Council of the
European Union

Brussels, 25 April 2017
(OR. en)

8441/17

ECOFIN 298
UEM 98
COWEB 53

COVER NOTE

From:	Secretary-General of the European Commission, signed by Mr Jordi AYET PUIGARNAU, Director
date of receipt:	21 April 2017
To:	Mr Jeppe TRANHOLM-MIKKELSEN, Secretary-General of the Council of the European Union
No. Cion doc.:	SWD(2017) 144 final
Subject:	COMMISSION STAFF WORKING DOCUMENT ECONOMIC REFORM PROGRAMME OF THE FORMER YUGOSLAV REPUBLIC OF MACEDONIA (2017-2019) COMMISSION ASSESSMENT

Delegations will find attached document SWD(2017) 144 final.

Encl.: SWD(2017) 144 final

EUROPEAN
COMMISSION

Brussels, 21.4.2017
SWD(2017) 144 final

COMMISSION STAFF WORKING DOCUMENT

ECONOMIC REFORM PROGRAMME

OF

THE FORMER YUGOSLAV REPUBLIC OF MACEDONIA (2017-2019)

COMMISSION ASSESSMENT

EN EN

Contents

1. EXECUTIVE SUMMARY

Continued economic expansion depends on resolving the political crisis and restoring investor confidence. The economy expanded at an accelerated pace each year between 2013-2015**,** supported by accommodative fiscal and monetary policy, and fuelled by public investment and exports. Growth slowed down in 2016, as a protracted political crisis dented gross capital formation. The financial sector remained well-capitalised and highly liquid. The ratio of non-performing loans dropped significantly as a result of write-offs required by the central bank. The Economic Reform Programme (ERP) projects that growth will pick up again in 2017-2019, to 3.5% annually on average, on the back of a revival in investment, strong exports and further increasing private consumption. The external sector is not expected to contribute to growth as imports, driven by rising domestic demand, are projected to outweigh expected export gains. There are downside risks on this economic outlook, especially if the political crisis is not resolved and continues to weigh on investor and consumer confidence.

Containing fiscal risks, increasing employment, and developing the domestic private sector remain key challenges for the economy. Public debt has more than doubled since 2008, mainly as a result of sustained primary deficits. Structural problems in the labour market, such as low participation rates, and mismatches between skills supply and demand, restrict growth potential, while the development of the domestic private sector is hindered by a lack of legal certainty for companies. Sustained efforts are needed to address these issues.

- **Budget execution remains weak and fiscal consolidation plans are not underpinned by concrete measures.** For the medium term, the ERP adheres to previous deficit reduction targets. However, in the absence of concrete revenue or expenditure measures, the fiscal consolidation plans seem to rely on improving growth prospects and thus face downside risks. Fiscal transparency can be improved, including detailed multi-annual information on government spending.

- **Growing fiscal risks and a further increase in public debt are jeopardising growth-enhancing infrastructure spending.** The ERP projects a further increase in public debt until 2019 as a result of additional guarantee-backed borrowing by state-owned enterprises carrying out public investment. A potential failure to meet deficit targets would cause debt to rise at an even faster pace. Additional significant fiscal risks stem from the lack of a strong medium-term budgeting framework and a rising pension fund deficit. Capital spending suffers from repeated mid-year budget revisions slashing the investment budget as well as shortcomings in the planning and execution of capital projects.

- **Inadequate public finance management (PFM) still constitutes a main constraint for effective, efficient, transparent and accountable economic governance and has negative effects on structural reform implementation**. Gaps include an insufficiently transparent and efficient public procurement system and insufficient monitoring of public procurement implementation. The ERP acknowledges the importance of PFM and the urgent need to adopt the 2017-2020 PFM reform programme after several years of delays.

- **The business environment remains somewhat unpredictable with frequent legal changes and many para-fiscal charges at different administrative levels. The** main weaknesses include a frequently changing regulatory framework along with insufficient consultation of stakeholders, a large informal sector and problematic access to finance for SMEs. The ERP does discuss some of these obstacles, but fails to address others. Overall, it does not focus sufficiently on structural reforms for private sector development that will have a more fundamental effect on competitiveness.

- **Low employment levels among women, youth and the low-skilled remain impediments to more inclusive economic growth in the country.** Key obstacles in education include low levels of preschool education, insufficient numbers of teachers, unattractiveness of the vocational education and training (VET) system and insufficient links to labour market needs. There is only limited cooperation across policy sectors to improve planning, outreach, delivery and monitoring of active labour market policies so as to tackle the lengthy school-to-work transitions faced by young people. The coverage of active labour market measures for low- skilled and low educated unemployed in particular needs to be stepped up, since at present most active labour market measures target unemployed with at least secondary education. High rates of poverty and material deprivation remain persistent social challenges and worsen inequality.

Implementation of the policy guidance jointly adopted in the Economic and Financial Dialogue of 25 May 2016 has been limited. The government did not identify concrete measures it could implement to underpin fiscal consolidation, and a medium-term budget framework is still missing. The information contained in the fiscal documents was not improved. No concrete steps have been taken towards adopting a credible PFM reform programme. The use of the urgency procedure to pass legislation has not diminished and there is no systematic stakeholder consultation. Activation measures for the unemployed have been strengthened, but measures targeting low-skilled or long-term unemployed are still scarce.

The macroeconomic projections in the ERP are plausible, but fiscal targets are too optimistic. Risks related to a continuation of the political crisis are clearly acknowledged in the growth projections, which have been revised downwards compared to the previous year's programme. The expectations for general government revenues and expenditure appear less realistic against this background, and fiscal deficit targets remain ambitious. The fiscal framework's spending priorities are broadly in line with the structural reform measures outlined in the ERP. Structural obstacles to competitiveness and reform measures presented in the ERP largely match bottlenecks and reform needs identified by the Commission. However, the planned measures sometimes do not cover market functioning or regulatory reform.. There is a mismatch between the diagnostics and the programme's focus on transport and other infrastructure investments. There are either no or just a few measures in other important areas such as services, industrial development, corruption, the informal economy, education and skills, employment and social inclusion. For the vast majority of measures, reforms are mostly reliant on donor support, which raises concerns regarding government commitment to and sustainability of the reforms.

2. ECONOMIC OUTLOOK AND RISKS

In 2016, the economy proved resilient amidst a protracted political crisis and sluggish investment. Following annual GDP growth of 3.8 % in 2015, the pace of expansion slowed down in 2016 to an estimated 2.4 %. Economic activity was driven by a surge in private consumption and exports, fuelled by enhanced production capacities of foreign companies established in the country. However, negative confidence effects from the enduring political crisis restrained private investment, and credit growth to enterprises declined significantly. The government also again reigned in capital expenditure, due to constraints arising from the political crisis, and to mid-year budget rebalancing. Consumer prices dropped for the third consecutive year, propelled by lower food, energy, transport and housing and utilities costs. The core inflation rate remained positive.

The ERP projects an acceleration of economic growth in 2017-2019 to 3.5% on average, based on strengthening investment and exports. Gross investments are projected to increase on average by 5.8 % annually, as a return to political stability will improve private investors' sentiment. Public investment spending, estimated at some 25 % of the economy's total investment spending since 2009, is expected to remain an important growth driver, also in view of ongoing and new public infrastructure projects. Further increase in households' disposable income and projected 2 % annual average employment gains are expected to propel private consumption to grow by 2.5 % on average between 2017 and 2019. The external balance is likely to detract from growth in each of these years,as rising domestic demand and foreign companies' production would push import growth to an annual average of 5.5 %, overcompensating for export gains.

