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Progress towards Meeting the Economic Criteria for EU Accession

The EU Commission's 2023 Assessments

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EUROPEAN ECONOMY

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European Commission
Directorate-General for Economic and Financial Affairs

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Institutional Paper 260

ABBREVIATIONS

ALL	Albanian Lek
BiH	Bosnia and Herzegovina
CEFTA	Central European Free Trade Agreement
COVID-19	Coronavirus disease 2019
CPI	Consumer Price Index
EBRD	European Bank for Reconstruction and Development
EIB	European Investment Bank
ERP	Economic Reform Programme
ESA 2010	European system of accounts
EU	European Union
EUR	Euro
FDI	Foreign Direct Investment
FX	Foreign Exchange
GDP	Gross Domestic Product
GEL	Georgian Lari
GFCF	Gross fixed capital formation
GG	General Government
ICJ	International Court of Justice
ICT	Information Communication Technologies
IDF	Investment Development Fund
IFIs	International Financial Institutions
ILO	International Labour Organization
IMF	International Monetary Fund
INSTAT	Institute of statistics Albania
ISCED	International Standard Classification of Education
LFPR	Labour Force Participation Rate
LFS	Labour Force Survey

MFA+	Macrofinancial Assistance Plus
MoF	Ministry of Finance
Monstat	Statistical Office of Montenegro
NBG	National Bank of Georgia
NBU	National Bank of Ukraine
NEET	Not in education, employment or training
NPLs	Non-performing loans
OECD	Organisation for Economic Co-operation and Development
PESR	Public enterprise for state roads of North Macedonia
PFM	Public Finance Management
PISA	Programme for International Student Assessment
POE	Publicly Owned Enterprise
pp.	Percentage point
pps.	Percentage points
PPP	Purchasing power parity
PPS	Purchasing power standard
PRB	Procurement Review Body
RSD	Serbian dinar
SAA	Stabilisation and Association Agreement
SBA	Stand-by Arrangement
SELDI	Southeast European Leadership for Development and Integrity
SMEs	Small and Medium sized Enterprises
SOEs	State-Owned Enterprises
SORS	Statistical Office of the Republic of Serbia
R&D	Research & Development
TRY	Turkish Lira
UK	United Kingdom

UNSCR 1244	United Nations Security Council Resolution 1244
USD	United States Dollar
VAT	Value-added tax
VET	Vocational education and training.
VTC	Voluntary Tax Compliance
WBIF	Western Balkans Investment Framework
WiiW	the Vienna Institute for International Economic Studies
WTO	World Trade Organization
y-o-y	year on year

CONTENTS

INTRODUCTION

In this Institutional Paper the Directorate General for Economic and Financial Affairs brings together into a single document the economic chapters of the European Commission's country reports for the ten enlargement countries Albania, Bosnia and Herzegovina, Georgia, North Macedonia, Kosovo[(*)], Moldova, Montenegro, Serbia, Turkey and Ukraine. The annual country reports assess progress achieved in the Western Balkan countries and Turkey in advancing the necessary political and economic reforms as well as the legal transformation in line with the EU accession criteria. For Georgia, Moldova and Ukraine the annual country reports are released for the first time and assess the level of compliance with the EU accession criteria. The European Commission adopted the country reports on 8 November 2023 as part of its 2023 Enlargement Package.

The purpose of this Institutional Paper is to facilitate the work of those scholars, researchers and analysts who are mainly interested in the economic aspects of the enlargement process. As such, it represents only a part of the overall progress made by the enlargement countries towards meeting the accession criteria. A proper full-fledged assessment of progress made under all examined aspects can be found in the 2023 reports, i.e. the Commission staff working documents[1] for each of the countries.

The accession criteria

In 1993, the Copenhagen European Council identified the economic and political requirements candidate countries will need to fulfil to join the EU. It also concluded that accession could take place as soon as they were capable of fulfilling them.

The criteria are:

– the political criteria - stability of institutions guaranteeing democracy, the rule of law, human rights, and respect for and protection of minorities;

– the economic criteria - the existence of a functioning market economy as well as the capacity to cope with competitive pressure and market forces within the Union;

– the institutional criteria - the ability to take on the obligations of membership including adherence to the aims of political, economic and monetary union, which includes the whole range of policies and measures that constitute the acquis of the Union. Candidate countries must adopt, implement and enforce the *acquis*. This requires the administrative capacity to transpose European Community legislation into national legislation, and to implement and effectively enforce it through appropriate administrative and judicial structures.

The European Commission first assessed progress made by the then candidate countries with respect to these criteria in the 1997 Opinions. Thereafter, the Commission, at the request of the Council, submitted annual Country Reports to the Council assessing the further progress achieved by each country towards fulfilling the criteria. These reports have served as one of the elements for the Council to take decisions on the conduct of negotiations and on the definition of the pre-accession strategy. Since 2005, also the potential candidate countries have been assessed according to the same format and methodology.

[(*)] This designation is without prejudice to positions on status, and is in line with UNSCR 1244/1999 and the ICJ Opinion on the Kosovo declaration of independence.

[1] Strategy and Reports (europa.eu)

The economic sub-criteria

Regarding the economic criteria, the Commission applies a set of sub-criteria to examine the progress achieved during each year. The compliance with the functioning market economy criterion is thus evaluated against the following five sub-criteria:

− high quality of economic governance

− macroeconomic stability (including adequate price stability and sustainable public finances and external accounts);

− proper functioning of the goods and services market (including business environment, state influence on product markets, and privatisation and restructuring);

− proper functioning of the financial market (including financial stability and access to finance);

− proper functioning of the labour market;

The capacity to withstand competitive pressure and market forces within the Union is assessed on the basis of the following four sub-criteria:

− a sufficient amount, at appropriate costs, of human capital, education, research, innovation, and future developments in this field;

− a sufficient amount and quality, at appropriate costs, of physical capital and infrastructure;

− changes in the sector and enterprise structure in the economy, including the role of SMEs;

− the degree and the pace of the economic integration with the Union, and price competitiveness;

It is important to note that these conditions do not serve as a simple checklist. First, the interplay and interaction of all conditions, and their mutually reinforcing effects on the economy, are pertinent. Second, there is an important time dimension involved. Meeting the economic criteria requires deep and lasting structural reforms that take time to be accomplished. The issue of track record becomes then very relevant. In this context, the concept of track record means the irreversible, sustained and verifiable implementation of reforms and policies for a long enough period to allow for a permanent change in the expectations and behaviour of economic agents and for judging that achievements will be lasting.

1. ALBANIA

1.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Albania is **between a moderate and a good level of preparation** in developing a functioning market economy and made **some progress** in this area. Despite the economic fallout from Russia's war of aggression against Ukraine, the Albanian economy showed resilience and GDP growth remained strong in 2022. Inflation increased to above the target in 2022 but remained single-digit and then decreased in early 2023. The strong recovery supported labour market performance, giving Albania the highest participation rate and one of the lowest unemployment rates in the region. Supported by strong revenue growth and a large increase in nominal GDP, the public debt ratio fell much more than expected, to below its pre-2019 crisis level, but remains among the highest in the region. Long-awaited reforms were launched to improve investment expenditure, planning and execution, and the monitoring of fiscal risks continued to improve, but weaknesses persist in both areas. There was some progress on revenue-related reforms but plans to adopt a medium-term revenue strategy have been abandoned, while a low revenue ratio continues to impede much needed investments. The financial sector remained stable and continued to expand but financial intermediation remains low. The business environment benefitted from a higher level of digitalisation of public services. However, challenges related to a large informal economy and a shortage of labour with relevant skills persist. Consultations of the public by the government did not improve significantly. Last year's recommendations to improve the functioning of the market economy were partly implemented, and remain partly valid. In the coming year, Albania should in particular:

→ achieve a non-negative primary balance and continue to reduce the public debt ratio while providing targeted support to vulnerable households and firms if needed, and continue to reduce arrears and use the regular revision process for budget amendments;

→ complete procedures to fully establish the National Single Project Pipeline and advance the necessary legal amendments to fully integrate public-private partnerships (PPPs) into it, and use a systematic risk assessment when deciding on new state guarantees and onlending;

→ adopt measures to increase tax revenue as a share of GDP in a growth-friendly way, while taking into account the results of a broad public consultation on tax policies.

