9	4.6	4.6
Average real wage growth	4.5	4.6	4.6	4.3	4.3
CPI inflation (annual average)	22.5	15.2	11.5	8.0	6.0
Exchange rate vis-à-vis EUR (percentage change of annual average)	20.2	19.7	7.2	2.5	2.9
Current account balance (% of GDP)	-3.4	-4.2	-4.4	-4.5	-4.6
Net foreign direct investment (% of GDP)	2.4	2.9	3.2	3.0	2.9
Foreign debt (% of GDP)	30.0	32.7	32.7	32.1	32.3

Source: PEP, if not otherwise indicated
(1) calculated, without demographic or price effects; growth rates: candidate countries: PEPs / EU: 2003-04: Spring 2003 COM forecast; thereafter same as in 2004

4. MEDIUM-TERM MACROECONOMIC FRAMEWORK

Contrary to past submissions, only one framework is presented but this does not affect the depth of the analysis. As in 2002, the Romanian document provides a full set of standardised tables including those on cyclical and long-term budgetary developments. The underlying assumptions and main results of the latter tables, however, are only sketchily discussed. The external assumptions underpinning the macroeconomic framework are not presented explicitly in table 7 but reportedly take into account the Spring Commission forecast as well as other international institutions' projections of global economic trends. While two different fiscal frameworks are illustrated within the same macroeconomic scenario, the "alternative" fiscal plan is described in only the broadest of terms, making it difficult to formulate a comparative assessment.

The macroeconomic framework does not differ substantially from that presented in the 2002 update with the exception of the projected evolution of the external and fiscal accounts. Annual GDP growth is still projected to remain close or above 5%. Contrary

to last year' submission, however, the economic expansion would be fully pulled by domestic demand as net exports' contribution to growth is projected to remain negative throughout the period. After dropping sharply in 2002, the current account is now projected to widen until 2006. However, despite a planned loosening in the fiscal stance, the external deterioration would remain moderate thanks to a planned reduction in the quasi-fiscal deficit.

4.1. Real sector

The pace of economic growth is projected to remain sustained throughout the period, as already was the case in the 2002 submission. Under the 2003 framework, however, net export would not contribute to growth that would be exclusively driven by domestic demand. The pace of economic expansion would accelerate in 2004 on the back of increasing gross fixed capital formation and household consumption before dropping off slightly in 2005 and 2006 as the envisaged investment boom moderates. Net export's contribution to growth would remain negative throughout the period but increasingly less so as export are projected to rise faster than import from 2004 onwards.

Reflecting the excessively sanguine projections of the 2002 framework and less favourable international trends, these revisions are broadly appropriate but possibly too timid, especially in view of the latest statistical evidence. The PEP projects household consumption to increase at a pace lower than real wages and these would themselves rise less than GDP. These assumptions, however, are not supported by on-going trends. In the second quarter of 2003, GDP grew 4.2% year-on-year, private consumption 7.4% and real net wages 8.3%. As a result, contrary to what envisaged by the PEP, imports have been growing much faster than exports in the second quarter of 2003 (respectively at 12.1% and 5.4% year-on-year). Both in the immediate and more distant future, therefore growth could easily be less balanced than projected by the PEP framework. While this risk is flagged in the text, the quantified estimates offered are rather unclear.

Estimating potential output for the first time, the 2003 PEP envisages actual GDP to expand at a pace just below that of potential GDP. While this estimation is a welcomed improvement relative to previous submissions, a more detailed discussion of the underlying assumptions and calculations would have been helpful.

As in the 2002 submission, labour productivity is projected to increase slightly less than both GDP and wages in real terms. Although a higher reduction in public sector employment is envisaged compared to last year's plans, the rate of unemployment is still projected to decrease throughout the period thanks to increasing private sector employment. The latter assumption, however, is hard to assess in view of the significant revisions in statistical indicators that de facto impair the analysis of recent labour market trends. Nevertheless, projecting a declining unemployment rate could well prove to be excessively optimistic in view of the assumed finalisation of structural reforms and the existence of large pockets of underemployment, notably in the agricultural sector.

4.2. Inflation

Although inflation fell more than targeted in 2002, the inflation target for 2003 was only marginally reduced and those for the following years kept unchanged. This caution

reflects the monetary authorities' desire to consolidate their reputation for meeting disinflation goals as well as their concerns regarding the remaining sources of inflationary pressures. In particular, the text acknowledges that further improvements in corporate governance and enterprise financial discipline are need to the issues of arrears accumulations and faster-than productivity wage rises. In future submissions, a more quantified discussion of the factors underlying the envisaged disinflation path would be useful.

4.3. Monetary and exchange rate policy

The monetary policy framework has remained unchanged with the National Bank of Romania continuing to intervene to keep the exchange rate on a path consistent with the inflation target while allowing for a real appreciation against the authorities' euro-dollar basket deemed compatible with a sustainable current account position. As clearly explained in the text, however, the authorities reduced the frequency, of foreign exchange market interventions while increasing their size, increasingly targeted interest rates rather than monetary aggregated, and further adjusted the array of monetary instrument at their disposal. In the future, the authorities plan to continue implementing their strategy as laid out in previous versions of the PEP. The introduction of an inflation-targeting regime is, however, pushed backwards another year to 2005. The authorities also plan to move to a free-floating exchange rate regime as the capital account is gradually liberalised. However, no exact details about the stages through which these changes would take place are provided. Also, while the text claims that interest rate changes will continue to validate, rather than anticipate, the downward trend in inflation, it also states that the authorities' disinflation policy will increasingly rely on the interest rate instrument. Finally, the reasons underlying recent hikes in the discount rate would have been worth discussing.

4.4. External sector

Contrary to the 2002 submission, the updated macroeconomic framework envisages a worsening trend in the current account deficit. After a step increase in 2003, however, the latter would widen only marginally and remain below 5% of GDP throughout the period. A wider trade deficit as of 2003 and a projected decline in transfers from abroad as a percentage of GDP would be the main factors underlying the overall external deterioration between 2002 and 2006. Representing the main difference to the external projections presented in the 2002 PEP, the sharp upward revision in the trade deficit reflects the considerable optimism underlying last year's forecast, the exogenous worsening of external prospects, and the current pick in domestic demand on the back of rising wages and booming credit. Ongoing trends suggest that the pace of the deterioration may be faster than projected under the PEP framework. Contrary to last year, EU transfers are now more appropriately projected to increase throughout the period, albeit not rapidly enough to have a positive impact on the current account balance in percentage of GDP[30]. Moreover, at some 0.8% of GDP, the significant shortfall between projected and actual EU transfers in 2002 highlights the importance of increasing Romania's absorption capacity so as to effectively take advantage of EU funds as a means to support the balance of payment.

