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COVER NOTE

From:	General Secretariat of the Council
To:	Delegations
Subject:	Conclusions of the Ministerial Dialogue between the Economic and Finance Ministers of the EU and the Candidate Countries

Delegations will find attached the Conclusions of the Ministerial Dialogue between the Economic and Finance Ministers of the EU and the Candidate Countries adopted at the ministerial dialogue of 6 May 2014.

CONCLUSIONS
OF THE MINISTERIAL DIALOGUE BETWEEN THE ECONOMIC AND FINANCE MINISTERS OF THE EU AND THE CANDIDATE COUNTRIES

The Economics and Finance Ministers of the EU and the candidate countries, representatives of the Commission and the European Central Bank and representatives of the central banks of the candidate countries met for their 16th economic policy dialogue. Ministers welcomed the submission of the 2014 Pre-accession Economic Programmes (PEP) of the former Yugoslav Republic of Macedonia, Montenegro, Serbia and Turkey which outline the countries' medium-term macroeconomic frameworks, fiscal strategies and structural reform agendas. The programmes cover the period from 2014-2016.

Ministers take note of the Conclusions of the General Affairs Council on 17 December 2013 in which the Council welcomed the Commission's proposals to strengthen dialogue on economic governance with enlargement countries, in order to help them to gradually meet the economic accession criteria and be better prepared in terms of economic reform, competitiveness and job creation.

Ministers welcome the new approach to economic governance through which the Ministerial Dialogue with candidate countries will provide more targeted policy guidance with a view to strengthening public finance, supporting private sector development and enhancing the functioning of the labour market.

As regards statistics, Ministers underline the importance of reliable and up-to-date data and therefore welcome the 2014 Progress Report on the Action Plan on Economic, Monetary and Financial Statistics in Candidate Countries. They were comforted that all candidate countries made progress in fulfilling the Action Plan requirements, but noted that additional efforts in some statistical areas are still needed to achieve a full compliance with the Action Plan requirements.

The former Yugoslav Republic of Macedonia

On 31 January 2014, the former Yugoslav Republic of Macedonia submitted its 2014 Pre-Accession Economic Programme covering the period 2014-2016. In light of the Commission's assessment, Ministers are of the opinion that the most pressing fiscal challenge is to enhance fiscal discipline and transparency. With reference to structural changes in the economy, the programme projects gradually increasing annual growth rates, averaging close to 4%. This appears optimistic and strongly depends on further strengthening of FDI and implementation of government plans for public investment. While growth in 2013 was driven exclusively by net exports, in 2014 and 2015 it is expected to be carried by domestic demand. The current account deficit is forecast to widen gradually, mainly as a result of a surge in investment-related imports and a further decline in private transfers, but remains moderate.

Ministers acknowledge that the objective of the medium-term fiscal strategy is to pursue a consolidation based on savings in current expenditures, so as to reach a budget deficit of 2.6% of GDP in 2016. In 2013, the deficit target had to be raised from 3.6% to 3.9% of GDP, due to weak revenue growth, spending pressures on welfare costs and the payment of arrears. At the same time, the strategy envisages an ambitious spending programme to support growth and employment. Ministers note that concrete measures to reach the fiscal targets are insufficiently specified, and that recent increases in pensions and announcements of further increases in social transfers and public wages complicate the planned consolidation in current expenditures. Moreover, general government debt, albeit still at a rather moderate level, has increased since 2008, and is projected to further expand in the medium-term. Total public debt is following the upward trend of general government debt, as a result of increased borrowing by public enterprises guaranteed by the government and is likely to continue growing due to the envisaged projects in infrastructure and for SMEs, leading to significant fiscal risks. Rising public indebtedness also risks putting an undue burden on monetary policy making. The transparency of fiscal data is blurred because published data is not compiled according to EU accounting standards.

The budgetary expenditure mix remains heavily biased towards current expenditure, in particular social spending, while committed funds for capital spending are regularly under-executed. Although large amounts of investments are envisaged over the period 2014-2016 to address shortcomings in transport and energy infrastructure, there is room for improvement towards a more growth-friendly structure. Social transfers, over half of it pensions, account for about 42% of total expenditure. The work towards better targeting of social benefits to support the most vulnerable groups should be continued.