The risks from a further protraction of the political crisis to growth performance are clearly acknowledged in the programme. The government presents two alternative macroeconomic scenarios for 2017-2019 based on what it views as the main risks to growth. As in previous programmes, the first scenario presumes lower-than-baseline growth in the main trade partner economies and weaker external demand, leading to a lower increase in both domestic demand and, in particular, in exports. Output growth is projected to be lower by 0.8pp on average in each of the 3 years of the period covered in the forecast. In addition, the 2017 ERP contains a second alternative scenario assuming a protraction of the domestic political crisis into 2017 which results in lower output growth in 2017 by 0.8 pp. The ERP clearly points out that investors and consumers are likely to show increasing restraint in spending should the crisis persist. It also underscores that achieving its baseline macro scenario depends on implementing the fiscal consolidation strategy.

The ERP's growth projections and identified risks are broadly plausible. Overly optimistic growth and public revenue assumptions for 2016-2018 in last year's ERP made a downward growth revision necessary mid-year as the slowdown in economic activity became evident. As a consequence, the GDP growth projections for 2017 and 2018 are lower by 1.2pps, on average for each of these years compared to the previous ERP. Private consumption growth in particular has been revised and is now projected to be lower by 1.1 pps on average each year. Yet, household spending may surprise positively assuming that the political situation improves, as the fundamentals remain solid. Disposable incomes are likely to benefit from robust though lower increases in real net wages, compensating for the decline in private transfers from abroad, and, based on the ERP's assumptions, by further increases in government transfers, including pensions in a low-tax environment. Further improvement in the labour market and a benign price environment are also beneficial to household spending.

The external sector is expected to detract from growth throughout the programme's horizon. This comes as a result of buoyant import demand related to the expected rise in domestic investment and to the production of foreign companies, which is intensive in imported raw materials and equipment goods. The ERP's assumptions about trade performance in 2017-2019 might be too pessimistic given the programme's baseline assumptions on external demand developments. Previous years' programmes consistently overestimated the trade deficit, likely underestimating the contribution of export-oriented production by foreign companies. The increasing share of higher-value added exports is also contributing to an improvement in export performance. The government markedly lowered its expectations for both export and import growth in 2017 and 2018 compared to the previous ERP, but does not explain further.

Inflation projections have been revised downwards compared to the 2016 ERP. In 2016, consumer prices dropped for the third consecutive year, declining by 0.2 % y-o-y. The largest contributions to this drop came from lower food, energy, transport and housing and utilities costs. The core inflation rate remained positive. Based on firming foreign inflation and global prices of primary commodities, the ERP realistically expects consumer prices to rise moderately between 2017 and 2019. For 2017 the government has significantly revised its expectations compared to the 2016 ERP as a result of a lower than expected increase in energy prices in 2016.

Challenges from the external sector remain contained. The current account deficit widened in 2016 more sharply than expected by the previous ERP, to 3.2 %, compared to 2.1 % in 2015. It was more than covered by foreign direct investment inflows, which amounted to 3.7 % of GDP. The shortfall in the primary balance became more acute and private transfer inflows slowed down, although they still covered the much improved merchandise trade deficit. The government expects the current account deficit to narrow in 2017-2019 to 2.5 % on average. Primary and secondary income from abroad are, however, expected to decline further, while both the merchandise and the services trade balance are foreseen to improve.

While foreign companies are becoming important growth drivers, spillovers to the domestic economy remain modest. Foreign companies established in the country accounted for over 45 % of total exports in 2016, up from 16 % in 2011. They are the main drivers of export diversification and thus contribute to raising the economy's resilience to external shocks. Since 2012, the share of higher-value added products in the country's export structure has increased gradually as foreign direct investment started to intensify in the sectors chemicals and machinery and transport equipment; these accounted for some 50 % of all exports in 2016 or almost double their share of 2011. The share of traditional export sectors, iron and steel and clothing, declined accordingly. However, export activity remains heavily concentrated with the top 20 exporters, about three quarters of them foreign-owned, accounting for some 60 % of the total. In spite of recent government programmes supporting the building of backward linkages between local firms and foreign companies, these relationships are mainly restricted to low-skilled service supply, rather than to technical cooperation. Therefore the economy is not fully realising the opportunity these companies offer for productivity-raising upgrading of domestic industrial production, which is required to help the economy achieve a self-sustaining structural change towards higher-value added production.

Table 1:

Macroeconomic developments and forecasts

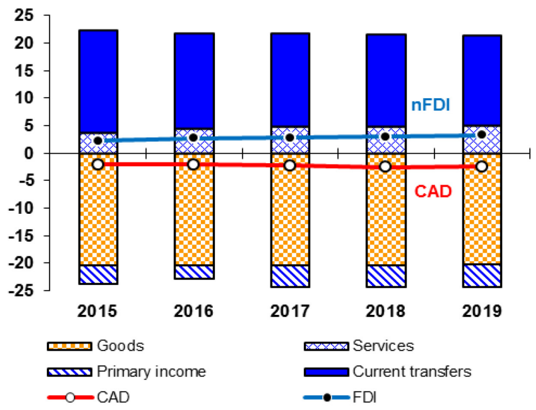
	2015		2016		2017		2018		2019	
	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**
Real GDP (% change)	3,8	**3,8**	2,1	**2,3**	3,2	**3,0**	3,6	**3,5**	na	**4,0**
Contributions:										
- Final domestic demand	3,8	**4,0**	2,6	**3,7**	3,2	**4,5**	3,4	**5,1**	na	**5,2**
- Change in inventories	0,2	**na**	-0,6	**na**	0,0	**na**	0,0	**na**	na	**na**
- External balance of goods and services	-0,4	**-0,2**	0,1	**-0,2**	0,0	**-0,5**	0,2	**-0,8**	na	**-0,7**
Employment (% change)	2,3	**2,3**	1,8	**2,3**	1,6	**1,8**	1,6	**2,1**	na	**2,4**
Unemployment rate (%)	26,1	**26,1**	24,4	**23,9**	23,2	**23,0**	22,0	**22,1**	na	**21,1**
GDP deflator (% change)	1,9	**1,9**	1,0	**1,5**	1,7	**2,2**	1,9	**2,2**	na	**2,4**
CPI inflation (%)	-0,3	**-0,3**	-0,2	**0,0**	0,7	**1,3**	1,5	**2,0**	na	**2,0**
Current account balance (% of GDP)	-2,1	**-2,1**	-2,5	**-2,1**	-1,7	**-2,3**	-1,6	**-2,6**	na	**-2,5**
General government balance (% of GDP)	-3,4	**-3,4**	-3,6	**-4,0**	-3,2	**-3,0**	-3,1	**-2,6**	na	**-2,2**
Government gross debt (% of GDP)	38,0	**38,2**	40,2	**41,3**	41,7	**42,7**	42,7	**43,0**	na	**43,9**

Sources: Economic Reforn Programme (ERP) 2017, Commission 2017 Winter Forecast (COM)

External debt is increasing as the public sector borrows heavily abroad. Gross external debt increased further in 2016, mainly on account of foreign borrowing by the government and by public sector companies. It amounted to 74.4 % of GDP at the end of the third quarter 2016, which is an increase of 5pps compared to end-2015. Despite this high level, the structure of external debt has improved recently. Three quarters of external debt is long-term, providing a stable maturity structure and mitigating refinancing risks, and some 80 % is denominated in euros. Debt indicators point to low indebtedness. The ERP contains a sustainability analysis of external debt as an annex, which is more elaborate than in past programmes and projects only a slight decline in the ratio until 2019. This would come as a result of lower private-sector borrowing, and in spite of increased borrowing by public enterprises. The share of more flexible kinds of debt (trade credits and intercompany loans) is projected to rise to some 40 % of total debt over the programme horizon, making external debt less vulnerable to shocks to the primary current account and to GDP growth.