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[30] Private transfers are fixed in nominal value, a prudent assumption justified by the difficulty of reliably projecting trends in workers' remittances.

The 2003 PEP usefully presents the sectoral saving and investment balances underpinning the projected evolution of the current account deficit. According to the data presented, increasing private sector investment would largely drive the expected deterioration in 2003. On the contrary, in 2004, a sharp rise in private domestic savings would almost fully finance the planned worsening in public sector net savings and a renewed increase in the private sector investment rate. The PEP, however, provides no detailed exposition of the reasons why 2004 should witness such a sharp rise in private domestic savings. As a matter of fact, ongoing trends suggest the latter might be falling short of the projected level already in the current year. A larger resort to foreign savings than envisaged under the PEP framework may therefore be required.

Given the PEP's current account deficit projections and the assumption that foreign direct investment flows would remain in the vicinity of 3% of GDP throughout the period, the foreign debt-to-GDP ratio is projected to remain nearly stable, after increasing to 32.7% in 2003. While still relatively low, such a level would be some 5% points of GDP higher than what targeted under the 2002 PEP. Servicing costs as a percentage of export, however, would decline throughout the period.

5. PUBLIC FINANCE

5.1. The medium-term fiscal framework

The fiscal plans presented in the 2003 PEP differ significantly from those outlined in last year's contribution. The authorities no longer aim to reduce expenditures as percentage of GDP but rather plan to increase them temporarily during the 2003-05 period. The revenue-to-GDP ratio is still projected to fall but not as sharply as in last year's framework. As a result of these trends, a larger deficit is now projected from 2004 onwards. According to the 2003 update, increased expenditures are required to complete the reform efforts. Moreover, higher fiscal deficits would not affect macroeconomic stability thanks to a parallel planned reduction in the quasi-fiscal deficit. The text, however, fails to provide a detailed and fully convincing argumentation for both of these claims. An alternative scenario is also sketched but in too broad terms to allow an assessment.

With the exception of 2003, when total receipts are projected to increase moderately[31], the revenue-to-GDP ratio is projected to fall throughout the period. The evolution of individual components, however, is more differentiated. Tax receipts are projected to rise on the back of the increase in excise collection caused by the progressive implementation of the *acquis*. However, these gains are outweighed by lower non-tax receipts and declining social security contributions caused by further cuts in (high) contribution rates. The framework prudently abstracts from the gains in tax compliance that could arise from the ongoing implementation of various administrative measures to improve tax administration.[32] In 2003, for instance, a large tax-payers unit was created in Bucharest while, in 2004, the authorities intend to unify the collection, audit and enforcement of social security contributions. Finally, the planned introduction of a new Fiscal Code, as of 1 January 2004, is expected to simplify the fiscal legislation and advance the process of harmonisation with the *acquis*.

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[31] All measures are in terms of percentages of GDP.

[32] The alternative scenario, instead, envisages increased tax collections in the order of 1.5-to- 1.9 % of GDP by 2006.

Table 2: Fiscal development
(general government, % of GDP)

		PEP framework			
	2002	2003	2004	2005	2006
Receipts	36.4	37.0	36.7	35.7	35.3
Expenditures	38.6	39.5	39.9	38.9	38.5
Net lending	-2.2	-2.5	-3.2	-3.2	-3.2
- Cyclically adj.	-2.5	-2.4	-2.9	-3.5	-3.6
Primary balance	0.3	-0.6	-1.4	-1.5	-1.4
Gross debt level	22.7	22.3	22.7	24.2	25.1

Source: PEP, if not otherwise indicated

Contrary to what was planned under the 2002 PEP framework, the 2003 update argues in favour of higher medium term expenditures in order to: finance the one-time costs of completing reforms (compensation packages for laid-off workers in public enterprises, environmental requirements for mine closures etc.), increase investment in human and infrastructure capital, support the reform of the pension system. According to the figures presented in the framework, however, the increase in expenditure would be only temporary with outlays peaking in the electoral year of 2004 before dropping back to their 2002 level by 2006. Investment is planned to be only marginally higher, whereas social benefits in kind and other expenditures would significantly rise, presumably to finance one-off transfers required to advance the restructuring, privatisation and, possibly, closure of public enterprises. There is, however, neither a description of the exact measures planned nor a quantification of their budgetary costs. Similarly, there is little quantified description of the reform strategy for the pension system and the relevant policy matrix only highlights additional budgetary needs for the final stage of pension "recorrelation" and the planned doubling of farmers' pensions in 2004. The alternative scenario draws quite a different picture since cuts in subsidies and transfers would allow aggregate expenditures to decrease while allowing for a more marked increase in capital outlays. An expenditure reserve would also be created and activated only following the achievement some undefined reform benchmarks. Details about this scenario, however, are too sketchy to allow for it assessment.

As a result of the trends described above, the deficit measured on a GFS basis[33] would rise to 3.0% of GDP in 2004 and remain constant thereafter. During the period 2003-05, annual deficits would therefore be 0.6% of GDP wider than planned under the 2002 PEP framework. Over the same period, the worsening of the primary balance would be more significant, with an average deterioration of 1.7% of GDP relative to the 2002 targets. This loosening of fiscal policy relative to the 2002 plans is neither justified by lower growth nor by a more comfortable external situation since growth prospects are roughly unchanged and the current account deficit is widening. In addition, estimates of cyclically-adjusted balances show that the deficit would deteriorate from 2003 onwards, increasing from 2.4% of GDP in 2003 to 3.5% in 2006. This was not the case in the 2002 PEP although estimates of cyclically-adjusted balances were then only

[33] GFS data are used because the Commission services' assessment of the 2003 fiscal notification found that the ESA 95 data provided by Romania did not yet provide a reliable base for an accurate assessment of the budgetary situation and its immediate developments.

preliminary[34]. The authorities, however, argue that only a larger deficit could accommodate the need for higher expenditures. They also stress that this would not have a significant negative impact on the balance of payments because the advances in structural reforms made possible by higher outlays would lead to a parallel reduction in the quasi-fiscal deficit. This claim, however, cannot be verified as no details are provided on the calculations of the quasi-fiscal deficit and on the measures possibly leading to its reduction in the forthcoming years.