Economic governance

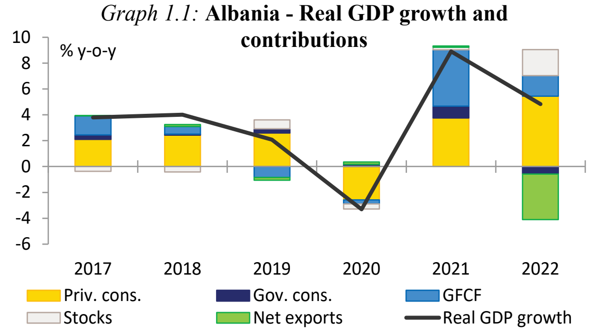
Albania continued to pursue stability-oriented economic policies. The authorities supported households and businesses and state-owned electricity utilities to cushion the impact of high energy and food prices, while complying with the fiscal rules. After a large decrease in 2022, the public debt ratio fell below its pre-pandemic level. The government continued to use specific legal ('normative') acts instead of the regular legislative procedure to amend the 2022 budget, but on fewer occasions than in 2021, and none in the first half of 2023. Albania submitted its 2023-2025 economic reform programme (ERP) to the European Commission at the end of January 2023, in which it underlined its plan to achieve a positive primary balance already in 2023. Parliament approved the 2023 budget on 24 November 2022 and the ERP on 5 February 2023.

Albania partially implemented the policy guidance jointly agreed at the Economic and Financial Dialogue between the EU and the Western Balkans and Türkiye in June 2022. Fiscal consolidation progressed, and control of arrears and fiscal risks improved, but there was limited progress on revenue-related reforms. Business support services were broadened and measures against informal employment were better coordinated, but information about the actions against informality and their effects remained limited. Labour market analysis and the preparations for implementing the Youth Guarantee progressed and reimbursements for medical costs increased, as did ad-hoc expenditure on social protection. Albania still has not ensured the necessary sustained and systematic increase of expenditure on social services, human development and innovation.

Macroeconomic stability

Albania's economy continued to show resilience, despite three consecutive shocks. Albania's real GDP growth averaged 2.7 % in 2013-2018. Though the economy was hit by the 2019 earthquake and the COVID-19 crisis, GDP contraction was less than expected in 2020 (3.3 %), followed by a strong economic recovery in 2021 (8.9 %), which extended into 2022 (4.9% GDP growth) despite the shock due to Russia's war of aggression against Ukraine. Solid increases in private investment and very strong private consumption growth led to higher-than-expected economic growth in 2022, outweighing shrinking public investment and consumption and a negative contribution of net exports to growth. A robust rise in private consumption was supported by continued strong employment and wage growth. Construction, manufacturing and services were the main drivers of growth on the production side, partly due to buoyant tourism. These macroeconomic trends largely continued in the first quarter of 2023, albeit at a slower pace, except for growing public consumption and investment.

Graph 1.1: **Albania - Real GDP growth and contributions**



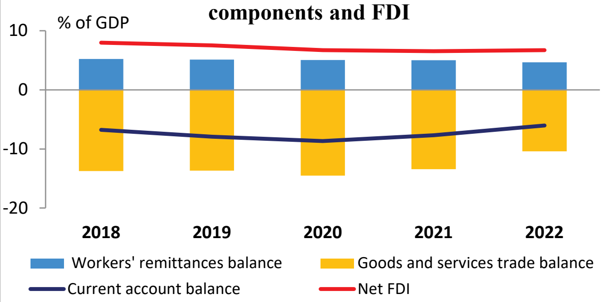
Source: WiiW, INSTAT, own calculations

Convergence with EU income levels stagnated in 2014-2019 with GDP per capita (at purchasing power parity) remaining at 30% of the EU average, but rising to 32% in 2021 and 34% in 2022.

Despite surging import prices, the current account deficit decreased in 2022. Sharply increased 2022 import prices widened the goods trade deficit, despite currency appreciation and strong growth in goods exports. However, a 30% surge in the services trade surplus, to 13% of GDP, contributed to a 1.7 pps decrease in the current account deficit to 6% of GDP in 2022. The share of remittances in GDP continued to fall, from 4.9% in 2021 to 4.5% in 2022, resulting in a decrease in the secondary income surplus to just above 6% of GDP in 2022. In the first half of 2023, the current account deficit continued to fall by about 27% compared with the first half of 2022, driven by a continuing surge of the trade surplus in services and by the growth of remittances.

Foreign direct investment (FDI) inflows grew strongly and financed the current account deficit in 2022. The completion of large energy projects led to a declining trend in FDI inflows after peaking above 8 % of GDP in 2015-2019, but they grew by 19% in 2022, which pushed the ratio up to 6.7% of GDP in 2022 from 6.4% in 2021. FDI inflows again fully financed the current account deficit in 2022, after falling short of it in 2020 and 2021. Public external debt fell by 3.3% nominally (in terms of GDP from 32% to 26.1%) and overall external debt dropped by 10 pps to 54.6% of GDP in 2022. Using buffers of the late 2021 Eurobond and in view of the less favourable conditions on the capital markets, the Albanian government only issued its 6th Eurobond in June 2023[2], which increased public external debt by 5.2% in the second quarter of 2023 compared with the second quarter of 2022. Foreign exchange reserves have consistently increased over recent years and remained at about EUR 5 billion throughout 2022 and until May 2023, before rising to 5.6 billion in July 2023, following two interventions in the foreign currency market to address a currency appreciation hike-.

Graph 1.2: **Albania - Current account selected components and FDI**



Source: IMF and Central Bank of Albania

[2] EUR 600 million, 5-year maturity, with a coupon of 5.9%.

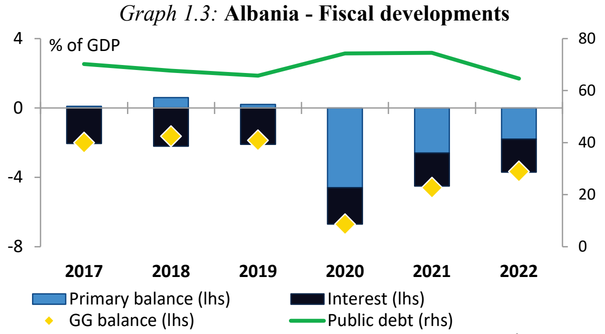
The reserves continued solidly covering 7 months of imports of goods and services and over five times the short-term external debt.