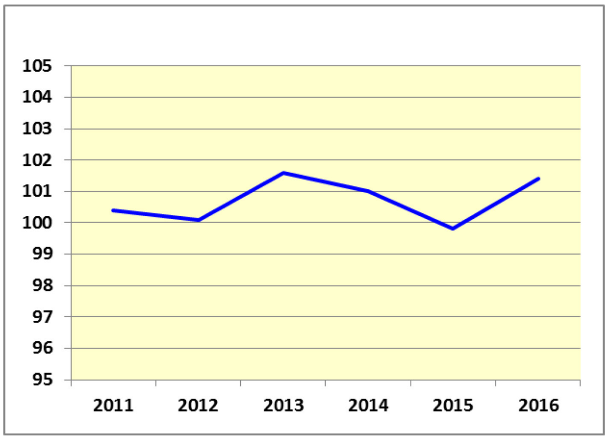
Graph 1: **External competitiveness and the current account**

Changes in the current account balance (% of GDP)



Sources: ERP 2017, Commission calculations

Real effective exchange rate (CPI based, total economy, 2005=100)



The banking sector shows resilience amidst a slowdown in loan and deposit growth. The sector's solvency, liquidity and profitability indicators remained robust throughout 2016. There was a marked slowdown in private sector credit growth in 2016, due in large part to the December 2015 central bank decision obliging banks to write-off by June 2016 fully-provisioned loans that had been on their books for more than 2 years. The bank also raised capital requirements for long-term consumer loans. Excluding the impact of write-offs, annual growth in credit to households and private companies amounted to 5.6 % on average in 2016, which is 3.5 pps lower than the previous year. The non-performing loan ratio dropped significantly in the second half of the year to 6.6 % of total loans by end-2016 as a result of the write-offs. Without the write-offs it remained at some 11%, as in 2015. There was a marked withdrawal of household deposits in April and May as a result of politically-induced speculation. The decline was more than recovered in the second half of the year, and overall deposit growth amounted to 6.7 % y-o-y in 2016.

Monetary policy is appropriate in the light of the challenges faced. In response to the massive outflow of deposits in the spring, the central bank raised the key interest rate by 75 basis points to 4 %. This was the first raise since 2013. However, transmission to commercial interest rates was sluggish. The central bank also took several macro-prudential measures, e.g. higher reserve requirements on deposits with foreign exchange element, and intervened in foreign exchange markets. As the situation in foreign exchange markets stabilised, the bank has lowered the key lending rate again in three successive moves of 25 basis points each since December.

Table 2:

Financial sector indicators

	2011	2012	2013	2014	2015	2016
Total assets of the banking system, mEUR, at end-year	5.385	5.738	6.008	6.509	6.889	7.230
Credit growth to private sector, annual change in %	8,1	7,3	4,3	8,4	9,0	4,6*
Deposit growth, annual change in %	4,6	7,2	6,1	10,4	6,5	5,7
Loan- to-deposit ratio, at end-year	86,4	88,1	88,8	88,1	90,6	87,0
Financial soundness indicators, at end-year						
- non-performing loans (in % of total loans to the non-financial sector)	9,6	10,4	11,9	10,8	11,3	6,6*
- regulatory capital to risk weighted assets	16,7	17,3	17,2	16,4	16,0	15,2
- liquid to total assets	32,0	32,9	32,8	33,2	31,4	30,9
- return on equity	3,4	3,8	5,7	7,4	10,4	13,6
- foreign-currency denominated loans (in % of total loans)	59,2	55,4	52,7	49,4	46,5	44,9

Sources: National Central Bank, DataInsight

*including mandatory write-offs

3. PUBLIC FINANCE

Budget execution was again weak in 2016. The government continued providing a fiscal stimulus to the economy throughout 2016. Pensions were, again, raised *ad hoc* beyond indexation. The government resorted to two supplementary budgets over the summer, necessitated by a downward revision of GDP growth and by compensation for flood victim respectively. These raised the general government deficit target to 4 %, from 3.2 % and increased budgeted current spending by 0.7 % of GDP, while lowering revenue projections and capital expenditure. As in previous years, revenue performance was again below even the revised budget projection due to lower Value-Added Tax (VAT) revenue. As a share of GDP and compared to 2015, revenues decreased by 3.1 pps. to 27.9 %. The 2016 general government fiscal deficit remained below the revised target, at 2.6 % of GDP, compared to 3.4 % in 2015. This came however on the back of a marked under-execution of capital expenditure (75 % of the revised budget, or 2.8% of projected 2016 GDP), which was downsized again as a result of both budget rebalancing and legal constraints imposed by the political situation.

The 2017 revenue and expenditure targets seem over-ambitious in the light of the 2016 outcome. On 17 October, the Macedonian Parliament adopted the 2017 budget. The budget provides for a general government deficit of 3% of projected GDP and is based on assumptions of 3 % real GDP growth and 1% annual inflation. The ERP projects the revenue share in GDP to increase by 0.6 pps. compared to the 2016 projection, to 32.7 % in 2017. However, this target appears hard to achieve in the light of the actual 2016 revenue outcome (27.9 %) and given existing shortcomings in revenue collection and compliance. In nominal terms the target would amount to an 18 % increase over the 2016 outturn, mainly as a result of higher collection of income and production taxes. The expenditure ratio would amount to 35.7 %, somewhat lower than the government's expectation for 2016 at the time of drafting, yet higher by 5.2 pps. than the 2016 outcome (30.5 %). Based on the 2017 budget, the ERP foresees a nominal increase in capital expenditure of almost 60 % compared to the 2016 outcome. This appears unrealistic in view of the persistent under-execution of capital expenditure, the continuation of political constraints hindering the commencement of new projects and the risk of renewed budget rebalancing mid-year. The fiscal stance is expected to be more restrictive, with the cyclically-adjusted primary deficit calculated by the government narrowing markedly and gradually to 0.7 % of GDP by 2019. Compared to the 2016 ERP, 2017 revenue projections have been revised upwards, albeit based on a lower growth projection. The general government deficit was revised upwards, but only marginally. The ERP would have benefited from an explanation how the government intends to meet these targets in the light of significantly revised growth assumptions.