The 2003 PEP does, nevertheless, provide greater information on sectoral savings and investment balances and attempts to shed more light on the links between budgetary projections and structural reform implementation than was the case in 2002 document. These efforts, however, would greatly benefit from a clearer presentation of the underlying issues. Also, while the parallel presentation of GFS and ESA 95 figures is understandable in view of the need for further improvement in the quality of ESA 95 data, the text should more clearly specify which set of figures constitute the main reference for the analysis. Finally, the extent to which successive PEP submission actually provided a medium-term framework for fiscal policy is doubtful since deficit targets have been regularly revised.

5.2. Debt management

The gross debt level of general government has declined to 22.7% of GDP in 2002 as strong nominal GDP growth and falling interest payments more than counterbalanced the impact of other factors which tended to increase the debt ratio like the depreciation of the national currency. As a result of slowing nominal GDP growth and the envisaged deterioration in the primary balance, however, the declining trend in Romania's moderate general government debt-to-GDP ratio is projected to come to an end. By 2006, the gross debt is projected to rise to 25.1% of GDP. A more detailed analysis of the factors underlying this trend, however, is impaired by the fact that table 5 does not seem to have been compiled correctly.[35]

As in the previous submission, the Romanian document provides a fairly exhaustive illustration of the structure and maturity of public debt. Prospects for improved debt management have strengthened in 2003 with the establishment of a Treasury Management Unit within the Ministry of Finance. Further institutional measures in this area include the gradual elimination of guarantees on foreign loans to public companies and the inclusion under the state budget of all service payments for called guarantees. Over the coming period, debt management will aim at extending the average maturity of debt, most notably by establishing pricing benchmarks over a three-year maturity horizon for domestic paper.

5.3. Deficit financing

The authorities plan to continue their efforts to finance the deficit in a non-inflationary way. As in 2002, foreign borrowing will cover some 60% of the budget deficit while

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[34] The 2003 PEP, on the other hand, does not offer any discussion of the methodological issues underlying the more recent estimates.

[35] The sum of the items in line 4, 5, 6 and 7 for any given year does not equal the difference between the gross debt levels reported in line 1 for that given year and the previous.

domestic financing will rely on longer maturity instruments in an attempt to establish a longer yield curve and spread out servicing requirements. There is no discussion on the impact that this strategy will have on monetary targets.

5.4. Fiscal risks

The 2003 PEP correctly identifies the main fiscal risks. Apart from those already flagged in previous submissions, such as poor financial discipline in the enterprise sector, a variable and fairly high call rate for loan guarantees and the weak financial state of the public pension system, the 2003 update relevantly adds the possibility that the intended reduction in the quasi-fiscal stance may fail to materialise. This section could be further enriched by a discussion on the measures the authorities would be willing to take in case the risks identified were to be realised.

6. STRUCTURAL REFORMS

The PEP broadly restates the policy agenda presented in previous submission and provides an exhaustive review of recent policy measures.

6.1. Enterprise sector

The authorities continue to aim at fostering the development of a market economy capable of withstanding competitive forces within the European Union by restructuring and privatising most state-owned enterprises, strengthening competition policy, improving the business environment, supporting small and medium enterprises and increasing the attractiveness of Romanian assets for foreign investors.

The document extensively reviews the latest achievements in most of these areas and presents the authorities' medium-term goals. Privatisation has advanced further and some of the long-term targets set by the authorities are now within reach. Openly admitting the failings of past restructuring measures for several large loss-making public enterprises, the text stresses the importance of the layoffs implemented in 2003 within the framework of a newly established severance payment regime. The document also illustrates the steps taken towards the restructuring of the energy, mining and defence sectors. In the area of competition policy, ambitious harmonisation targets are set. An illustrative section describes planned and implemented measures aiming at improving the business environment, enhancing the functioning of the bankruptcy regime and supporting the development of small and medium enterprises.

As in past submissions, however, the document fails to draw a comprehensive picture of the state of reforms and avoids an in-depth analysis of the underlying obstacles and their proposed solution. Links between planned policy measures and projected macroeconomic trends are still sketched only in the broadest of terms and there is no quantified discussion on the impact of planned reforms on key issues such as the quasi-fiscal deficit and the accumulation of arrears.

6.2. Financial sector

As in previous submission, the 2003 update offers a very clear presentation of recent developments in both the banking and non-banking sectors. It also precisely sets out the short and medium term goals and instruments through which the authorities aim to foster the development of an efficient financial sector.

In the banking sector, for instance, prudential supervision is being brought up to international standards while being extended to credit co-operatives. Public ownership is being reduced and remaining state-owned banks restructured. An action plan for implementing the recommendations of a recent Peer Review was drawn up, accounting regulations are being harmonised and the interbank payment system modernised. Improved regulations and stronger supervision are also being established in the capital market and in the insurance sector.

6.3. Labour market

The update illustrates the latest developments and the planned goals of the authorities' strategy for fostering a decline in the rate of unemployment. Albeit informative, the text would have benefited from the analysis of the factors underlying unemployment in Romania. Also, no reference is made of the enactment of the new Labour Code in April 2003 and no assessment is made of its impact on labour markets mechanisms.

The text provides updated information on social security reforms. Although extensive financial details are provided, aggregate tables would have allowed a clearer presentation and laid the basis for explicitly linking this section to the budgetary trends projected under the macroeconomic framework. The section on the pension system seems to imply that the legislative framework for the introduction of a three pillars system will be prepared by end-2003. However, no details are provided and there are no estimates of the impact this would have on the sustainability of the pension system and on medium term budgetary trends (as in last year' submission, table 9 is provided but not discussed).

6.4. Administrative reforms

The document presents the main measures taken during the last twelve months within the framework of the authorities' strategy for administrative reforms. These included the restructuring of the government structure (and the reduction in the number of ministries from 22 to 14), the enactment of a series of legislative initiatives to strengthen the financial capability of local governments and the adoption of a law to increase transparency in the public administration. In the forthcoming years, the authorities intend to develop and implement a strategy for the reform of the civil service.

6.5. Agriculture

As in the previous submissions, the 2003 document describes the main trends in the agricultural and rural sectors before reporting updated information on the measures being planned by the authorities. Once again, however, there is little integration between this section and the macroeconomic framework despite the relevant weight of

the Romanian agricultural sector for output and labour market trends. This would have been particularly useful since under the macroeconomic framework the share of labour employed in the agricultural sector is projected to drop sharply from 36% in 2002 to 26% in 2006.