Table 1.1: **Albania - Key economic figures**	**2014-19** average	**2020**	**2021**	**2022**
GDP per capita (% of EU-27 in PPS)[1)]	30	31	32	34
Real GDP growth	2.9	-3.3	8.9	4.8
Economic activity rate of the population aged 15-64 (%), total	66.1	69.1	69.3	73.2
female	*57.3*	*61.2*	*61.4*	*66.8*
male	*75.0*	*77.1*	*77.3*	*80.0*
Unemployment rate of the population aged 15-64 (%), total	15.0	12.2	12.1	11.3
female	*14.1*	*12.4*	*12.4*	*11.7*
male	*15.7*	*12.1*	*11.8*	*10.9*
Employment of the population aged 15-64 (annual growth %)	3.3	-1.9	-0.4	4.8
Nominal wages (annual growth %)[2)]	2.9*	2.7	6.3	8.2
Consumer price index (annual growth %)	1.7	1.6	2.0	6.7
Exchange rate against EUR	133.7	123.7	122.5	119.0
Current account balance (% of GDP)	-8.2	-8.7	-7.7	-6.0
Net foreign direct investment, FDI (% of GDP)	8.2	6.7	6.5	6.7
General government balance (% of GDP)	-2.8	-6.7	-4.6	-3.7
General government debt (% of GDP)	69.8	74.3	74.5	64.6

Notes :
1) Eurostat
2) average gross monthly wages, average of 2015-2019
Source: national sources

Inflation rose significantly, though less than in Albania's peers, and the Bank of Albania began to tighten its monetary policy stance. Annual inflation averaged 2% in 2021 but rose sharply from late 2021 due to rising international food and energy prices to an average of 6.7% in 2022. Nevertheless, it remained the lowest in the region, helped by subsidised retail electricity prices and the appreciation of the lek against the euro, mostly due to significant external inflows from tourism and FDI. In response to the inflation rate exceeding the 3% target, and the broadening of domestic demand-driven price pressures, the Bank of Albania (BoA) raised the policy rate by 2.75 pps in several steps to reach 3% in March 2023. Inflation has been slowing since November 2022, to 4% in August 2023 as price increases for food, energy and transport decelerated, appreciation of the Albanian lek against the euro accelerated (from 2.8% in 2022 to 7.8% year-on-year in the January to August average 2023) and financial market conditions tightened.

Graph 1.3: **Albania - Fiscal developments**



Source: National sources

In 2022, high GDP and revenue growth helped to lower the public debt ratio below its pre-pandemic level. The fiscal deficit was below 2 % of GDP in 2015-19, but increased sharply to 6.8 % of GDP in 2020, due to the impact of the pandemic. A strong economic rebound and rising inflation fostered high revenue growth, contributing to the fiscal deficit falling to 3.7% of GDP in 2022, despite significant energy-related spending. Exceptional support to the state-owned electricity provider and vulnerable groups was partly offset by savings on interest and personnel expenditure, and under-execution of foreign financed investments. As a result, the overall annual expenditure increase was moderate at 2.1%. The high GDP denominator and a small nominal decrease in public debt led to a 10 pps public debt ratio decrease from its peak of 74.5 % in 2021 to 64.6 % in 2022. For 2023, a fiscal deficit of 2.5% of GDP and a positive primary balance are foreseen. The exceptional provision for budget support to state owned energy companies in the budget was not needed, and the funds are planned to be reallocated.

The tax revenue ratio remains low, despite improvements in the tax administration. Increasing social contributions and local taxes pushed the overall tax revenue ratio upwards to 25.7% of GDP in 2017, but since then it decreased to 25.4% of GDP in 2022, which is low compared to peers. It is also low given the need for significant investment in physical and human capital. Improvements in the tax administration, and substantial reforms such as the introduction of automated electronic VAT invoicing (‘fiscalisation’), excise harmonisation and indexation and digitalisation were successfully implemented in the last three years, but have not yielded an increase of the revenue ratio. The tax revenue structure has remained unchanged over the last decade, characterised by a heavy reliance on revenue from consumption and low revenue from capital taxation and social contributions (the average social contributions revenue of 5.8% of GDP are the second lowest in the region). The 2023 amended income tax law, which takes effect in 2024, will broaden the tax base bringing self-employed professionals into the personal income taxation. Following a suspension of public consultations on the long-planned medium-term revenue strategy (MTRS) in 2022 the authorities have undertaken a review and update of the 2020 draft, which should aim for a broader tax base and a higher revenue mobilisation in a comprehensive and systematic way with public buy-in.

Weaknesses in the management of public investment persist, but new initiatives have been launched to address them. Though public investment spending has increased strongly since 2017, partly driven by post-earthquake reconstruction, it remains backloaded and generates increasing arrears in the last quarter of the financial year. In 2021 and 2022 these were partly settled with year-end budget amendments, using unexpected excess revenue. However, structural weaknesses in investment planning and execution persist, partly because the selection and monitoring of public investment projects remains fragmented across types of investment and government agencies that use different procedures. In addition, national legislation still separates investment planning for public-private partnerships (PPPs) from that of conventional projects. Post-earthquake reconstruction spending lacked transparency as it was not integrated into the regular public finance procedures. Reforms launched at the end of 2022 aim to harmonise and improve the evaluation procedures for various types of public investment projects and resulted so far in setting up a national single project pipeline, which also strengthens project prioritisation in line with fiscal space and can contribute to reducing arrears. An amendment to the PPP-legislation is still necessary for integrating PPPs into those new procedures.

Fiscal space improved, and the overall macroeconomic policy mix was appropriate in the face of high inflation. Good fiscal performance and a reduction in the debt-to-GDP ratio has improved the fiscal space, but vulnerabilities remain significant given the exposure to external shocks and continued high debt ratio (in comparison to regional peers). The fiscal response to the energy shock mainly consisted of continuing to subsidise the regulated electricity price for all households and SMEs, though it could have been better targeted to reduce fiscal costs and to include incentives for investments in energy-saving. Nevertheless, the overall spending restraint supported the 2022 monetary policy stance and contributed to dampening inflationary pressures. The macro-fiscal policy mix was generally appropriate to address the high inflation rate and to support economic stability and recovery.

Functioning of product markets

Business environment

Business satisfaction with public services is improving, but there are increasing concerns about labour shortages. The 2022 Balkan Business Barometer, an annual independent survey of businesses in the region, shows that businesses’ satisfaction with public services improved in 2021 and 2022, supported by a higher level of digitalisation. More public services are now available online, including 31 tax services which allow taxpayers to pay taxes online to a certain extent. In addition, applications for all business licences can be made online. Efforts to set up a complete and digitalised cadastre within the next two years are progressing, but there are still delays and discrepancies as regards the information on property deeds. Improved digital public services help to reduce corruption, but irregularities in public procurement procedures are still perceived as an obstacle for businesses, although implementation of these procedures is improving, and the number of unsolicited proposals and new PPPs have decreased. The introduction of cash limits for business-to-business transactions is one measure taken to address the significant level of informal economic activities that add to unfair competition. There is a growing perception that difficulties in recruiting skilled labour is becoming an obstacle to business and entrepreneurs are increasingly demanding government measures to help retain workers and to provide incentives for the return of the diaspora.