Ministers note that improving employment opportunities is critical. Unemployment remains very high, although it gradually declined over the last years. Youth and structural unemployment still need particular attention. While budget funds and capacities for active labour market policies are being increased, greater emphasis needs to be put on developing the skills of the workforce in line with those required by employers, also with a view to enabling increased labour mobility into higher-productivity sectors. The government adopted a reform plan for vocational training, yet its implementation is slow. Incentives to work for lower-income workers remain hampered by a disproportionately high rate of labour income tax and social contributions on low salaries.

The restoration of the bank lending channel remains a key challenge in the near-term, and the central bank's attempts to remove potential supply-side constraints to the bank lending channel through standard and non-standard measures have thus far yielded only moderate results. The burden on banks' balance sheets from non-performing loans decreased slightly in recent months, but remains sizable, and effective rates on loans are coming down only gradually. External vulnerabilities are likely to remain sizeable with a high dependency on net current transfers to cover such imbalances. A further narrowing of the trade deficit and higher export diversification would strengthen the ability of the economy to cope with these challenges. Ministers note the need to maintain adequate reserve buffers in view of the monetary and exchange rate policy regime in place. In the face of high liability euroisation, tail risks for the banking system in the event of currency depreciation should also not be overlooked, pointing to the need to continue with efforts at de-euroisation.

Strengthening the investment climate should be pursed with determination. Despite significant progress, there are still important shortcomings in the regulatory environment. It remains burdened by cumbersome licensing procedures, difficult contract enforcement and still lengthy and costly business exit procedures, while employers' flexibility of adjusting their capacities to demand fluctuations is still hampered by legal restrictions of work organisation. In many cases, local firms lack the necessary know-how and capacities to create linkages with foreign companies and be integrated into foreign supply chains. The innovative potential of firms, and the shift of production and exports to sectors with higher value-added and higher productivity need to be strengthened.

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

- Implement the 2014-2016 medium-term fiscal strategy as planned and protect the execution of growth-enhancing capital spending by preparing contingency fiscal measures to compensate for unexpected revenue shortfalls or expenditure pressures; adopt a cautious and selective approach to the issuance of sovereign guarantees.
- Continue to improve the composition of spending, by prioritising investment projects according to their productive potential on the basis of cost-benefit evaluations; increase the efficiency of social spending.
- Improve medium-term budget planning and execution; increase fiscal transparency by providing more detailed data on planned and executed capital expenditure, including of public enterprises, in the context of the annual budget cycle and the medium-term strategy; adhere to EU accounting standards, notably ESA 2010; and resume the submission of fiscal notifications.
- Improve the employability of workers, by better aligning vocational and tertiary education with labour demand needs, better target active labour market policies and publish regular performance evaluations.

- Accelerate the further implementation of the "regulatory guillotine", including the facilitation of licensing procedures for new companies through the quick completion of the one-stop shop system for business registration; and establish a fast and inexpensive bankruptcy procedure; implement the innovation strategy, including the efficient functioning of the Innovation Fund.
- Continue to take measures to repair the bank lending channel, including by fostering the clean-up of non-performing loan portfolios and make further progress to reduce indirect financial stability risks by promoting the use of the domestic currency.

Montenegro

On 30 January 2014, Montenegro submitted its 2014 Pre-Accession Economic Programme covering the period 2014-2016. In the light of the Commission assessment, Ministers are of the opinion that the major and most pressing fiscal challenge is to put public debt on a declining path. The macroeconomic scenario underpinning the budgetary projections in the programme seems broadly optimistic. Real growth would accelerate to 3.8% in 2016, relying on a sharp increase of investments to replace net exports as the main engine of growth, while the structurally high current account deficit would narrow. The Commission forecasts a lower growth path as well as a deterioration of the current account deficit based on a higher import dependency of investments.

The objective of the ambitious fiscal strategy outlined in the programme is to continue the consolidation of public finances. Despite the payment of a state guarantee, the budget deficit decreased below 3% of GDP in 2013, further fiscal consolidation is planned for 2014, and the budget should come close to balance in 2015. However, the challenge of ensuring fiscal sustainability and taming public debt growth remains. The stock of public debt has doubled since 2007, reaching more than 56% of GDP at the end of 2013. Furthermore, both the 2014 budget law and the medium term Pre-Accession Economic Programme do not include the fiscal impact of the debt-financed Bar-Boljare highway nor of the section Smokovac-Mateševo whose construction is expected to start this year. Not only is there scope to improve the transparency of public finances but additional adjustment measures will be required to contain the rise in public debt.