Mid-term consolidation is envisaged, but specific measures to achieve this remain unclear. The government projects total revenues to rise by 28 % between 2016 (actual outcome) and 2019, and total expenditure to increase by 25 % in nominal terms. In line with the 2016 fiscal strategy, the programme envisages a reduction of the general government deficit to 2.6 % of GDP in 2018, unchanged from previous year's ERP and fiscal strategy, and then to 2.2 % in 2019. In the absence of concrete revenue or expenditure measures, these plans seem to rely on strong growth and optimistic revenue assumptions. Given that the government reached the target set for 2018 already in 2016, it could set itself more ambitious targets. This would have to be underpinned by clear and costed consolidation measures for 2017-2018, but without jeopardising growth-enhancing capital spending. This would also be a positive step towards stabilising general government debt ratios.

The government's plans to raise the efficiency of revenue collection and of spending seem to progress only slowly. Given an inflexible expenditure structure and low tax rates, the government has declared its intention, in the 2017 ERP (as in previous' years programmes), to underpin its fiscal consolidation plans by measures increasing the efficiency of social and capital spending and by improving tax collection and administration. Social assistance programmes remain fragmented and the measures announced by the government to streamline these payments have not visibly been implemented. General government capital expenditure amounted to only 4 % of GDP on average between 2011 and 2016, a relatively modest amount among peer countries. Moreover, there seems to have been a decline in the quality of public investment in recent years with a move towards projects with lower growth-enhancing potential and towards lower-value added sectors. To raise its efficiency, public capital spending needs better prioritisation from the outset, based on multi-year projections of all involved costs, including the maintenance needs of transport infrastructure projects, as well as ongoing monitoring and performance evaluation.

Budget transparency concerns remain. Although the government's budget documentation has become more comprehensive in recent years, important information is missing from the annual budget law and the medium-term fiscal framework. This relates mainly to (i) composition of deficit financing; (ii) financial assets; (iii) budgetary arrears; (iv) costing of major policy changes; (v) contingent liabilities. The ongoing project to set up a medium-term expenditure framework to improve budget planning capacities and increase transparency is progressing at technical level. Swift implementation of its results is essential.

Table 3:

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

	2015	2016	2017	2018	2019	Change: 2016-19
Revenues	31,0	32,1	32,7	32,4	31,6	-0,5
- Taxes and social security contributions	27,5	27,1	27,6	27,3	27,9	0,8
- Other (residual)	3,5	5,0	5,1	5,1	3,7	-1,3
Expenditure	34,4	36,1	35,7	35,1	33,8	-2,3
- Primary expenditure	33,2	34,9	34,3	33,6	32,2	-2,7
of which:						
Gross fixed capital formation	4,2	4,8	5,4	5,5	5,4	0,6
Consumption	11,6	12,0	11,2	10,7	10,1	-1,9
Transfers & subsidies	14,9	15,4	15,2	15,0	14,5	-0,9
Other (residual)	2,5	2,7	2,5	2,4	2,2	-0,5
- Interest payments	1,2	1,2	1,4	1,5	1,6	0,4
Budget balance	-3,4	-4,0	-3,0	-2,6	-2,2	1,8
- Cyclically adjusted	-3,4	-3,8	-3,1	-3,1	-3,3	0,5
Primary balance	-2,3	-2,8	-1,7	-1,2	-0,7	2,1
Gross debt level	38,1	41,3	42,7	43,0	43,9	2,6

Source: ERP 2017. Figures for 2016 are based on the Finance Ministry's projections from mid-2016.

Public infrastructure investment is vital, but driving up debt levels. While growth-enhancing public investments in the country's transport and energy infrastructure are vital to increase the economy’s productivity and competitiveness, the ERP acknowledges the risks these investments pose to public debt developments. Mainly driven by the borrowing of state-owned enterprises tasked with carrying out these investments, public debt had risen by 27 pps. by end-2016, reaching close to 50 % of estimated GDP, up from its lowest level in 2008. The government projects a further rise to 56 % of GDP by end-2019 due to a further increase in borrowing by public sector companies. With general government debt projected to rise to 44 % of GDP by 2019, this implies an increase in public guarantees to 12 %, compared to 9.2 % of GDP at end-2016. The Public Enterprise for State Roads is the country's largest borrower, with guarantees amounting to some 4% of GDP. At the same time, borrowing costs are on the rise, in response to the protracted political crisis and a recent downgrading of the govenrment's long-term debt by Fitch.

Sizeable refinancing needs ahead. The government expects the level of public guarantees to decline after 2019 as the bulk of public construction projects would have been implemented by then. Repayments of sizeable external commercial loans are due to commence in 2019, followed by Eurobonds maturing in 2021 and 2023, respectively. These will require substantial refinancing, notwithstanding the government's abundant deposits at the central bank. Annual gross financing needs are estimated at about 14% of GDP on average between 2017 and 2020, rising to about 17 % in 2021 as the third Eurobond (500 million) matures. Over one fifth of the total is accounted for by external debt repayments. The government plans to finance the budget deficit and maturing debt repayments by a combination of external sources (international financial institutions, commercial banks, Eurobonds) and domestic sources. The proceeds of the July 2016 Eurobond (450 million) cover the 2016 budget deficit (some EUR 260 million) and finance parts of foreign debt repayments in 2016 and 2017.

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

The adoption of envisaged fiscal rules has been stalled by the political crisis. To boost transparency and fiscal discipline the government had planned to introduce fiscal rules as an amendment to the Constitution, before the political crisis had set in. These rules would limit the general government fiscal deficit to 3% and the public debt level to 60% of GDP. However, these plans were put on hold as the political situation deteriorated and the two thirds parliamentary majority required for amending the Constitution could not be achieved.

Box: Debt dynamics

General government debt is expected to increase by 2.6 pps. between 2016 and 2019. The debt-increasing impact of the primary deficit would diminish gradually, as a result of fiscal consolidation, while the contribution of interest payments would increase. Real growth and inflation would, to an increasing extent, moderate the rise in debt. For 2019, the government projects a substantial debt-raising stock-flow effect which it fails to explain further.

Table 4:

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

	2015	2016	2017	2018	2019
Gross debt ratio [1]	**38,1**	**41,3**	**42,7**	**43,0**	**43,9**
Change in the ratio	0,1	3,2	1,3	0,3	0,9
Contributions [2]:					
1. Primary balance	**2,3**	**2,8**	**1,7**	**1,2**	**0,7**
2. "Snow-ball" effect	**-0,2**	**-0,6**	**-0,7**	**-0,7**	**-0,8**
Of which:					
Interest expenditure	1,2	1,2	1,4	1,5	1,6
Growth effect	-0,6	-1,3	-1,5	-1,6	-1,7
Inflation effect	-0,8	-0,6	-0,6	-0,6	-0,7
3. Stock-flow	**1.3**	**1,0**	**0,3**	**-0,2**	**1,0**

Notes:

[1] End of period.

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

Source: ERP 2017, Commission calculations

This year's ERP no longer mentions these projects. It would nevertheless be sensible to pursue the introduction of fiscal rules, but in a simple law rather than in the Constitution.

This would make it easier to implement the rules and allow for subsequent adaptations using a less cumbersome procedure than that required for constitutional changes.