Mixed progress on improving legal certainty for businesses and making public consultations more effective. The adoption of the new 'Unified Law on Investment', originally planned to be adopted in 2020, is reportedly postponed to end-2023, delaying the expected improvement in legal security for investors. The mandatory publication of the government's draft documents on the government's online platform increased transparency although its use for public consultation has remained very limited and actual consultations must still rely on ad hoc outreach by government institutions. In this context, Albania made progress by mapping the stakeholders of the line ministries at the end of 2022 to notify them about public consultations in their area of interest. A new "council of enterprises", composed of public and private sector representatives, has been set up to improve consultation of SMEs. In February 2023, the Financial Action Task Force (FATF) reported that Albania largely completed the implementation of the agreed action plan on anti-money laundering and reforms to counter the financing of terrorism. In June 2023 FATF decided to propose an on-site visit, which took place in August and led to Albania's delisting in October. Nevertheless, Albania should ensure that any future VTC law (including potential criminal amnesties) complies with the EU acquis and international standards'.

State influence on product markets

High food and energy prices triggered increased government support but intervention in the price-setting mechanism was deemed unconstitutional. Rising food and energy price led Albania to adopt a financial support package (the 'social resilience package') in March 2022 to support the transport sector, farmers and vulnerable households and to increase the budget for subsidised electricity prices3. A sovereign guarantee scheme for businesses exposed to rising food prices was also adopted. In April 2022, the government created two temporary boards ('Transparency Boards') with government and private sector representatives, which set regularly adjusted ceilings for the wholesale and retail prices of selected food commodities and fuels. However, in 2023 the Constitutional Court decided that these boards were not in line with the constitution and so had to be abolished. In 2023, a one-time windfall tax was introduced on the extraordinary profits in 2022 of the energy providers in the liberalised market. The government announced relief measures for exporting businesses that are affected by the strengthening of the lek, a temporary financial compensation for businesses in agriculture and fishery, which are struggling with the 25% increase of the minimum wage that took effect in April, and plans for a sovereign guarantee to support the liquidity needs of larger companies faced with high inflation, wage increases and currency appreciation.

Privatisation and restructuring

The state's presence in the economy slightly increased but remained limited overall. In 2022, Albania reported State aid of 0.3% of GDP mostly in form of tax exemptions and grants, excluding support to agriculture. According to recently established sector accounts, the public sector's share of gross value added of the economy averaged about 10.6% in 2015-2019 and slightly increased to 11.1% in 2020. The proportion of public sector employment4 to total employment decreased from 16.3% in 2014 to 14.3% in 2017, before picking up to 15.3 % in December 2021. According to a list of public sector institutions, the central government of Albania is the majority or full owner of 76 central state-owned

[3] The increasing international prices for electricity imports are so far not reflected in the prices for households and SMEs. The state budget balances the differences for the state-owned electricity distributor.

[4] As a share of total employment of 15 to 64-year-olds, according to LFS (INSTAT).

enterprises, mostly in transport infrastructure and energy, in addition to enterprises in water supply and sewerage in local government or municipal ownership. Restructuring and liquidation of state-owned enterprises continued, and in 2022 a new nomination framework for the boards of State-owned enterprises was adopted by the Council of Ministers. In 2021, the state-owned Albanian Investment Corporation, which develops dormant state assets by mobilising private capital, started to review state assets and formalise partnerships with governmental institutions, and it has now prepared 7 proposals.

Efforts continued to improve the monitoring of state-owned enterprises (SOEs) and the associated fiscal risks. State-owned energy utilities' dependence on regular public guarantees and loans remains a source of fiscal risks. This is aggravated by the hydropower sector's vulnerability to rainfall fluctuations and to climate change risks, for which mitigation measures are still underdeveloped. Fiscal risk statements regularly accompany the budget and have been expanded since 2021 to include disaster risks and the financial assessments of an increasing range of state-owned enterprises and utilities. These proved useful for forecasting financing needs for the public electricity sector in 2022[5], when adverse weather caused a decline in domestic electricity production, and rising international prices led to surging electricity import costs. An instruction issued in December 2022 introduced additional reporting requirements for all public bodies on potential fiscal risks, including those related to PPPs, but the capacities and the mandate of the fiscal risk unit has yet to be upgraded to make full use of this information.

Functioning of the financial market

The financial sector remained stable, but risks from the high share of foreign currency and variable interest loans persist. Bank profitability (the return on equity) continued its recovery from 12.9% in 2021 to an average of 15.5% in the first half of 2023, following a drop to an average of 8.5% in 2022. Overall banking sector capital, in relation to risk-weighted assets, remained unchanged between 18-19%, which is above the regulatory minimum, but a few small banks do not fulfil the macroprudential requirements adequately. Liquidity declined in 2022, but was still above the regulatory limit set by the Bank of Albania and recovered slightly in 2023. The ratio of non-performing loans to total loans fell 3 pps from mid 2020 to mid 2022, and have remained around 5.2% since then. However, there are concerns that the interest rate risk could transform into a credit risk as bank loans, about 75% of which carry variable rates, are being repriced. Several updates of banking legislation and regulation were adopted in 2022 which strengthen macroprudential requirements (liquidity buffers, net funding ratio, capital adequacy) and risk management. The recent resolution of the dispute over the fees for private bailiff services, which facilitate the execution of collateral, is therefore timely. Banks have a sizeable exposure to sovereign risk, given the 25% share of government securities among their assets. Euroisation was already high and increased slightly. The share of foreign currency deposits is above 50% and foreign currency loans are about 49% of the total, although the share of loans that are not hedged against exchange rate risks decreased. The consolidation of the banking sector continued, with the merger of the small Alpha bank into OTP. This reduces the number of banks in Albania to 11. The small but growing non-bank financial sector expanded to 38 institutions[6] but its share of GDP was unchanged at 12%. This includes the insurance market, which is estimated at about 2.3% of GDP, dominated by non-life insurance. New legislation provides sets a framework for growing use of new instruments like factoring and leasing in addition to strengtherening risk management requirements in the non-bank financing sector.

[5] The government provided direct on-lending of 0.4% of GDP and budget support of 1% of GDP to the sector to cover the increased costs.

[6] Including 12 insurance companies, 8 investment funds, and a number of institutions providing microcredit, financial leasing, factoring, money transfer and electronic payment services.

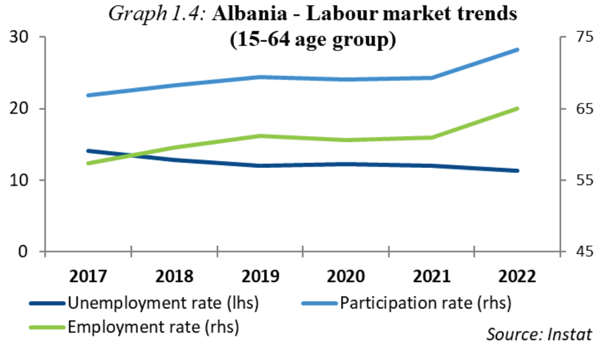
Access to finance

The modernisation of payment systems improved access to finance but capital market development is just beginning. Total credit growth accelerated from an average of 6.9% in 2021 to 11.2% in 2022. Lending to the private sector[7] also accelerated, from 6.9% in 2021 to an average of 12.3% in 2022, but slowed to 7.3% by July 2023 as interest rates continued to increase. The financial intermediation level remained low, with loans to the non-financial private sector standing at 32.7% of GDP, about 15 pps below regional peers. In 2022, the regulatory framework for the modernised payment system was completed. This has led to more adults holding a bank account and to an increase in electronic payment facilities across the country. Card payments increased by 18%. Bank financing is still the dominant means of external business financing. In April 2023, the Government set out to promote active participation in the capital market, including by state owned enterprises, municipalities and foreign investors. The policy aims to promote bonds placements in view of increasing demand e.g. from private pension funds and to deepen the secondary market for government securities. In addition, institutions of the Albanian banking and financial sector have begun to implement the 2022-2027 national strategy for financial education, which aims to address the comparatively low level of financial literacy in the Albanian population.