6.6. Additional reform areas

The 2003 document adds education to the additional reform areas already identified in previous submissions as key to the long-term development of the economy (namely infrastructure, transport, housing, environment protection, regional policy and the health system) The document illustrates recent developments in all of these areas and lays out the authorities' main policies and priorities. Costing estimates are provided in the matrix of policy commitments.

The update also illustrates the further steps taken to institutionalise the social dialogue. The 2003 PEP was itself a subject of the formal mechanisms through which the social dialogue takes place. As already announced in the 2002 document, future initiatives will aim at embedding the dialogue within a medium-term framework and better defining its scope by limiting it to issues related to the safety net measures accompanying restructuring and wage and employment policies.

7. INSTITUTIONAL AND ANALYTICAL CAPACITY

The Ministry of Development and Forecasting remained responsible for the PEP main drafting and co-ordination tasks until its disappearance in the context of the administrative reorganisation of the Romanian Government implemented in late June 2003. PEP-related responsibilities and dedicated staff were subsequently re-allocated to the National Commission for Forecasting, a newly formed body of the central public administration financed from the budget of the Government General Secretariat. These institutional changes do not seem to have impaired the preparation of the 2003 document that relied upon issue-specific contributions from all Ministries involved as well as from National Bank of Romania. As for previous versions, the macroeconomic framework was elaborated with the help of a locally developed econometric model and the Romanian version of the World Bank's RMSM-X model.

The PEP was discussed and approved by the government following consultation with the social partners. The final document follows quite closely the model outline. All standardised tables have been provided along with a rather detailed matrix of policy commitments. Further work is required on table 8 and 9 (cyclical developments and long-term sustainability of public finances) whose results could be better integrated in the main text. No figures were provided on external assumptions beyond 2004. The discussion on budgetary trends and plans relies, at times somewhat confusingly, on both GFS and ESA 95 figures. The latter are similar but not identical to those submitted in the 2003 fiscal notification exercise. No explanation for these differences is provided.

TURKEY

PRE-ACCESSION ECONOMIC PROGRAMME 2003

ASSESSMENT

1. OVERALL SUMMARY AND ASSESSMENT

The programme's key objectives during the period 2003-2006 are to strengthen macroeconomic stability and to increase the welfare of the society. Key priorities are to ensure a sustainable growth environment, to reduce inflation and to bring down government deficit and debt ratios to EU levels. Lowering regional differences is also considered to be important in the programme period. These measures are implemented with the perspective of fulfilling the Copenhagen criteria for EU membership.

The policy mix to achieve those targets strongly emphasises disinflation and fiscal sustainability. A strict fiscal approach is the main key to this end. Monetary and income policies are supposed to support the disinflation process. The floating exchange rate regime will be maintained. Structural reforms are designed to strengthen the economy and to improve competitiveness. Particular attention is devoted to privatisation, education and administrative reforms.

The new programme takes into account many of the points raised in the 2002 assessment and illustrates an improving technical and analytical capacities of the Turkish administration. The format and information provided in the programme is to a large extent in line with the requirements. Compared to last year, the current programme is more realistic with respect to the economic framework and fiscal targets.

Overall, the macroeconomic scenario is largely consistent and feasible. Compared to last year, the general picture is more cautious, assuming an only moderate growth contribution from private and public consumption. Similar to last year, the success of this economic scenario strongly depends on a significant improvement in the investment climate, declining real interest rates and continued market and consumer confidence. Access to external sources of finance appears to be of crucial importance for achieving the described growth pattern.

The discussion of fiscal issues gives a good summary on how the Turkish authorities intend to rebalance public finances and to maintain the fiscal sustainability. However, a more detailed presentation of expenditure and revenue categories would have been helpful. The achievement of the fiscal objectives relies to a large extent on maintaining a significant primary surplus and on benefiting from declining interest rates.

Structural reforms are centred on strengthening market forces, completing the reform of the financial sector and modernising public finances and public administration. Improving the quality of education and reforming the agricultural sector are further priorities. However, the degree of future policy commitment and the provision of quantitative data still are rather low, except in cases of projects with external financial and technical support. Like last year, a more elaborated discussion of policy trade-offs and policy interdependencies would have been useful.

2. JOINT MINISTERIAL CONCLUSIONS

The Economic and Finance ministers of the EU and of the acceding and candidate countries Ministers approved at their meeting of 4 November 2003 the following Joint Conclusions:

"….

Turkey

- The improvement of this year's programme was welcomed as it incorporates many of the suggestions made in the assessment of the 2002 PEP. It demonstrates the Turkish administration's improving technical and analytical capacities in preparing such a programme. Also the major achievements with reducing inflation and macroeconomic volatility have allowed the government to better provide for a more credible medium-term scenario and planning framework.
- The macroeconomic performance in 2002 with high growth, falling inflation and a moderate government deficit was welcomed.The macroeconomic scenario is, in contrast to last year's PEP, more realistic and broadly consistent with current and likely future trends, assuming a more moderate growth contribution from private and public consumption. The programme correctly stresses as key priorities to ensure a sustainable growth environment, to reduce inflation and to bring down the government deficit and debt ratios to sustainable levels. Full compliance with the IMF-programme is essential for the maintaining the confidence of markets, further lowering interest rate levels and ensuring the sustainability of the recovery.
- A strict fiscal approach is key to achieving these ends. The PEP offers a good overview of the Turkish authorities intentions to rebalance public finances and to achieve fiscal sustainability in the medium term. However, a more detailed presentation of expenditure and revenue categories in line with ESA 95 accounting standards would have been helpful.
- Structural reforms are centred on strengthening market forces, completing the reform of the financial sector and modernising public finances and public administration. Further progress is also needed in the area of privatisation of enterprises and, in the light of persisting high unemployment levels, reform of the labour market.

…."

3. RECENT ECONOMIC DEVELOPMENTS

The report presents a clear and concise picture of economic developments in 2001 and 2002. Concerning 2003, the document covers all relevant data available by early August. Compared to last year, the presented data is more detailed.