The ERP contains a **sensitivity analysis of the budget deficit** based on lower growth, lower revenue and higher expenditure than assumed in the baseline scenario. If GDP growth averages only 2.7 % over 2017-2019 (baseline scenario: 3.5 %) the deficit would be higher by 0.3 pps. in 2017, 0.5 pps. in 2018, and 0.7 pps. in 2019. If a domestic demand shock lowered 2017 growth to 2.2 %, the 2017 budget deficit would be 0.5 pps higher than in the baseline scenario. Lower revenue growth of 20 %, during 2017-2019 would result in a higher deficit by 0.7 pp. on average. A third scenario assumes higher expenditures (+25 %) in 2017 and 2018, resulting in higher budget deficits (+0.4 pp. in 2017, +0.7pp. in 2018).
A **sensitivity analysis of public debt developments** in response to interest rates and exchange rates shows that due to the high share of external government debt at variable interest rates, and denomination in euros, debt servicing costs would not increase significantly as a result of a 1 pp. increase in interest rates in 2017-2019 and a 10 % appreciation of other currencies in the debt portfolio in relation to the euro. The impact would be more significant if interest rates were to raise by 2 pps. in this period (which would lead to a 10-11 % annual increase in debt-servicing costs).

4. STRUCTURAL REFORMS

While the overall presentation of structural reform measures in the ERP has improved, their prioritisation remains problematic. The ERP contains clearer and more concise language and layout than in previous years. In addition, the overall diagnostic identifying key constraints on growth and competitiveness is relevant, as are some of the area diagnostics, although these vary in quality. At times, the area diagnostics are incomplete, especially on regulatory reform and market functioning. Additionally, there has been no visible improvement on prioritising reform measures, despite criticism already expressed in the 2016 Commission assessment. There is still a heavy emphasis on building transport infrastructure, both in terms of the number of actions planned and allocated budgets. The diagnostic does not justify this emphasis by demonstrating that transport is a more significant obstacle than, for example, skills or entrepreneurship. In general though, the estimation of the measures' impact on competitiveness has improved in response to the Commission's 2016 ERP assessment.

The proposed measures are spread over eight of the nine reform areas, leaving out the area of social inclusion, poverty reduction and equal opportunities. There is, however, still a particular focus on energy, transport and telecom markets (five measures) with emphasis on building transport infrastructure capacity. Also, the measure included under trade facilitation is an infrastructure measure rather than a policy reform. There is a justifiably strong emphasis on the agricultural sector. The emphasis on these two areas/sectors is especially clear when looking at the programme's budget allocations. There is less focus on improving the business environment and no measure tackling the informal economy, even though several key obstacles to competitiveness have been identified. Similarly, the two areas of education and skills and labour market and employment only include two measures despite the existence of key bottlenecks to the overall competitiveness of the economy in these areas.

The measures primarily entail investing in public infrastructure projects, although some also include more administrative and legislative reforms. Moreover, financing is mainly secured through external donor sources. Here, the relatively small contribution of the national budget to these projects raises concerns about government commitment to the reform process and measure sustainability when follow-up government engagement and expenditure for continuation or maintenance will need to be secured.

Main structural bottlenecks to competitiveness and growth include an unpredictable business environment with a frequently changing regulatory framework, little stakeholder consultation and no systematic law enforcement, a large informal sector, and problematic access to finance for SMEs. Private sector investment is persistently low, especially in research and innovation, while entrepreneurial skills remain underdeveloped. Public financial management remains inadequate, which also constitutes a considerable constraint on effective, efficient, and transparent economic policy and hence on economic development. Active labour market policies still need to improve their outreach and coverage to have a significant impact on the labour market. The policy guidance jointly adopted in the Economic and Financial Dialogue of 25 May 2016 covered these three areas but were only partially addressed.

Public finance management

The country's public finance management (PFM) system is weak when it comes to medium-term budget planning; public investment management; fiscal transparency; and assessing the budget impact of policy proposals. The transparency and efficiency of public procurement systems remain low, including the monitoring of public procurement implementation. The ERP diagnostic identifies some of these shortcomings, but not all.

The intention to adopt a comprehensive PFM reform programme in 2017, included as a measure in the ERP, is welcome. After adoption this needs to be followed up by concrete actions and clear timelines. The ERP provides some indications on the expected positive impact on competitiveness, but little discussion of risks and no further information on budgetary impact or social outcomes.

The measure on providing an IT platform for co-ordinating, monitoring and evaluating funds on a regional and local level is rolled over from the 2016-2018 ERP and is relevant as it would address the recommendation to improve fiscal transparency and budget planning capacity. It is well-designed and includes detailed, tangible and feasible activities. Nonetheless, the measure is not necessarily a systemic reform to improve fiscal transparency and budget planning capacity. It is arguably more of a public administration reform, which falls outside of the scope of the ERP.

Transport, energy and telecommunications markets

The economy is still characterised by a high energy intensity and inefficiency in energy production and limited integration into the regional power market. The ERP underlines that energy sector performance will be a key condition for sustained economic development and improved competitiveness and highlights the ageing energy system and convincingly argues for the need to revitalise the network and system management. However, the diagnostic does not include important issues such as liberalisation of utilities markets to increase competition. Despite recognising that electricity market liberalisation has been delayed and is now expected by 2020, the ERP does not discuss further specific measures to improve market functioning. The diagnostic on the transport market concentrates on road and rail networks but fails to assess the relative importance of this constraint. The country's transport networks are in adequate condition by regional standards and not necessarily a key constraint to growth and competitiveness. The telecommunications sector is relatively well developed and the diagnostic does not identify any obstacles to competitiveness.

None of the measures related to transport aim to reform the transport market through regulatory reform but focus exclusively on infrastructure investment. The measure to construct a joint railway border station with Serbia is new but it is not clear to what extent this responds to a key constraint to competitiveness. The measure does not indicate a budget for maintenance investment, and little or no discussion of risks and mitigating actions. The two measures on upgrading and rehabilitating corridors X and VIII include sub-measures on both rail and road transport. The 2016 Commission ERP Guidance note states that such infrastructure measures should be put in the wider context of reforming each specific transport market. The ERP did not follow this request, contributing to the programme's imbalance toward infrastructure investment at the expense of structural reforms with a potentially larger impact on competitiveness. The actions for construction measures planned in the 2016 ERP were all partially implemented.

The ERP does not foresee further regulatory measures targeting these markets. There is no discussion of measures to remove regulatory and administrative obstacles to opening transport markets, creating a transparent regulatory environment, and fixing fees that send proper price signals to users and allow for infrastructure repayment and maintenance. Not addressing such structural regulatory constraints significantly hinders any opening up of the economy. The Commission encouraged the government in its 2016 assessment and in discussions to refocus the ERP on structural reforms rather than infrastructure projects. In addition, as referred to in the 2016 Commission's ERP assessment, large infrastructure projects carry a higher risk of corruption and increase the need for a PFM reform programme with rigorous expenditure monitoring. Furthermore, reliance on external resources for new projects raises a concern over securing adequate follow-up resources for subsequent maintenance of the infrastructure system.

The two measures on energy aim to deal more comprehensively with energy needs but do not tackle regulatory reform. The measures focus on the supply side to increase production and transmission capacity to increase efficiency and strengthen regional connectivity and network reliability and security. The measures are rolled over from 2016, with the actions only partially implemented. There are still open issues on how to manage the country's ageing power generation plants, tackle dependency on imported gas and address the high energy inefficiency of the economy. The latter would require additional demand-side measures, including price and tariff reforms to send proper costing signals and align with the EU Energy Union goals. Also, the measures do not address the overarching need for market liberalisation and reform priorities related to the country's Energy Community obligations, particularly those on opening the electricity market, participating in the regional electricity Coordinated Auction Office and preparing and adopting the national energy efficiency and renewable energy action plans.