Functioning of the labour market

The labour market continued to improve. Solid employment growth, averaging 3.7% a year in 2015-2019, helped lower the unemployment rate (in the 15-64 age group) from 17.5% to 12%. The labour market recovered most of its pandemic-related losses in 2021 and strengthened significantly in 2022, when employment growth averaged 5%. The unemployment rate dropped to 11% in the last quarter of 2022 and the inactive population decreased by 14.3%. The labour-force participation rate climbed to 74.8% by the end of 2022 and 75.8% mid 2023, approaching the EU average, as did the closing gap between male and female labour force participation which dropped by 3 pps to 11.5 pps (mid 2023). However, the recent employment increase is not matched by an equivalent increase in social insurance contributors, which might indicate a growth in informal employment. The unemployment rate for 15-29 year-olds remained persistently above 20%, masking on one hand an increase in their participation rate by 3pps, but on the other hand an increase in the number of unemployed people aged 25-29. Although employment growth continued in the first half of 2023 with an average 3.5% it did not lower the overall unemployment rate, mainly because of an increasing number of unemployed young people (15-29). Despite the improving labour market situation, emigration increased by 10.5% compared with 2021, leading to a population decrease of 1.1 % in 2022. This also contributes to the ageing of the population and hits the financing of the pension system, on which Albania already has a low ratio of contributors to beneficiaries.

Graph 1.4: **Albania - Labour market trends (15-64 age group)**



Source: Instat

Real private sector wage growth was not matched by public sector wage growth and triggered plans for a comprehensive reform of public sector salaries and wage increases. Public and private sector wage growth was balanced (both 6.6%) in 2021, but in 2022 nominal private sector wages grew by 12.3% (5.5% in real terms) on average, while public sector wages only increased by 2.3% in nominal terms, resulting in a drop in real wages. In April 2023, the government launched a public sector salary review, aimed at restructuring and updating salary scales and bringing public wages closer to regional levels. A revised regulatory framework was announced to consolidate the principles and mandates for the setting of the public salary schedule for about 130 000 public sector employees. The objective is to raise the

[7] Annual average growth adjusted for written-off loans and exchange rate impacts.

average monthly public wage in several steps to the equivalent of about EUR 900 by 2025 and to retain and attract staff in positions of critical importance for the public, including health workers, teachers and police. The first stage increased public sector wages in the second quarter of 2023 by 20.5% year on year, pushing overall average wage growth to 14.9% in the first half of 2023 compared to the same period in 2022. The estimated total cost of ALL 39 billion would mean a 50% increase in the current public sector wage bill and potentially a deviation from the planned fiscal trajectory, in addition to likely spill-over effects to private sector wage developments. In January 2023, the minimum wage in Albania was the lowest in both nominal terms and in purchasing power standard among countries in the region with available data. The government lifted the minimum wage by 25% year-on-year in April 2023 to ALL 40 000 and announced a further increase to ALL 45 000 (about EUR 400). Since early 2022, the minimum wage has exceeded 50% of the average monthly wage and generated high wage growth in the lowest income sectors like agriculture.

1.2. THE CAPACITY TO COPE WITH COMPETITIVE PRESSURE AND MARKET FORCES WITHIN THE UNION

Albania has **some level of preparation** to cope with competitive pressure and market forces within the Union and made **some progress** in bolstering competitiveness. Structural reforms in the energy market progressed, and transport infrastructure, the digitalisation of the economy and education outcomes continued to improve, but significant gaps with regional and European levels remain. Albania's competitiveness is hindered by relatively low levels of entrepreneurial and technological know-how, unmet investment needs in human and physical capital, persistently low spending on R&D and, increasingly, by shortages of skilled labour. Trade openness increased through surging exports of services (tourism), but remains low overall, as the exports of goods remain well below potential.

As some of the Commission's 2022 recommendations were not fully implemented, last year's recommendation remain partially valid and in the coming year Albania should in particular:

→ improve the labour market relevance and quality of vocational education and training (VET) to increase enrolments, and invest in the digital skills of young people and adults;

→ increase spending on education, social protection and health as a percentage of total expenditure and issue instructions to collect data on public expenditure on R&D;

→ accelerate the diversification of renewable energy sources, develop business support services for SMEs' green transition, digitalisation and e-commerce, and support cooperation between business and academia on innovation.

Education and innovation

Education reforms are progressing, but it remains difficult for young people to transition into the labour market. Albania recorded improving results in the last PISA tests (15-year-olds in 2015 and 2018) and relatively good results in the latest international assessments of fourth-grade students' mathematical and scientific understanding (TIMSS 2019) and their reading comprehension (PIRLS 2021)[8]. This might indicate that recent reforms of the education system are having some effect, despite the relatively low spending on the education system of about 3% of GDP on average in 2017-2022. However, the gap in the education level to the EU average remains wide and higher public expenditure on education is necessary to speed up convergence. In addition, regional surveys[9] show that about a quarter

[8] TIMSS = Trends in International Mathematics and Science Study, conducted every four years at the fourth and eighth grades. Albania participated for the first time in TIMSS in 2019, only with 4th graders. PIRLS =Progress in International Reading Literacy Study, assessing students' reading achievement in their fourth year of schooling every 5 years. Albania participated in 2021 for the first time. It scored in both studies above most regional peers but limited testing scope and issues with data quality limit comparability. TIMSS & PIRLS International Study Center.

[9] Balkan Public Opinion and Business Barometers 2022

of young respondents consider that skills learned in the education system do not match the needs of their job, and 45% of companies surveyed identify applicants' lack of skills as a reason for unfilled vacancies (2022). Participation in vocational and educational training (VET) remains particularly low (17.7% of upper secondary students, compared to the regional average of 58%) and attendance numbers actually fell in 2022. This contributes to the continued high rate (26.1%) of young people (aged 15-29) not in education, employment or training (NEET) at the end of 2022, and the high emigration of people with a lower level of education10. The private sector's involvement in VET improved, but schools have yet to develop and follow curricula with sufficient and attractive work-based learning that is relevant to the labour market. Though ongoing reforms of the VET system address these issues, their funding and the pace of implementation are not yet adequate In addition, implementation of the 2023-2030 national employment and skills strategy, which envisages the employment policies that are necessary including upskilling and adult training, needs sufficient funding to raise the skill levels of the relatively large group of Albanian adults with a low level of education, and thus alleviate the shortage of skilled labour.

Albania has better access to EU research funds, but domestic funding remains negligible. Public funding for research and development is foreseen to increase from the estimated 0.1% of GDP in 2022, but it is unlikely to reach the level of 1% of GDP envisaged in draft 2023-2030 national strategy on technology and innovation (STI), and reliable data on actual research funding is not yet available. There are no cost-based tax incentives currently being offered to private companies for training and research. Though some efforts have been made to stimulate public/private cooperation in this area, the very limited level of investment in innovation remains an obstacle to the much-needed increase in productivity. Albania's association agreement with Horizon Europe entered into force in 2022, giving its research institutions access to EU funding for research and innovation that is comparable to EU Member States.