On account of the monetary and exchange rate policy regime[1] currently in place, fiscal policy remains the main policy instrument available to smoothen the economic cycle. In this regard, Montenegro will strengthen its fiscal framework. A new Budget and Fiscal Responsibility Law will enter into force still in 2014, introducing numerical fiscal rules such as upper limits for budget deficit and public debt of 3% and 60% of GDP respectively. It is important that the authorities ensure its effective implementation while exercising caution in the issuance of state guarantees. To be effective, the fiscal strategy must also be underpinned by structural reforms. The budget is characterised by the predominance of non-discretionary spending, namely pensions and public sector wages. These expenditures have been frozen in 2013 and 2014, but additional reforms would need to be considered for attaining long-term sustainability, such as the planned alignment of public administrations salaries and steps towards the reorganisation of the public sector and pension reforms.

Montenegro faces a number of challenges in economic competitiveness. The macroeconomic policy tools to guide the economy on a path of sustained convergence are severely constrained by unilateral euroisation. At the current juncture, the absence of a policy interest rate and the significant limitations to its lender of last resort function reduce the central bank's ability to influence bank lending and thereby to support economic growth. The weak pace of lending by banks and a high burden of non-performing loans (NPLs) in banks' balance sheets, which is also reflected in persistently high lending rates, remain the main near-term challenge hampering economic growth.

While acknowledging the progress already made, Ministers note that there is scope for further improvements to the business climate. Investors would notably benefit from increased predictability and simplification in the regulatory environment and from more transparency and a reduction of red tape and costs as regards construction permits and fees, especially at local level. Further efforts are also required to improve the judicial system, and in particular contract enforcement.

1 Ministers recall the Council position on unilateral euroisation from 2007, which should be fully taken into consideration by the Montenegrin authorities.

Labour market imbalances are reflected by persistently high youth and long-term unemployment. Moreover, the existence of an important disparity between education outcomes and labour market demand –as reflected by the high level of youth unemployment with tertiary education– worsens structural unemployment. The reform of the education system has been delayed. The national collective agreement which applies to both private and public sectors and the lack of flexibility in the wage setting process at firm level, add to labour market rigidity. Efforts are also required to tackle informal employment.

In the light of this assessment, Ministers hereby invite Montenegro to:

- Steer public debt into a downward trajectory by taking additional adjustment measures required to limit the impact of the financing of the highway on public debt and implement effectively the law on Budget and Fiscal Responsibility. In order to improve the transparency of public finances, Montenegro is invited to adopt in 2014 a strategy for implementing the European System of Accounts (ESA2010) and submit fiscal notifications.

- Prepare, as a first step, a review of the old-age pension indexation system, and implement the plan on restructuring of the public sector as well as the reform of public sector salaries to remove disparities across public bodies.

- Further improve the predictability and simplification of the regulatory business environment, notably through the so-called "regulatory guillotine", and reduce the costs of municipal fees on construction permits without endangering the sustainability of local governments' finances.

- Pursue the reform of education, with a view to better aligning education and skills with labour market needs and strengthening cooperation between education and business. Introduce more flexibility in the labour market through distinct collective agreements for public and private sectors.

- Implement the planned voluntary financial restructuring programme (the so-called "Podgorica approach") to address the high burden of non-performing loans on bank balance sheets from both a stock and flow perspective.

- Find a sustainable solution for the aluminium company KAP.

Serbia

Serbia submitted its 2014 Pre-Accession Economic Programme, covering the period 2014-2016, on 24 January 2014. In the light of the Commission assessment, Ministers are of the opinion that, despite several rounds of consolidation efforts and an important reduction of the budget deficit in 2013, Serbia is still facing mounting debt and budget deficit challenges. The macroeconomic scenario underlying the programme is broadly plausible. Following an export-led recovery in 2013, which translated into a significant reduction of the current account deficit that still remains structurally high, economic growth is expected to slow down and remain modest over the medium-term. The envisaged growth profile depends crucially on increased investment and exports, assumed to be supported by the country's EU accession prospects and an acceleration of structural reforms.