Sector development

Agricultural sector development

The agricultural sector suffers from poor irrigation as well as a large share of state-owned and fragmented land. The ERP rightly emphasises the problematic fragmentation of agricultural land. Private farms are too small to take advantage of economies of scale or to invest in new technologies. In addition, the share of irrigated land is significantly lower than in neighbouring countries. Forms of economic cooperation between farmers are at an embryonic stage of development. Moreover, migration from rural areas continues and a significant part of the land is abandoned.

The measures are well-conceived and attempt to tackle the primary structural constraints facing the sector; including land fragmentation, outdated equipment and technology, and increasing irrigation water shortages. All three measures are complementary to each other, meaning that coordinated implementation would strengthen their effectiveness. Two of the three measures are rolled over from the previous ERP where they had also been assessed as highly relevant, and the planned 2016 actions for both were fully or mostly implemented. The measure to improve irrigation systems is based on a clear diagnostic and assesses future requirements, including those arising from climate change and the growing need for additional irrigation, water management and flood protection structures. The ERP sets out timelines and includes considerable budgets. Given the size of construction work and the potential multi-dimensional impacts, a description of direct stakeholder involvement would be helpful.

The measure on the consolidation and defragmentation of agricultural land is a necessary and complex reform with potentially a significant positive impact. At the same time, the specific means to achieve the reform is not well detailed and possible risks have not been considered. There is no discussion of developing proper legislation on abandoned land, efficient monitoring of the use of state-owned land or of amending the law on land consolidation to incorporate state-owned land into the process. The new measure to establish agricultural cooperatives provides a detailed description and feasible timeframe and could further promote rural development and investment, and facilitate competitiveness and employment in the agri-food processing industry. There is, however, no discussion of risks and mitigating actions.

Industry sector development

There is a need to diversify industrial exports in terms of sectors and trading partners, as traditional products such as iron and steel, and textiles, still make up an important share of exports**.** Other key obstacles include the dependence on imported raw materials, underdeveloped enterprise clusters, limited access to finance, and insufficient management and marketing skills. The links between domestic industry and international production chains, including in the Technological Industrial Development Zones (TIDZ), are weak. The analysis in the ERP plausibly highlights these main bottlenecks to competitiveness of industry, but could in addition have mentioned the problematic access to energy, the significant skills gaps and insufficient levels of technological capabilities in domestic companies. No measures are planned as regards industry sector development.

Services sector development

The services sector employed almost 52% of the workforce in 2015 and provided over 60% of GDP. The ERP identifies three services sectors the government considers as having high growth potential (electronic commerce, tourism and creative industries). The brief diagnostics for each lists some of the main structural sectoral obstacles, and include regulatory impediments, including on consumer data, online security and lack of consumer awareness. The analysis also recognises the lack of a long-term strategy for developing tourism. It is, however, not clear on what criteria the sector selection is based as there is no diagnostic of the services sector as a whole. What the ERP refers to as "Creative Industries" is rather the information and communication technologies (ICT) sector.

The measures to increase the competitiveness of the tourism, hospitality and creative industries lack detail and are not embedded in a strategic approach. Two of the sectors (tourism and creative industries) also had measures in the previous ERP. The reporting of measure implementation lacks information on some activities. The measure on increasing competitiveness in the tourism and hospitality sector is relevant but is not part of the existing strategic national policy for tourism development. Similarly, the measure on increasing competitiveness in the ICT sector could have positive effects on higher valued-added production and employment for SMEs, but does not seem to be part of a strategic or comprehensive approach. The annual activity description is not very specific and could be further detailed, and there is no discussion of risks or mitigating actions. The measures are funded by an external donor, which raises concern over government commitment and sustained financial continuity or possible follow-up action.

Business environment and reduction of the informal economy

Private sector development is hampered by the large informal sector, a weak access to finance and a weak access to electricity and political instability. The ERP diagnostic recognises some of these. It describes the country's relatively favourable position in the region but also depicts the deterioration in several areas in recent years, including on enforcing contracts, corruption, the informal economy (accounting for an estimated 20% of total employment), access to finance and fragmented government e-services. Other important challenges facing business, such as the unpredictable legal environment, including an uneven application of regulations and frequent changes to the legal framework receive inadequate attention in the programme.

Recurrent legislative changes without adequate stakeholder consultation make the business environment less predictable and reduce ownership. There is a need for more stakeholder involvement, in line with the 2016 policy guidance. However, this is prevented by continued use of the urgency procedure for legislation, and the lack of systematic use of the National Electronic Register of Regulations (ENER). The share of the informal economy in the economy remains large, distorting private sector competition and depriving the government of revenues; it would have warranted a reform measure. The weak links between FDI and local businesses could have been further elaborated.

The measures aimed at development of a national portal for e-services and the adoption of a national strategy for SMEs address some constraints, but to a limited extent. Given the many obstacles to competitiveness, this area could have contained more measures. The measure to develop a national portal for e-services can contribute to increased ease of doing business and strengthened transparency. It is likely to assist SMEs through decreased administrative burdens, especially in conjunction with measures to simplify requirements for licences and remove unnecessary regulations. The measure is related to one included in the previous ERP but there was no progress or implementation of it in 2016.

The new measure to adopt a national strategy for SMEs with an action plan represents a useful first step to provide a much-needed update of the national strategy. The numerous implicit actions included in the strategy and action plan need to be more clearly explained and prioritised. Similarly, the impact assessment requires a more precise discussion of specific activities. There is no discussion of risks or mitigating actions for adoption of the strategy and action plan.

Research and innovation

Limited access to finance, lack of innovation infrastructure and weak cooperation between academia and the private sector are key obstacles to growth in the RDI area. The ERP diagnostic notes that relative RDI performance has steadily improved over the past years, albeit from a very low base. However, it also recognises that as a share of total GDP, total R&D expenditure remains low (0.52% of GDP in 2014) and essentially consists of public expenditure, with negligible private sector contributions (0.02% of GDP in 2010). The diagnostic shows an awareness of the strong correlation between investment in R&D and competitiveness and economic growth. It rightly acknowledges the low RDI absorption capacity of SMEs as a problem. However, it does not analyse the reasons for the weak cooperation between universities and private sector.

The measure on improved infrastructure and access to funding for research plans to provide funding instruments for several stages of the innovation cycle. The measure is rolled over from the previous ERP, albeit under a different name. The activities planned in 2016 were not implemented. The measure is targeted at SMEs and should help increase innovation and competitiveness; this will depend on SME absorption capacity, which has been low. There is a concern that no actions are planned to improve such absorption capacity, limiting the potential impact of this measure.

The measure on creation of a 'Triple Helix Partnership' between academia, private sector and government fosters an inclusive approach to structural reform in this area. It is rolled over from the ERP 2016-18 and concentrates on three sectors, based on potential growth and country strategies: agriculture, ICT and renewable energy. The focus is not exclusive and several other industrial and service areas are included as well. In 2016 the planned establishment of the National Technology Transfer Office (NTTO) was delayed due to regulatory compliance issues. NTTO establishment is now foreseen for 2017. Again there is no discussion of mitigating actions for the risks related to measure implementation. If this measure can be sufficiently developed it could lead to the creation of several innovation hubs and have an appreciably positive impact on the economy.