Physical capital and quality of infrastructure

Investment recovered in 2021 and 2022 and infrastructure projects made some progress. Total investment (gross fixed capital formation) averaged 24.4% of GDP in 2014-2018 before dropping by almost 2 pps in 2019-2020. In 2021 and 2022, investment rebounded to 24.4% and 24.0 % of GDP respectively, fuelled by rising private and foreign direct investment as well as public-financed post-earthquake reconstruction. This pushed public investment to 6.8% of GDP in 2021, before it fell to 5.4% of GDP in 2022. The share of gross fixed capital formation in GDP is the second highest in the region, and about 1.2 pps above the EU average. Net FDI inflows rose by 22% year-on-year in 2022, mostly flowing into real estate, energy, finance and manufacturing. Albania has made progress with the preparation and construction of road, rail and port infrastructure projects, which are improving interregional connectivity (the Adriatic-Ionian Corridor) and trade-related infrastructure (rehabilitation of the rail line from the port of Durrës to Tirana, construction of a new rail line to the international airport). In addition, a new 2023 – 2030 transport sector strategy and action plan was prepared, with an estimated budget of EUR 1 billion. The logistics performance index of the World Bank on Albania's trade and transport-related infrastructure records an increase from 2.29 in 2018 to 2.7 in 2022 (1 = low to 5 = high, EU = 3.6).

Digital infrastructure improved but needs further investment. Though the percentage of businesses with access to fast network connections (>10MB/s) increased from 79.8% in 2020 to 90.5% in 2021 there has only been a small rise in internet use and business websites. Fixed broadband penetration increased from 17 to 20 per 100 inhabitants in 2021 and remains an issue, particularly in rural areas. These have 40% of the population but only a quarter of the fixed broadband subscribers. Investment in digital infrastructure is also needed in schools. Many schools lack computers - there are about 0.2 computers per pupil - and have poor internet connections, which remains an obstacle to using digital technologies in schools. Households with access to the internet increased from 88.3% in 2021 to 96.5% in 2022, with an increasing share also accessing the internet via a fixed broadband connection.

[10] OECD "Labour Migration in the Western Balkans: Mapping Patterns, Addressing Challenges and Reaping Benefits". https://www.oecd.org/south-east-europe/programme/Labour-Migration-report.pdf

Hydropower remains the main source of electricity, but Albania made some progress in the development of its electricity sector. Although this is a renewable source, hydropower creates a dependency on unpredictable rainfall, exacerbated by climate change. This means that the country's electricity import needs fluctuate, leading to calls for more efforts to diversify electricity sources. Albania aims to increase solar energy production capacity to 1 GW and has awarded two contracts for solar photovoltaic farms with 240 MW capacity through solar power auctioning. In addition, the first auctions for wind power resulted in contract awards for 222.5 MW installations in July 2023. These are important steps towards reducing Albania's 98% dependence on hydroelectric production. The power sector law[11] was amended to improve its alignment with the EU *acquis* on energy, as required by the Energy Community secretariat. This enabled the effective separation of the electricity distribution system operator from the production operator. The Albanian Power Exchange (ALPEX) also went live and held its first electricity auction in April 2023. ALPEX is a joint venture company, owned by the transmission system operators of Albania (OST) and Kosovo (KOSTT), entrusted with operating both day-ahead and intraday markets. Transparent price signals can be provided for investments in renewable energy through ALPEX, though retail electricity prices are not yet fully liberalised for all customers. The recently adopted Law on renewable energy sources and new incentives for households to install solar panels and water heaters are expected to help to reach the increased renewable energy share targets in the 2020–2030 national energy and climate plan for energy efficiency (NECP).

Sectoral and enterprise structure

The economic structure continued to shift gradually away from agriculture and towards construction, manufacturing and services. The share in gross value added of the agricultural sector fell from 22.9% to 21% in 2014 -2019. It increased slightly to 21.3% in 2022 but remained higher than other sectors, exceeding the share of manufacturing by a wide margin despite this sector's gradual increase (to 7.5% in 2022). The increase in the combined share of services by 2.7 pps in 2015-2019 to 55.4% of gross value added reversed in 2020, and was down to 54.1% in 2022. Within the services aggregate, the category 'wholesale and retail trade, transport, accommodation and food service activities' recorded a strong 1.9 pps increase in 2022 compared with 2021, while the category 'public administration and defence; compulsory social security; education; human health and social work activities' fell. Reflecting stronger investment activity, the construction sector's share in gross value added increased to 11.2% in 2022, about 1 pp higher than its average in 2015-2019. Agriculture provided 33.7% of employment in 2021, down from 36% in 2019 and 2020 but still accounted for over 50% of employment in more than half of Albania's prefectures. Manufacturing's share of total employment increased slightly to 11.2% in 2021, whereas services' share increased to 44.4%.

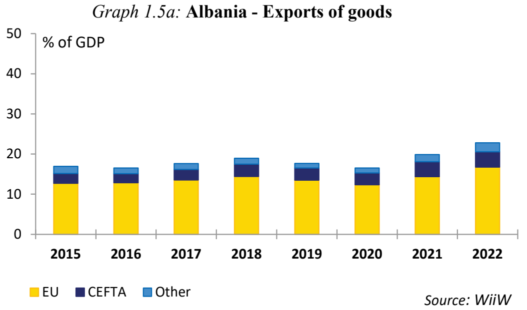
Tax registrations of businesses and farmers continued to increase. Tax registrations of farmers increased by 34.1% in 2022, most likely related to the support scheme for farmers' fuel costs, whereas the number of active registered non-agricultural enterprises increased by 5.6%. A total of 92.6% of active enterprises employed fewer than 10 people (85.6% employed 1 to 4 people), 5.7% had 10-49 employees, whereas 1.6% of enterprises had 50 or more employees and comprised 50.6% of total employment. The percentage of registered enterprises that provide services (85.6%), was unchanged from 2021. There is a high concentration (64.8%) of active enterprises in the prefectures of Tirana, Durrës and Vlorë, which account for about 50% of the population. In total, 5.3% of active enterprises are jointly or wholly owned by foreigners, contributing to 12.5% of employment, the majority (62.7%) of which have owners from Europe, in particular from Italy and Greece.

[11] The decision to close Case ECS-4/17 in April 2022 was based on the complete transposition into national law of the Electricity Directive's provisions related to DSO unbundling, the completion of legal unbundling and substantial progress in functional unbundling.

Economic integration with the EU and price competitiveness

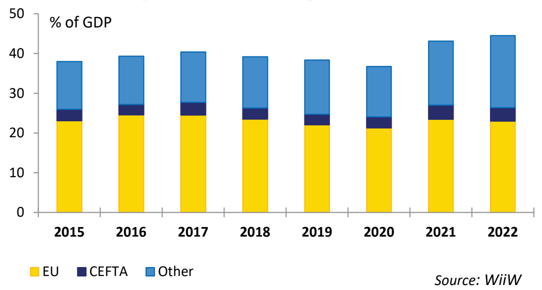
The EU remains Albania's main trading and investment partner. Trade openness (the sum of exports and imports as a share of GDP) averaged 75.7% of GDP in 2015-2019. After a drop in 2020, it jumped from 74.7% of GDP in 2021 to 88.5% of GDP in 2022, driven by strong growth both of exports and imports, which rose to 37.5% and 49.6% of GDP respectively. Despite the increase in exports' share of GDP (up by 10 pps since 2015), it remains the lowest in the region, largely due to the very low share of goods exports. Exports remain dominated by services, mostly tourism-related. The EU remained the main destination for the export of both goods and services (2020 data). The EU's share of Albania's goods exports increased in 2022, halting the downward trend of the previous 5 years, but the EU's share of Albania's imports continued to decline. The trade in goods with countries in the Central European Free Trade Agreement (CEFTA) decreased, in particular due to a 2 pps drop in its proportion of Albania's exports. FDI inflows from the EU jumped from 30% of the total in 2015-2018 to 51% in 2019-2022. Between these periods, the shares of Switzerland and Türkiye, once the source of the second and third largest inflows, decreased from 33.7% of the total to 11.4% and from 8% to 7.6% respectively. The EU's share of FDI stocks remained high at 54.4%. In January 2022 an inter-ministerial working group was established to draft a 2022-2027 export promotion programme, expected to be finalised in 2023. The real effective exchange rate increased by an average of 0.5 % in 2022, but by 2.6% in the first quarter of 2023 (compared with the 2022 average).