Ministers acknowledge that the medium-term objective of the fiscal strategy is to slow down the growth of public debt. Public debt should be kept below 70 % of GDP throughout the programme period, owing to primarily expenditure-based consolidation measures and structural reforms to reduce the budget deficit, including below-the-line-operations, to 3.2 % of GDP in 2016. However, the consolidation path is rather back-loaded, starting only in 2015. In 2014, despite additional consolidation efforts, increased expenditures, some of which due to the short term costs of the restructuring of state-owned enterprises, are expected to lead to a high deficit of 7.1% of GDP. Additional efforts will be needed both this year and in outer years to further strengthen and frontload the consolidation strategy. In view of this, the reform of large entitlement programmes, like the pension system and public administration, governance, in particular in large loss-making state-owned enterprises, and state aid provisions, envisaged in the programme, besides enhancing overall economy productivity, should provide the backbone of a sustainable reduction of budget deficits over the medium-to-long term. These efforts will not only enhance the resilience of the Serbian economy to external shocks, but would also alleviate the disproportionate burden of the adjustment put on monetary policy.

Monetary authorities faced difficult policy trade-offs between external and domestic objectives. In this context, the sizeable funding needs of the public sector in a changing global environment and the potential knock-on effects notably on the exchange rate in a highly euroised economy emerged as major constraints on policymaking. Looking ahead, addressing structural bottlenecks in credit channels appear as a key policy priority for the authorities on account of both the weak pace of credit extension and the high burden of non-performing loans in bank balance sheets. Maintaining inflation within the established objectives and reducing the high volatility of inflation should continue to represent a priority for authorities, as this will ensure long-term anchoring of inflation expectations and greater efficiency of monetary policy. This is important because failures to meet established inflation objectives in the past could impair both the credibility of the inflation targeting framework and the authorities' de-euroisation policies.

The Serbian economy has a number of structural weaknesses. Addressing them would require tackling the large and inefficient public sector, improving the business environment, strengthening the rule of law and reducing labour market rigidities and the large informal employment. The modest and narrow based economic recovery has so far failed to relieve the banking sector from its high level of non-performing loans and the financial system remains under pressure. Ministers note that the authorities are well aware of the magnitude of the challenges and encourage them to follow-up on their announced policy intentions. Bold measures to improve the business environment and support private sector development, such as reviving the "regulatory guillotine" and facilitating the process of dealing with construction permits should be adopted with urgency. Completing the restructuring of state-owned enterprises, which has commenced last year, is long overdue and further significant gains could be reaped by improving the functioning of the public sector at large. Since the success of the reforms hinges to a large extent on creating new jobs and a more dynamic labour market within a context of very high unemployment (over 20% of the labour force), further decisive measures are needed to overcome obstacles to job creation. Finally, implementing the public administration and pension reforms planned in the program is essential.

In the light of this assessment, Ministers hereby invite Serbia to:

- Strengthen fiscal consolidation, by taking additional measures to reduce the budget deficit in 2014 and the following years and further support the envisaged medium-term consolidation path by credible public sector reforms. To this end, the authorities are encouraged to implement the public administration and pension reforms planned in the programme, by standardising salary grades for public officials and taking steps to revisit employment in the public sector in a sustainable manner, as well as limiting possibilities for early retirement and gradually increasing the retirement age for women.
- Further strengthen public finance management, notably by improving the capacity of the tax administration and the budget process with regards to arrears, which would be instrumental in supporting consolidation efforts.
- Address the high burden of non-performing loans on bank balance sheets.
- Use the opportunity of the low prevailing rate of inflation to fully cement the central bank's anti-inflationary credentials and thereby anchor medium-term inflation expectations, while investing further efforts in developing and implementing policy measures to reduce inflation volatility.
- Adopt the necessary legislation and complete, as outlined in the programme, the restructuring process of state-owned enterprises; review the efficiency of all forms of state aid and take steps to reduce subsidies and state guarantees, and improve governance, in particular in large loss-making state-owned enterprises.
- Improve the business environment and support private sector development, notably by reducing the scope of para-fiscal charges and simplifying the regulatory environment ("regulatory guillotine") and the process of dealing with construction permits.
- Increase labour market flexibility and reduce rigidities by extending the maximum duration of short-term employment, linking severance payments to the number of working years with the current employer, and simplifying the structure and calculation of salaries and compensations.

Turkey

Turkey submitted its 2014 Pre-Accession Economic Programme, covering the period 2014-2016, with a four-week delay on 27 February 2014. The programme does not take into account recent significant market and policy developments and does not fully comply with the Commission's guidelines for such programmes.

The economy has expanded strongly over the past twelve-year period, raising the average living standard of Turkish citizens significantly. In the light of the Commission's assessment, Ministers consider that the Turkish authorities should strengthen macro-economic policies for external and internal rebalancing. The implementation of comprehensive structural reforms should be accelerated to unleash the country's full economic potential and to support the reduction of macro-economic imbalances.