During 2001-2002, the Turkish economy experienced a sharp recession when real GDP declined by 7.5% in 2001 and a recovery with output growth by 7.8% in the following year. The decline had been a response to the financial crisis in February 2001. The switch to a freely floating exchange rate was accompanied by a marked depreciation of the Turkish lira, leading to a sharp increase in inflation and falling real disposable incomes. Furthermore, the costs of bailing out the banking sector had led to a marked increase in the fiscal burden. The recovery in 2002 was mainly driven by exports and

restocking, while domestic demand remained weak. In the first quarter of 2003, the recovery continued to be mainly based on those two components. However, indicators such as industrial output and capacity utilisation pointed towards a broadening of the recovery.

Table 1: Economic development

		PEP framework			
	2002	2003	2004	2005	2006
GDP growth at constant market prices	7.8	5.3	5.1	5.1	5.1
Contribution to GDP growth:					
- Final domestic demand	1.7	7.2	5.6	5.8	4.9
- Change in inventories and net acquisition of valuables	7.0	-0.4	-1.7	-1.6	-0.7
- External balance of goods and services	-0.9	-1.5	1.2	0.9	0.9
Investment ratio (% of GDP)	21.3	22.2	22.4	22.9	23.3
GDP per head (PPS, % of EU average) (1)	23.0	23.9	24.5	25.2	25.8
Participation rate (% of 15-64 age group)	49.6	50.2	50.4	50.6	50.8
Unemployment rate (ILO definition)	10.3	11.4	10.4	10.0	9.6
Employment growth	-0.8	1.4	3.3	2.6	2.7
Labour productivity growth	8.1	3.8	1.7	2.4	2.3
Average real wage growth	-14.2	n/a	n/a	n/a	n/a
CPI inflation (annual average)	45.0	26.8	14.4	9.8	6.2
Exchange rate vis-à-vis EUR (percentage change of annual average)	29.7	17.5	12.1	9.4	7.1
Current account balance (% of GDP)	-0.8	-3.2	-2.7	-1.9	-1.2
Net foreign direct investment (% of GDP)	0.5	0.8	0.6	0.7	0.8
Foreign debt (% of GDP)	72.4	59.8	59.2	56.1	53.7

Source: PEP, if not otherwise indicated

(1) calculated, without demographic or price effects; growth rates: candidate countries: PEPs / EU: 2003-04: Spring 2003 COM forecast; thereafter same as in 2004

After the sharp rise in 2001, inflationary pressures declined during the remaining period. Important factors for this development were weak domestic demand and a strong exchange rate. Furthermore, moderate public sector wage agreements helped to strengthen credibility of the government's disinflation programme.

Labour markets continued to be affected by the economic crisis. Unemployment increased from 8.4% in 2001 to 10.4% in 2002, while employment declined by 0.3% and 0.8% in 2001 and 2002, respectively. Rural unemployment rates remained significantly lower than in urban areas, largely due to the widespread practise of unpaid family workers in agricultural areas.

The current account turned from a surplus of 2.3% of GDP in 2001 into a deficit of 0.8% of GDP in 2002, reflecting the acceleration of economic activity and the high import content of exports and restocking. In 2003, the external balance continued to deteriorate. Despite a strengthening of the exchange rate, Turkish exports managed to increase their market share and to raise their share of higher value added commodities in total exports. Tourism revenues reached a record high in 2002 but suffered from the looming Iraq crisis in early 2003.

A strict monetary policy has been an important tool in the disinflation process, using base money as a key monetary anchor. During 2001-2002, the Central Bank could improve its reputation as an independent institution with the primary objective of achieving and maintaining price stability. The increased confidence of market participants supported the strengthening of the Turkish currency and allowed to gradually reduce benchmark interest rates. Furthermore, efforts have been undertaken to reduce the costs of banking intermediation and to diversify the financial instruments available. The Central Bank maintained the free floating exchange rate regime and limited its interventions to the smoothening of sharp fluctuations. Furthermore, it used the strength of the Turkish currency to increase its foreign exchange reserves.

Public finances improved mainly due to declining interest rates, while current non-interest expenditures remained stable. After the sharp deterioration in the ESA 95 general government deficit from 5.8% of GDP in 2000 to 26.9% in 2001, the government deficit declined to 10% of GDP in 2002. Although an important part of the high deficit in 2001 was due to accounting decisions, the decline in 2002 is nevertheless important. However, the improvement reflects to a large extent a drop in interest rate payments from 33.7% of GDP in 2001 to 19.4% in 2002. Non-interest expenditures remained stable at slightly above 18% of GDP, while tax revenues declined from 27.1% of GDP in 2001 to 24.2% in 2002. Despite a slight deterioration on the revenue side a significant primary surplus of 6.2% of GDP (GFS method)[36] has been achieved in 2002.

4. THE MACROECONOMIC FRAMEWORK

Like last year, the Turkish authorities have presented an elaborated economic framework for the period 2003-2006. The main policy priorities are to ensure a sustainable growth environment, reducing inflationary pressures and bringing public sector deficit and debt ratios to EU averages. Key instruments in this respect are the strengthening of the market economy and the improvement by competitiveness by reducing state influence and the establishment of independent regulatory agencies.

The key objective of monetary policy is to support price stability. Base money is the central aggregate to influence monetary developments in the economy. The document presents the introduction of inflation targeting as main policy tool for achieving and maintaining price stability. Unfortunately no details are presented how this policy will be implemented. Concerning exchange rate policy, the programme envisages the continuation of the current free floating exchange rate regime. Income policy will use inflation targets as guideline for public sector wage settlements. In an attempt to improve the personal income distribution, pensions of low-income groups have been raised. In order to strengthen the private sector wage bargaining process, the current social dialogue in the framework of the Economic and Social Council will be used.

The quantitative framework for the period 2003-2006 is well presented and contains detailed information on key variables. However, the link between the macroeconomic framework and the impact of structural reforms described in sections 3 and 4 would have deserved more attention. The programme's external assumptions are in line with international forecasts, including the EU Commission's spring 2003 forecast. Compared

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[36] The table on general government revenues and expenditures seems to be aggregated according to the GFS standard. A presentation in ESA 95 would have indicated an increase in the primary surplus from 0.3% of GDP in 2001 to 9.8% of GDP in 2002.

to these forecasts, the Turkish programme is somewhat more optimistic with respect to world import prices. The assumption on the EUR/USD exchange rate is based on the Commission's spring forecast, which at the time of the writing of the PEP was close to the actual average EUR/USD rate.