Graph 1.5a: **Albania - Exports of goods**



Source: WiiW

Graph 1.5b: **Albania - Imports of goods**



Source: WiiW

2. BOSNIA AND HERZEGOVINA

2.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Bosnia and Herzegovina is at an **early stage** of establishing a functioning market economy and there was **no progress** in this area. After a strong rebound in 2021 from the pandemic-induced crisis, economic growth slowed down to about 4.0% in 2022, reflecting a deteriorating international environment and accelerating inflation. The labour market was resilient and unemployment fell, but it nevertheless remained very high, while labour out-migration persisted. Driven by high inflation, budget revenues increased strongly and the public debt ratio fell. However, the quality of public spending remained weak, while the public sector remained inefficient and oversized. The current account deficit increased but its financing was ensured. The financial sector remained stable. The business environment continued to be negatively affected by Bosnia and Herzegovina's fragmented internal market and a large informal economy. The rule of law and the functioning of the internal market deteriorated further, with recent disputes on the validity of constitutional court ruling for the whole country and traffic blockages at inter-entity boundary lines. Political stalemates and lack of cooperation among the various levels of government continued to hinder necessary structural reforms. Russia's war of aggression against Ukraine so far had mainly indirect effects, through higher import prices and uncertainty as well as weaker third-country external demand.

The implementation of last year's recommendations was very limited. The 2022 recommendations remain fully valid.

To improve the functioning of the market economy, Bosnia and Herzegovina should in particular:

→ strengthen country-wide regulatory and supervisory institutions, reinforce country-wide analytical and policy-formulation capacity and publish complete and consistent country-wide data in a timely manner, in particular in the area of public finances;

→ improve the business environment by simplifying business registration and licencing procedures and by harmonising and mutually recognising licences and certificates between entities;

→ increase the transparency and efficiency of the public sector, in particular by establishing an appropriate institutional and regulatory framework for better, de-politicised governance and improving the efficiency and governance of publicly owned enterprises to reduce their burden on government spending; furthermore, improve the efficiency of tax collection by ensuring the effective exchange of taxpayer information between the country's tax authorities, and in particular clarify the constitutional competence for establishing a central (i.e. country-wide) registry of bank accounts of private individuals, in line with the EU acquis.

Economic governance

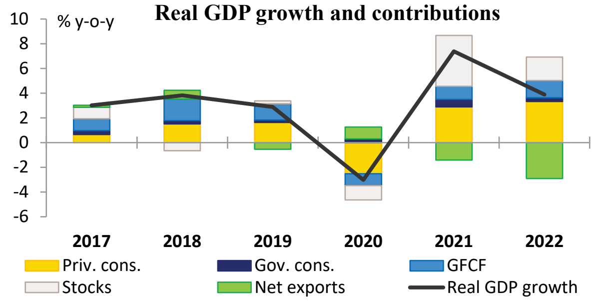
Economic governance did not make progress during the last year, resulting from a legislative recess in autumn in the run-up to the October 2022 general elections and time needed for the subsequent government formation. Bosnia and Herzegovina's short and medium-term track record in adopting and implementing overdue structural economic reforms remains very limited, in particular with respect to countrywide measures. The main reasons for this are lack of political commitment and insufficient cooperation among key stakeholders together with highly politicised decision-making processes and institutional fragmentation. The 2023-2025 Economic Reform Programme, an important element for Bosnia and Herzegovina's participation in the economic and financial dialogue with the EU, was again submitted with a significant delay and its quality was once again low, suffering from a lack of internal consistency and insufficient comittment towards country-wide reforms. Furthermore, the country failed to participate sufficiently in other EU meetings which try to prepare candidate countries for their integration into EU procedures. Russia's war of aggression against Ukraine affected Bosnia and Herzegovina mainly through indirect channels, leading to higher import prices and a slowdown in import demand from trading partners. In response to the higher cost of living the authorities increased public sector wages and pensions and raised social transfers.

Implementation of the policy guidance jointly adopted at the economic and financial dialogue with the EU in May 2022 was limited. The authorities took steps to cushion the effects of external shocks and to improve the countrywide public finance management system. However, in most other areas, in particular in improving the functioning of country-wide institutions, no progress was achieved.

Macroeconomic stability

Economic activity slowed down in 2022, reflecting a deteriorating international environment and accelerating inflation. Annual output growth slowed from 7.2% in 2021 to 4% in 2022. To some extent this slowdown reflects a base-year effect after the strong rebound in 2021 and early 2022, which however also led to increasing price pressures. The main drivers of growth in 2022 were exports, gross investment (in particular inventories) and private consumption. In 2023-Q1 economic activity slowed down further, with weaker private consumption and investment bringing year-on-year output growth to 1% compared with 5.9% one year before. Increased prices for imported energy and primary commodities as a result of Russia's war of aggression against Ukraine further contributed to inflationary pressures. At the same time, external demand decelerated, although from a high level. During 2018-2022, average growth was around 3%, with exports and private consumption as the main drivers of growth. Real GDP per capita in purchasing power standards was 35% of the EU average in 2022, compared with 31% some 5 years earlier. The main impediments to faster income convergence with the EU are low investment, a poor business environment and lack of reforms resulting from persistent political tensions, cumbersome licencing procedures and economic and institutional fragmentation.

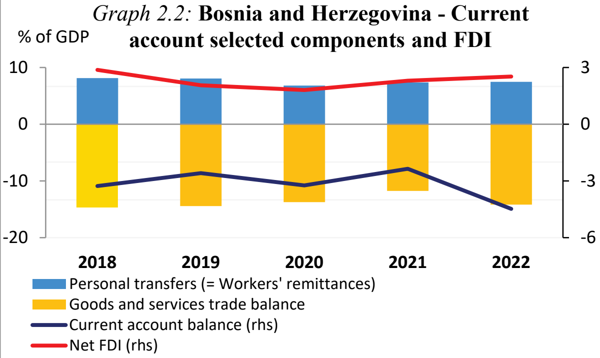
Graph 2.1: **Bosnia and Herzegovina - Real GDP growth and contributions**



Source: WiiW

The current account deficit widened in 2022. The current account deficit increased to 4.5% of GDP in 2022, compared with 2.4% in 2021, largely reflecting decelerating export revenues and higher spending on imports driven by increased commodity prices. In the first quarter of 2023 the deficit dropped to 3.6% of GDP, largely due to lower spending on imports. The deficit in the balance of goods and services has been largely financed by current transfers, primarily consisting of workers' remittances, accounting for more than 10% of GDP. Net FDI inflows rose to 2.5% in 2022 and to 3.6% of GDP in 2023-Q1. A large part of these FDI inflows was reinvested earnings, while foreign greenfield investment remained. Official foreign exchange reserves, which benefited from pandemic-related financial assistance including special drawing right (SDR) allocations by the IMF, dropped at the end of 2022 to a still-solid level equivalent to about 7 months of imports, largely due to higher spending on imports. Bosnia and Herzegovina relies strongly on longer-term financing at favourable rates by international financial institutions, such as the IMF, the EIB and the World Bank. The gross external debt ratio remained moderate, at some 58% of GDP at the end of 2022. Overall, the financing of Bosnia and Herzegovina's current account appears feasible, while external vulnerabilities are moderate.