External trade and investment facilitation

Obstacles in this area relate to SMEs' difficulties in entering export markets due to relatively high logistical and customs costs and to a lack of managerial, financial and technical capacities. The ERP highlights these constraints, together with the limited linkages between FDI and domestic companies.

The measure upgrading customs clearance facilities at road border crossings considered bottlenecks to cross-border trade, is likely to support trade. The measure focuses on improving the physical structures and does not include associated plans to increase IT capabilities, such as the project to develop a new customs IT system (Customs Declaration and Excise Documents Processing System) whose completion is long overdue. Such an integrated approach is required if the volume of traffic crossing at these points is to increase in line with projections. Another important customs administration project already implemented (the New Computerised Transit System NCTS) is also not mentioned as a supporting element.

Education and skills

Key challenges in education and skills area include the low attendance in preschool education, insufficient number of teachers, the unattractiveness of the VET system and insufficient links to labour market needs, as well as low participation in lifelong learning, and a low level of transversal/soft skills. The main challenges for higher education are quality, accreditation and evaluation, relevance of study programmes, skills mismatch and lack of cooperation with the labour market. The vocational education and training system is characterised by weak capacity of the VET Centre and VET providers and lack of effective cooperation with the business sector The ERP diagnostic recognises most of these challenges.

However, the ERP fails to mention the low quality of primary and secondary education. Relevant indicators, such as the 2015 PISA results, where the country is at the bottom of the ranking table - over 100 points below the OECD average in each of the three domains, point to persistent challenges of the country's education system, revealing, i.a. that two-thirds of 15-year-olds are functionally illiterate in each tested subject area. The country's largely segregated education system brings additional challenges, in particular the fact that students from the different communities are taught separately, making it harder to ensure a uniform level of quality and investment in education across all schools.

The measure on the further development of the qualification system focuses primarily on occupational standards. Apart from them, an effective qualification system needs other elements and the steps for their implementation require a strong institutional framework not yet expressed clarly enough in the ERP. The occupational standards (e.g. 60 new occupational standards) will not suffice to achieve the impact on competitiveness it is claimed it will have, if the links between the labour market needs, curricula, learner assessment and certification are not incorporated into a systematic approach. Other important aspects include increasing the quality of work-based learning, updating teacher skills, developing post-secondary education. The activities under the measure should be more specific in terms of: selection of the two priority sectors for development of new qualifications; data collection approaches; the role of Skills Observatory; and, quality assurance of qualifications. The budgetary impact is rather general and tends to show a listing of donor supported initiatives rather than a government-led holistic and strategic approach.

Employment and labour markets

Low employment levels among women, young people and Roma remain impediments to more inclusive economic growth in the country. Despite continued marginal improvement, the female employment rate (20-64 years) remains quite low at 42.1 % (2015). At the same time, the rate of young people not in employment, education or training is persistently high at 33.9 % (2015). The ERP diagnostic reflects the key challenges. However, there is only limited cooperation across policy sectors to improve planning, outreach, delivery and monitoring of active labour market policies to tackle the lengthy school-to-work transitions. In addition, regulatory and procedural barriers impede access to internships and work-based learning.

The provision of activation measures for vulnerable young people, women and long-term unemployed has only been partially strengthened. Most activation measures for young unemployed people target people with at least secondary education who are active job seekers. At the same time, the administrative division between active registered unemployed people and others looking for work (i.e. passive unemployed people) creates an artificial and administrative barrier to the take-up of active employment measures. Investment in activation measures targeting people with low levels of education is insufficient. The current operational plans provide scarce options for activating passive registered unemployed people, the long-term unemployed and unemployed people with only primary education. Such people should be provided with literacy courses and similar offers profiled for their educational/gender/ethnicity background. While the Employment Service Agency's capacity to carry out profiling and personalised counselling of job seekers has been strengthened (to a large extent by EU-funded activities), the continuity and sustainability of reform efforts still need to be secured.

The measure for profiling of the unemployed and designing individual employment plans continues a previous commitment to build up the capacity of the Employment Service Agency. The instruments planned are welcome steps towards a more effective delivery of services and a sustainable fight against unemployment. However, the coverage of low-skilled unemployed people needs to be gradually increased, since most active labour market measures target unemployed people with at least secondary education. Only 7500 unemployed people per year will receive support through individual employment plans. This figure is low given the number of people who face difficulties gaining employment. The high adviser–client ratio and limited resources are impeding factors that may put at risk full accomplishment. In addition, the number of unemployed people to be covered will remain the same for all 3 years, which might not necessarily reflect reality. To have a reasonable impact on the labour market the measure has to be more ambitious in terms of coverage and funding.

Social inclusion, poverty reduction and equal opportunities

The high rates of poverty - 21.5 % (2015) - and material deprivation - 51.4 % (2015) - remain persistent obstacles to social inclusion and are worsening inequality. The unemployed and households of two adults with three or more dependent children face the highest poverty rates – 39.7 % and 52.2 % respectively. While the ERP recognises the key challenges, the current policy does not provide appropriate and accessible social protection for all in the context of high unemployment rates, irregular wages and high demand for social welfare. The social assistance scheme may have generated disincentives for potential low-wage and part-time earners to shift from inactivity or from the informal sector to formal jobs. In addition, child protection is essentially targeted at working parents (i.e. through child benefit, use of public kindergartens, etc.) and there is very little or no support for the unemployed and low-income households with children.

No reform measure is proposed under this heading even though data point to multiple barriers for vulnerable groups, gender gaps and a high incidence of poverty. However, to advance the national agenda on social inclusion and fight marginalisation and poverty, what are needed are updated insights on the incidence of vulnerability and a clearly expressed commitment to tackle multidimensional aspects of social exclusion and poverty in the country, through measures in such areas as education, employment and regional development. This implies a need for a more fundamental reform so that the country has a social welfare assistance system that is better run, better targeted at those who need it and which engages in inter-institutional coordination.