4.1. Real sector

The economic background of the 2003 PEP is characterised by strong output growth of 5.3% in 2003, and a minor slowdown to 5.1% during the remaining programme period. Based on 3 different methods to calculate potential output, the programme expects that the economy will reach the potential output by 2004 and will remain close to potential in 2005-2006. Interestingly enough, no rising inflationary pressures are expected from this growth pattern. The main reasons for the favourable growth performance are the effects of structural reforms. Compared to the 2002 PEP, the current programme has largely maintained its GDP growth profile for 2004-2005. For 2003, it is more optimistic, based on a better then expected output performance realised so far. Concerning the sources of growth, the 2003 programme shows a stronger reliance on investment and exports, while the expectations concerning private and public consumption and imports are more cautious. This growth pattern is largely plausible, given the negative impact of the strict fiscal policy on public consumption and disposable income. 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 relatively low growth rates of imports would have deserved a more detailed explanation, given the high import content of investment and exports. Furthermore, a reference to the likely implications of this growth profile on government revenues would have been interesting.

Regarding the contribution of the various production factors to economic growth, Turkey's output appears to have been mainly driven by capital, contributing 73% to total growth during 1990 - 2000. The share of labour has been 17.3%, while the increase in total factor productivity has been 9.5% only. During the remaining programme period, this distribution is expected to become more even, with the share of capital accumulation in growth generation reaching a share of 37% on average during 2003-2006, the share of employment 30.7% on average and that of total factor productivity 32.3%. The increase in the investment ratio from 21.3% of GDP in 2002 to 23.3% in 2006 will be increasingly financed by domestic savings, reflecting increased confidence in economic stability.

As a result of strong capacity increasing investment, the programme is rather optimistic concerning employment generation, expecting an average employment increase of about 2½% each year. However, an increase in the labour force will limit the decline in unemployment.

4.2. Inflation

The programme expects a continuation in the decline of inflationary pressures, reaching a 12-month consumer price inflation of 5% by December 2006. The targets of the period 2003-2005 are identical with the 2002 PEP (20% in December 2003, 12% end of 2004 and 8% in 2005). The main policy tools to achieve this objective will be fiscal discipline, forward-indexation of public sector wages, inflation targeting which is

supposed to be implemented as soon as appropriate. Like last year, the presentation of the disinflation process would have gained through a more detailed discussion, mentioning the intended measures and describing how and to which extent those measures are expected to affect price developments. Furthermore, it would have been interesting to discuss the impact of public sector prices on inflationary pressures on the one hand and the consequences for public sector revenues on the other hand. Another interesting question, linking various economic policy fields, would have been to elaborate further the consequences of lower public sector prices on the profitability of state owned enterprises. The important role of the public sector in supporting the credibility of the disinflation programme by agreeing on wage rounds in line with inflation targets would have deserved to be highlighted.

4.3. Monetary and exchange rate policy

Like in the 2002 PEP, the key objective of monetary policy is to support the disinflation process. At present, the central bank is using base money and short-term interest rates as main policy tools. Clearly specified floors and ceilings for monetary aggregates, such as net domestic assets and net international reserves, are key orientation marks in this respect. As soon as inflationary inertia have sufficiently declined, the central bank intends to switch to inflation targeting. A more detailed description on how it intends to pursue inflation targeting would have been useful. The exchange rate policy is characterised by a free float. The only interventions are to smoothen abrupt exchange rate fluctuations. Based on reversed currency substitution and a strong balance-of-payments situation, the programme implies a real appreciation of the exchange rate during 2003-2005. This should support the disinflation process. In contrast to last year, the programme does not take a position with respect to the objective of membership to the EMU.

4.4. External sector

Despite significant output fluctuations during the recent years, Turkey's current account balance remained fairly close to balance. For the programme period, a largely balanced current account is expected. The main reasons for this scenario are optimistic assumptions on export growth and tourism revenues. The expected volume of workers remittances has been revised downwards, reflecting the continuous decline over the last few years. As a result, the current account deficit is expected to decline from 3.2% in 2003 to 1.2% in 2006. In view of this relatively moderate dimension, the programme expects no difficulties in financing the current account deficit, despite considerable repayment obligations towards the IMF, amounting to about € 16 bn during 2005-2006.

In addition to the baseline scenario, the programme presents two alternative scenarios, analysing the effect of lower than expected external demand and of missing the inflation targets. In the trade shock scenario, exports in 2004 are expected to be 5% below the base line scenario. As a result of the high import content of exports, the impact on GDP growth and the current account is very limited. The programme also contains a brief discussion of possible factors negatively effecting the disinflation path, such as the deviation from fiscal discipline, unexpected developments in the exchange rate and oil prices etc. Unfortunately no quantification is presented.

5. PUBLIC FINANCE

The overall objective of Turkey's fiscal policy is to contribute to the establishment of a sustainable growth environment and at the same time to support the disinflation process. Achieving substantial primary surpluses appears to be the main fiscal tool in this respect, contributing to disinflation and debt sustainability. Yet, the document does not describe in more detail how to achieve those targets. The presentation of the public finances would have gained significantly by discussing the various measures and their impact on the presented objectives. Main revenue-related measures are an improved efficiency of tax collection and a broadened the tax base. At the same time, the programme expects the phasing-out of temporary one-off measures, which were adopted in view of financing the costs of the 1998 earthquake and the 2001 financial crisis. On the expenditure side, the emphasis is on reducing public sector employment and to raise the efficiency of the current expenditure system. Unfortunately, no quantitative estimates of the budgetary effects of the described measures are given. Concerning the expenditure structure and the quality of the fiscal adjustment, the programme foresees an increase in the general government fixed capital formation, from 3.4% of GDP in 2003 to 4.1% in 2006. Unfortunately, no further information is given on how those additional expenditures are supposed to be used. Furthermore, more details on plans to improve the quality of public investment would have been useful.

Compared to the 2002 PEP, the 2003 document expects a lower primary surplus and a slower decline of general government net borrowing. The main reason is a more cautious assumption on the decline in interest payments and the expectation of a declining share of revenues. As a result of a higher government lending, the debt ratio declines at a slower speed then in the 2002 programme. Like last year, the detailed tables on public sector finances seem not to be fully in line with ESA 95 standards. In this context, some more information on plans to switch to ESA 95 comparable tables would have been useful.

5.1. The Medium-term fiscal framework

The medium-term fiscal framework is characterised by the objective of reaching a substantial primary surplus during the whole programme period, accounting for slightly above 7% of GDP during 2003-2006. Only in 2005, the primary surplus is expected to reach 6.4% of GDP. The main reason for the lower surplus in 2005 are lower total revenues, reflecting the ending of one-off measures, like the tax peace plan, and the reduction in corporate taxation, taking place as of 2004.