The macro-economic scenario underlying the programme projects stronger growth in conjunction with current account improvement and lower inflation. This scenario does not sufficiently take into account that recent market and policy developments have altered the short-term economic prospects. The central bank has increased short-term interest rates sharply and financial conditions have tightened significantly. Some slowdown in domestic demand seems probable in the current year, while external demand is expected to have a positive impact on the growth outlook in 2014.

On the external side, Turkey faces a large and persistent current account deficit. It is associated with an annual financing requirement corresponding to around a quarter of GDP, including the re-financing of existing external debt. Currently, the roll-over ratios of the private sector do not suggest significant risks for external debt refinancing. However, the capital inflows required to finance such a high current account deficit, in combination with variations in global risk sentiments, might contribute to pronounced fluctuations in economic growth. Without a significant reduction of the current account deficit, external debt sustainability risks might increase over the medium term. The chances of achieving a current account improvement, as projected in the programme, has increased in view of the recent currency depreciation and monetary policy tightening which should help to raise private saving. The recovery in Europe, Turkey’s largest trade partner, is expected to contribute to an improving export performance.

On the internal side, inflation remains at the high single-digit level which is problematic in terms of macro-economic stability, resource allocation and re-distributive effects. Currently, exchange rate pass-through is exerting upward pressure on domestic prices and the programme's projected decline of inflation is unlikely to be attained in the near term. The central bank's monetary policy framework, implemented in late 2010, has failed to lower inflation to the 5% target and to anchor inflation expectations. Although price stability is the central bank's primary objective, it has simultaneously pursued secondary goals, relying on a policy mix with multiple instruments. Given the necessity to anchor inflation expectations at the current conjuncture, it appears advisable for the authorities to let monetary policy focus firmly on the pursuit of price stability and address the secondary goals with prudential, fiscal or structural policies. In this context, the central bank's decisions on 28 January 2014 are a welcome step as they have brought real interest rates into positive territory and simplified the monetary policy framework. They will also help to reduce the external imbalance by raising the chronically low private saving rate.

Public finances have shown moderate deficits in recent years with expenditures exceeding budgetary limits and expanding faster than nominal GDP. The structural balance of general government has also been negative in spite of the large current account deficit and relatively high inflation. The programme projects a gradually declining structural deficit in 2014-2016. The debt-to-GDP ratio has fallen to a sustainable level of well below 40%.

The need to reduce the structural external imbalance calls for improvements in the international competitiveness of Turkish goods and services through increased productivity. The key to this is structural and governance reform, including increased labour market flexibility, a better educated and trained labour force, and improvements to the business environment.

In the light of this assessment, Ministers hereby invite Turkey to:

- Promote domestic saving in view of the persistently large current account deficit. Fiscal policy has an important role to play in this regard by following a sufficiently restrictive stance. Reducing the rigidity of public expenditures would help to make the fiscal policy stance more responsive to macroeconomic needs. The EU experience suggests that the adoption of a fiscal rule would provide an important fiscal anchor, enhance credibility and support the envisaged reduction of the structural balance.
- Continue to take consistent steps to re-focus monetary policy on the pursuit of price stability, with other policy objectives being pursued with separate measures, and thereby contribute to improving both the functioning and the credibility of the inflation targeting regime
- Make sustained efforts to improve the business environment and Turkey's attractiveness as an investment destination, not least for foreign direct investments, in view of the continuing dependence on large capital inflows. This requires wide-ranging reforms, including making it easier to start businesses and strengthening competition through continued liberalisation of product and service markets.
- Accelerate the implementation of a comprehensive structural reform programme. Overall, this is essential to improve the functioning of the markets for goods, services and labour which, in turn, would increase potential growth and international competitiveness on a sustainable basis. In particular, Turkey should upgrade and make better use of its human capital through the pursuit of the education agenda and the deepening and widening of labour market reforms. Specifically, the qualifications of low-skilled workers should be improved through training and female labour force participation should be stimulated through flexible working conditions.

Overall, Ministers underline their commitment to this surveillance process which should ensure a continued anchoring of the candidate countries' medium-term economic programmes. Ministers also encourage candidate countries to make further progress with respect to their macroeconomic, budgetary and structural policies. Ministers will meet again in the course of 2015 to continue their dialogue, including on the implementation of the 2014 conclusions. Likewise, the dialogue at the level of the Economic and Financial Committee and its counterparts will continue in 2015.