ANNEX 1: IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2016

2016 policy guidance	Summary assessment
PG 1: Underpin fiscal consolidation by identifying concrete revenue and expenditure measures; move towards a better targeting of transfer spending and improve the growth-friendliness of public finance, in particular by fully executing planned priority public investment spending. Protect against fiscal risks by using any excess revenue to create fiscal buffers.	PG 1 has **not been implemented**: • The government has not defined measures underpinning fiscal consolidation plans. • Revenue projections were adjusted downward twice mid-year. • Capital expenditure spending reached only 75% of revised budget, mainly as a result of two budget rebalancings cutting capital spending. • Pensions were again increased ad hoc by 5% on average above indexation in 2016.
PG 2: Improve fiscal transparency and budget planning capacity by the swift introduction of a medium-term expenditure framework; by providing multi-annual projections of detailed revenue and expenditure components in the medium-term strategy as well as by comprehensive reporting of extra-budgetary expenditure in the consolidated fiscal reports. Inform systematically about payments arrears.	PG 2 has **not been implemented**: • There was no enhancement of information contained in the fiscal documentation. Gaps remain, for example, regarding the budget impact of policy changes; multiannual costing of investment projects; information on payment arrears. • The medium-term fiscal strategy for 2017-2019 does not contain details of annual revenue or expenditure categories, nor does it contain a numerical composition of external and domestic sources of deficit financing. • The project for implementation of a medium-term expenditure framework started in December 2015 and is still ongoing.
PG 3: Develop comprehensive strategies involving all relevant stakeholders in order to both further foster the resolution of non-performing loans by banks and further promote the use of the local currency with a view to reducing risks to financial stability and the real economy. There would be a case for a gradual removal of the central bank's accommodative monetary policy stance to the extent that authorities' sanguine macroeconomic scenario is realised (including through its impact on inflation expectations and on the output gap).	There has been **limited implementation** of PG 3: • There was no comprehensive strategy developed to deal with the resolution of non-performing loans. The central bank required commercial banks to write off all non-performing loans that had been fully provisioned for more than 2 years, by June 2016. This implied a move of a part of NPLs from on-balance sheet item to off-balance sheet item, with banks keeping the opportunity to collect the claims, and debtors still having the NPL on their balance sheet.
PG 4: Adopt a credible public finance management reform programme. Prioritise public investments against clear policy objectives and identify the needs to which they respond. Increase the transparency on the selection criteria for the investments and on their impact on economic growth and on the fiscal path.	There has been **limited implementation** of PG 4**:** • The National Investment Committee responsbale for preparating and implementing infrastructure investments was created in June 2015 and has become more operational. It has introduced tools incl. cost-benefit analysis, and single pipeline approach and met several time, most recently in December 2016 to present investments to be submitted to the WBIF. • There is as yet no PFM reform programme finalised and adopted yet with a concrete action plan for its implementation. Due to the political crisis this process might be substantially delayed. A PFM policy dialogue is planned to be carried

	out and the PFM reform programme is expected to be approved once the new government is established and functional.
PG 5: Ensure a reliable and predictable regulatory environment for businesses by reducing the use of the urgency procedure for legislation, ensuring proper consultation of the stakeholders and reinforcing the independence of commercial courts.	PG 5 has **not been implemented**: • Although the country improved its ranking in the World Bank Doing Business Report 2017, it dropped in other ranking reports. The practice of using urgent procedures for adoption of business related legal acts continued. There is no systematic consultation with interested parties to ensure transparency and ownership. Consultation relies solely on the National Electronic Registry of Regulations (ENER) and the work of the National Competitiveness Council (which was closed recently). However, these do not secure proper consultation with the business sector.
PG 6: Strengthen the provision of activation measures especially for vulnerable youth, women and long-term unemployed and further improve the capacity of the Employment Service Agency for profiling and personalised counselling of job seekers.	PG 6 has been **partially implemented**: • The provision of activation measures especially for vulnerable young people, women and the long-term unemployed has been partially strengthened. Most activation measures for young unemployed people address people with at least secondary education who are active job seekers. However, the current operational plans provide few options for the activation of passive registered unemployed people, the long-term unemployed and unemployed people with only primary education. • The capacity of the Employment Service Agency for profiling and personalized counselling of job seekers has been strengthened, to a large extent thanks to EU-funded activities. The continuity/sustainability of activities like staff training and IT upgrading still needs to be secured.

ANNEX 2: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The Economic Reform Programme (ERP) 2017-2019 was submitted by the government on 31 January 2017. It is broadly in line with the medium-term fiscal strategy and the 2017 Budget Law. The programme includes sections assessing the sustainability of the external position and the main structural obstacles to growth. This responds to the requirements for candidate countries and potential candidates to progressively adapt their economic and fiscal surveillance to bring it into line with the new EU approach to economic governance. No components of the ERP are missing.

Inter-ministerial coordination

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

Stakeholder consultation

The draft ERP 2017 was put on the website of the Ministry of Finance for the period 26 December 2016 to 10 January 2017, when it was open to comments/recommendations by external stakeholders, including social partners. The government also invited interested stakeholders to contribute directly at a public ERP consultation which was held in Skopje on 4 January 2017 at the Ministry of Finance, but only five participants attended. The contributions are included as an annex to the ERP.

Macroeconomic framework

The macroeconomic projections are more realistic than in previous years. They take account of the government's downward revision of growth projections in the summer. The programme presents two alternative scenarios compared to the baseline, assuming lower growth in trade partner countries, and lower domestic demand in 2017 as a result of a further protraction of the political crisis, respectively. An analysis of external debt sustainability is provided as an annex.

Fiscal framework

For 2016, the programme is based on the most recent budget projections following the second budget revision, and on fiscal data available at the end of the third quarter. In spite of the revised economic growth assumptions, the programme adheres to the fiscal targets of previous years, but it does not present concrete measures underpinning the planned consolidation. Compared to the 2016 fiscal outcome, the revenue projections, and the envisaged increase in capital expenditure for 2017-2019 seem unrealistic. There is no detailed numerical breakdown of deficit financing sources, and of domestic and external debt repayments falling due. The programme would have benefitted from information on the expected budget impact of policy changes, as well as explanation of the differences in projections compared to last year's ERP. The programme includes an analysis of the budget deficit's sensitivity to lower GDP, lower revenue, and higher expenditure growth, and of the sensitivity of public debt to changes in interest rates and exchange rates.

Structural reforms

In contrast to ERPs submitted in 2015 and 2016, the structure of the 2017 ERP follows much more closely the guidance note and provides both an overarching analytical assessment and a focused diagnostics per sector area. The measures now have clear headings with measure description, timelines per year, budget estimations, competitiveness impact assessments, and social outcome estimations (except measures 1, 17). Some measures include -or at least very briefly mention- implementation risks, but risks are missing from measures 9, 11, 12, 13, 17 and 19. Even if risks are briefly mentioned, none of the measures include a discussion of planned mitigating actions. In some cases the proposed measures are described or named in terms of desired outcomes or objectives.

The ERP only refers briefly to two of the three structural reform measures from the 2016 policy guidance with little further reporting on their implementation. The reporting on the structural reform measures of the 2016-2018 ERP is, however, generally clear as it is helpfully described in Table 12.

The ERP describes in total 19 measures, thereby respecting the set maximum of 20 measures. The page limit of 40 pages was only slightly exceeded at 44 pages.

Some of the measures across the nine diagnostic areas lack precise focus and are rather diffuse and/or lack detail on precise annual activities, such as in the area of Business environment (e.g. the adoption of an SME strategy incorporating a broad range of measures and actions) or the measures in the services sector where annual activities also are rather general. Further, some of these measures amount more to objectives/desired outcomes rather than a precise targeted and focused activity.

The Annex tables 9-12 were all completed although table 10 (Matrix of policy commitments) was only filled in partially as many cells were left empty or given a '0' – value. While there might be valid reasons for this as measures do not necessarily always have direct budgetary impacts, it more often seems to indicate a lack of precision or insufficient analytical capacity to further detail the budgetary expenditure and revenue impacts of the measures. Reflecting the main text, and similarly to the previous ERP, Table 11 (Summary of structural reform measures) could have contained more specific details. The summaries in Table 12 (Reporting on the implementation of the structural reform measures of the ERP 2016-2018) were clear and helpful.