The share of general government revenues in GDP is expected to decline during the programme period, reflecting the phasing-out of a number of temporary revenue increasing measures and the effect of additional investment promoting fiscal measures. 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. Overall, when excluding privatisation revenues, general government receipts are expected to decline by 1.3 percentage points of GDP during 2003-2006. This reduction in the tax burden is seen as a measure to achieve justice in the tax system. Compared to last year, the decline in the tax burden is somewhat more pronounced.

On the expenditure side, a similar decline in non-interest expenditures of the general government is expected. The main reasons for this decline are reductions in public sector employment and the effects of efficiency increasing measures. The by far biggest

contribution to the decline in total general government expenditures is assumed to come from decline in interest payments, decreasing by 8 percentage points of GDP, from 17.8% of GDP in 2003 to 9.7% in 2006. Overall, public expenditures are expected to decline by 9.3 percentage points of GDP, from 54.1% in 2003 to 44.8% in 2006.

The 2003 programme contains for the first time cyclically adjusted budgetary balances. The results indicate a very high share of the structural component in the Turkish fiscal performance. The calculations also indicate that the growth of the Turkish economy during most of the programme period is above output potential. Some more information on the factors behind this strong growth would have been helpful. Furthermore, the provided data indicates a constant output gap during 2004-2006, which would have deserved some more explanation, especially with respect to the treatment of the end-year problem of this exercise.

Table 2: Fiscal development
(general government, % of GDP)

		PEP framework			
	2002	2003	2004	2005	2006
Receipts	41.9	43.6	42.7	41.8	42.3
Expenditures	55.1	54.1	52.2	47.5	44.8
Net lending	-13.1	-10.5	-9.5	-5.8	-2.5
- Cyclically adj.	-13.3	-11.9	-11.4	-7.9	-4.8
Primary balance	-6.2	-7.2	-7.1	-6.4	-7.2
Gross debt level	102.5	92.3	91.1	87.6	83.2

Source: PEP, if not otherwise indicated

5.2. Public debt management

The programme explains the institutional arrangements for the management of public debt and describes the Law on Public Finance and Debt Management from April 2002, which regulates debt management and introduces borrowing limits. The main factors for the reduction of the debt ratio are expected to be declining interest rates and substantial primary surpluses. Furthermore, 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. For improving the management of contingent liabilities, the treasury will apply an active risk management strategy. 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. Furthermore, risk accounting has been established. In view of improving transparency, quarterly public debt management reports will be published and the responsible minister will present an annual special report to parliament and to the budget commission.

In line with the overall setting of the fiscal policy, the gross debt level is expected to decline continuously, from 102.5% of GDP in 2002 to 83.2% in 2006. Considerable primary surpluses, declining interest rates and strong economic growth will be the main factors for this decline.

Two different sensitivity analyses were presented. One examined the sensitivity of public finances with respect 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, the other assumes public expenditures to remain constant in nominal terms. A separate sensitivity analysis focuses on the debt stock dynamics. Various scenarios have been calculated, analysing the impact of differences in growth, interest rates and the primary surplus. According to those calculations, the debt situation appears to be sustainable. The most critical scenario was the one assuming growth to be one percentage point lower and real interest rates to be 5 percentage points above the baseline scenario.

5.3. Deficit financing

No information on the financing of the borrowing requirement is presented.

5.4. Fiscal risks

Like in the last PEP, the main fiscal risks are seen to be those related to the debt stock's high sensitivity to interest rate and exchange rate fluctuations and a lower than expected primary surplus, resulting from higher than expected public spending for wages and transfers to the social security institutions. Contingent liabilities and lower than expected privatisation revenues appear to be further risks to the sustainability of public finances. In this context, a presentation of potential contingency plans in order to compensate for those risks would have been interesting. Long-term sustainability issues, such as the financial implications related to the demographic structure or to pension issue, are not discussed. Accordingly, no quantitative information on those issues has been provided.

6. STRUCTURAL REFORMS

The programme’s key structural reform objectives are to reduce the size of the public sector, to reform the agricultural sector and to create a robust banking system. Furthermore, the programme intends to meet the Copenhagen criteria by attaining a sustainable growth environment and a competitive economic structure. To achieve those targets privatisation and public sector reforms are presented as key policy measures.

The presentation of the structural reform programme builds strongly on the description of last year. The structural part would have gained clarity by starting with a short analysis of identified deficiencies of the Turkish economy and a more explicit explanation of how the described policy measures will contribute to address the chosen policy objectives. Unfortunately, no further background on the interdependencies between the overall policy objections and the choice of the concrete policy measures is given. Furthermore, references to developments since the 2002 programme are very limited.

The matrices of policy commitments contain more information than last year. Overall, the presented costs of structural reforms appear to be on low side. It seems that only a part of the total budgetary costs of the presented reforms has been included, as the budgetary impact of the presented reforms accounts to less than 2% of GDP only. Given the scope of the presented reforms, the overall budgetary costs are probably higher.

Furthermore, due to the low degree of expenditure specification in the programme's public finance part, it is not possible to relate the measures to the budgetary expenditure

dynamics. Thus it is not possible to see, if and how the costs of those reforms are already integrated in the presented expenditure profile. The presentation strongly emphasises already adopted measures, but is sometimes rather vague concerning concrete future measures in most of the policy fields.

6.1. Enterprise sector

Concerning structural reforms in the enterprise sector, the programme emphasises the crucial role of privatisation for improving the economy's efficiency and competitiveness. According to the fiscal framework, Turkey expects privatisation revenues of at least 1% of GDP during 2004-2006. Unfortunately, in contrast to last year, the programme does not provide any information on concrete privatisation plans beyond the current year. Thus it is not possible to assess, whether those expected privatisation revenues are indeed realistic. In this context, a more detailed presentation of the enterprises in the privatisation portfolio and expected revenues would have been useful. Furthermore, in view of the usually high costs for preparing state owned enterprises for privatisation, a significant positive budgetary effect appears to be optimistic.

Concerning the regulatory environment, the programme describes measures related to the competition legislation, the establishment of a state aid supervision and monitoring body and the improvement of the investment environment. In the field of competition legislation, the programme cited a number of measures to further align the Turkish legal framework with the EU acquis. Besides the plan to establish the state aid supervisory body by end 2003, no further measures concerning supervisory and regulatory bodies are envisaged. With respect to improving the investment environment, the programme describes mainly measures taken so far. With respect to the regulatory reforms, no time frame is given, nor is there any information on the expected budgetary costs.

6.2. Financial sector

The programme gives a detailed description of recent measures to consolidate the financial sector and of the accrued fiscal costs. Furthermore, quite detailed plans to continue the ongoing sector reforms are presented. Unfortunately, only in few cases, a time schedule is presented. Furthermore, estimates of fiscal costs are not presented.

In the banking sector, the Turkish authorities intend to privatise the most important state-controlled banks by 2005. The sale of the *Vaquif bank* is supposed to be completed by October 2003. The SME oriented bank, the *Halk bank* is planned to be sold by 2004 and the agricultural bank *Ziraat*, is foreseen to be privatised by 2005. In the area of private banks, the programme foresees a continuation of the current efforts to strengthen the sector's capital base, to reduce open foreign positions, to resolve non-performing loans, and to align by 2006 credit limits and the risk group definitions to international standards. Furthermore, the Banking Regulatory and Supervisory Agency (BRSA) will lead efforts to reduce banking intermediation costs. Another measure to align the sector's regulation with international standards is to reform the current general deposit and credit guarantee system by mid-2004. In addition, the programme foresees measures to increase the diversity of financial services, to strengthen the financial sector surveillance, to speed up the resolution of non-performing loans and to strengthen the regulatory and supervisory structures of the financial sector. With respect to capital markets, the described measures aim at modernising the current trading systems and to

align sector's regulatory framework and the capital market board's accounting methods to international standards. In the insurance sector, the programme envisages efforts to strengthen administrative and supervisory institutions and to align the sector's regulatory framework with international standards.

The document would have gained by presenting more quantitative data on the budgetary implications of the banking sector reform.

6.3. Labour market

The programme recognises the importance of increasing employment, improving the qualification of the labour force and labour productivity and raising the efficiency of the labour market. Furthermore, the programme stresses the crucial role of SMEs for job creation and the need to provide support in the fields of training, financing, organisation, marketing and technology. In addition, the programme underlines the importance of changing the employment structure in favour of non-agricultural sectors and to raise the participation rate. However, no operational labour market objectives are presented.

For the programme period, the Turkish authorities plan to continue the social support project, which is implemented by the privatisation administration. Furthermore, retraining programmes and providing consultancy will be continued and a programme to strengthen the administrative capacities of the Turkish Employment Agency will be launched by 2003. Furthermore, attempts to modernise the regulations concerning professional certificates and standards have been started. The programme gives only estimates of the costs of 2 projects, the privatisation social support project and the Occupational Health and Safety project. Both projects receive support from the Worldbank. The budgetary impact of those 2 projects is below 0.1% of GDP.

6.4. Administrative Reform

Concerning administrative reforms, the programme refers to the detailed presentation in the *Urgent Action Plan* and describes a series of measures foreseen during the programme period. The Turkish authorities intend to adopt a comprehensive public administration reform, to carry out a study on the functional review of the government, to reform the civil service, the local administrations and the regional development agencies. Furthermore, the programme presents plans to improve the access of citizens to the public administration and to strengthen the governance of state enterprises. In addition, the Turkish authorities intend to modernise the management of public finances and to increase budgetary and financial transparency. The most concrete project in this respect is the shift towards a new budgetary accounting system, which should allow a more transparent and up-to-date presentation of budgetary processes. This project is supported by the Worldbank and is supposed to be completed by the end of 2006.

6.5. Agriculture

The report presents various reform initiatives to establish a highly competitive and sustainable agricultural sector. One important element in this context is the Agricultural Reform Implementation Project (ARIP), which benefits from financial and technical World Bank support. In order to replace the costly and distorting agricultural price

support system, a project to switch to a direct income support for farmers is implemented. Furthermore, the Turkish authorities have started an EU supported 3-year programme to establish an integrated information system on animal health and border controls. In addition, the programme foresees various measures to align the sector's legislation and standards to the EU acquis. The total budgetary impact of these reforms is estimated to be close to 1% of GDP. In view of the size of the agricultural sector in Turkey, these costs appear to be rather limited. Like last year, the impact of the described measures, such as deregulation and privatisation, on the employment situation in the agricultural sector is not discussed.

6.6. Additional reform areas

Like last year, the programme presents a variety of further structural reform areas, such as education, regional development, social security, health, telecommunication, environment and energy. In the area of education, the Turkish authorities intend to increase the schooling rates and to improve the quality of education. To this purpose, numerous initiatives are foreseen, which are partly supported by the Worldbank and EU funds. The described measures address the most pressing issues and the progress achieved so far is encouraging. However, the expected budgetary impact is estimated to be slightly above 0.1% of GDP only.

Concerning regional development, the Turkish authorities have started preparations for a National Development Plan and various other medium-term oriented regional development programmes, such as the Turkey-Bulgaria Cross-Border Cooperation Programme. In the area of social security, the Turkish administration plans to restructure the social security system, to establish a general health insurance system and an integrated social security system. Concerning health, the programme plans to restructure and simplify the administration of public hospitals and to improve the accessibility and quality of health services. Like in other areas, projects financed by the Worldbank and the EU seem to play an important role.

7. INSTITUTIONAL AND ANALYTICAL CAPACITY

Like last year, the Pre-accession Economic Programme has been prepared under the leadership of the State Planning Organisation, including contributions from 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 consists of the Prime Minister and representatives of key ministries. The structure and content of the Pre-Accession Economic Programme indicates a significantly improved familiarity with the technical tools and analytical requirements of this exercise.

The document has taken into account most of the suggestions of the last assessment and has provided a more complete and more realistic Pre-accession Economic Programme. The macroeconomic framework has been well specified and the general approach has become more realistic and cautious. Thus, the economic framework can be seen as a good starting point for the subsequent policy discussion. Additional scenarios provide supplementary information on the debt sustainability. However, in the chapter on public finances, a more differentiated presentation of key revenue and expenditure categories

would have been helpful to illustrate the concrete intentions of the medium-term fiscal policy. The part on structural reforms has improved with respect to providing more detailed information in some key policy areas. However, like last year, the presentation would have gained through a more elaborated discussion of the envisaged policy mix, including the discussion of policy trade-offs and economic interdependencies.