Graph 2.2: **Bosnia and Herzegovina - Current account selected components and FDI**



Source: Central Bank of Bosnia and Herzegovina and Agency for statistics

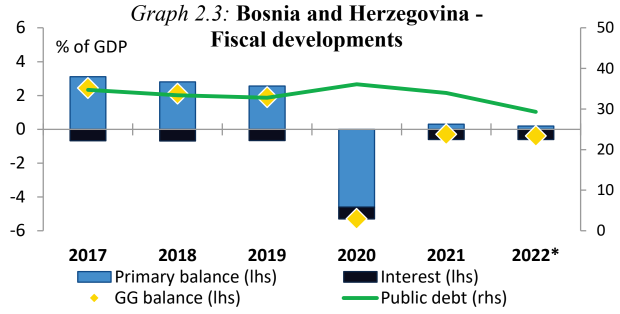
Table 2.1: **Bosnia and Herzegovina - Key economic figures**	**2014-19** average	**2020**	**2021**	**2022**
GDP per capita (% of EU-27 in PPS)[1)]	31	33	34	35
Real GDP growth	3.2	-3.1	7.4	4.0
Economic activity rate of the population aged 15-64 (%), total	54.5	58.2	59.1	59.1
female	*42.7*	*46.1*	*46.7*	*46.3*
male	*66.2*	*70.4*	*71.4*	*71.8*
Unemployment rate of the population aged 15-64 (%), total	23.1	16.2	17.5	15.5
female	*26.4*	*19.0*	*22.2*	*19.9*
male	*21.0*	*14.4*	*14.5*	*12.7*
Employment of total population (annual growth %)*	3.3	-1.2	0.9	2.3
Nominal wages (annual growth %)	1.6	4.0	4.4	11.7
Consumer price index (annual growth %)	0.0	-1.1	2.0	14.0
Exchange rate against EUR	1.96	1.96	1.96	1.96
Current account balance (% of GDP)	-4.6	-3.2	-2.4	-4.5
Net foreign direct investment, FDI (% of GDP)	2.3	1.8	2.3	2.5
General government balance (% of GDP)	1.1	-5.2	-0.3	-0.4
General government debt (% of GDP)	37.4	36.1	34.0	29.3

Notes:
1) Eurostat
** There is no comparable time series for the age group 15-64*
Source: Eurostat, national sources

Inflation surged in 2022 but moderated somewhat after the autumn. Headline inflation accelerated during 2022, especially after Russia's war of aggression against Ukraine which resulted in surging energy and food prices. Annual consumer price inflation reached a peak of 17.4% in October 2022, but moderated to 4.0% in July 2023. On average, inflation was 14% in 2022 and 8.5% in the first 7 months of 2023. Headline inflation was especially driven by increases in food prices which account for about one third of the consumption basket.

Monetary policy continued to be anchored by the currency board arrangement. This monetary regime has served the economy well so far as an important pillar of macroeconomic stability. However, it also implies that the burden of adjustment to external shocks must be accommodated by other policy areas, in particular fiscal policy to manage demand, and structural reforms to improve the functioning of markets. Domestic political tensions have continued to prevent the appointment of a new board of the Central Bank, including the governor, whose mandate expired in August 2021 and which continued to operate only on a technical mandate.

Graph 2.3: **Bosnia and Herzegovina - Fiscal developments**



Source: National sources

Public finances continued to benefit from strong, primarily inflation-driven revenue growth, but weak fiscal governance continued to pose challenges. General government revenues rose by 13.4% in 2022, in line with headline inflation. Tax revenues increased by 16.7%. In parallel, government spending was revised upward, rising by 13.6% for the whole year. This additional revenue was used for increasing social benefits, such as pensions, extraordinary payments to vulnerable groups and an increase in public wages. In contrast to the focus on current spending, already approved funds for infrastructure investment, such as related to the energy sector, were suspended. According to preliminary data from the Central Bank, this resulted in a nominal drop of central governments' public investment by some 8% in the first three quarters of 2022. According to first estimates, the general government registered a deficit surplus of 0.14% of GDP in 2022, compared with a surplus deficit of 0.34% of GDP in 2021. Budget plans for 2023 are characterised by significantly higher spending targets for current expenditure, partly to compensate public employees and pensioners for the rapid increase in inflation, while capital spending is planned to remain subdued. The public debt ratio dropped to 29% of GDP in 2022 from 34% in 2021, driven by high nominal GDP growth. Overall, cooperation and information exchange among the various fiscal authorities has remained very limited, which facilitates tax avoidance. Bosnia and Herzegovina's tax revenues rely strongly on a single source, namely indirect taxes. Continued calls by the *Republika Srpska* entity to dismantle the state-level Indirect Taxation Authority thus pose a threat to the revenue collection system and the country's fiscal stability. Contingent liabilities pose a significant risk, in particular in the area of public enterprises. There is a high degree of non-alignment with EU public sector accounting standards, which strongly impedes the assessment of Bosnia and Herzegovina's actual fiscal position. As a result, both the deficit and debt ratio could be significantly higher than reported. Fiscal rules have been adopted in one entity only, and there is no independent fiscal institution to monitor and enforce compliance with fiscal discipline.

Overall, Bosnia and Herzegovina's macroeconomic policy mix does not adequately address the country's main challenges. Political disputes delay necessary reforms to improve its growth potential and fiscal policy focuses on short-term objectives, neglecting longer-term challenges. As Bosnia and Herzegovina's currency board regime limits the room for monetary policy, fiscal policy is one of the country's key macroeconomic policy tools. However, this policy tool is not used sufficiently to steer the country towards stronger growth and faster convergence with EU income levels. The effectiveness of fiscal policy for enhancing Bosnia and Herzegovina's growth potential is further severely limited by the insufficient degree of cooperation among the various fiscal policy stakeholders and the absence of an independent and competent fiscal council.

Functioning of product markets

Business environment

The business environment suffers from Bosnia and Herzegovina's fragmentation and political uncertainty. According to recent OECD surveys, oer half of businesses in Bosnia and Herzegovina identify burdensome procedures, paperwork and cost as a major obstacle to obtaining licenses, a higher proportion than in any other country in the region and well above the regional average of 35%. Businesses that wish to operate across the entire economy still face technical and administrative obstacles, must frequently obtain the same licenses or permits in each entity or local government area and pay a range of different taxes and fees. This increases the costs of establishing a company, protects incumbent companies from competition and deters investors, hindering the functioning of an effective single economic space. Contract enforcement, in particular settling commercial disputes, remains difficult and there is a substantial backlog in court cases. Establishing and implementing property rights remains difficult in some areas, such as real estate registration. Lack of cooperation and coordination among the various stakeholders is another major impediment to establishing a countrywide level playing field, with wide-ranging negative effects on the business environment. Recently, the *Republika Srpska* entity adopted legislation contesting the application of Bosnia and Herzegovina's constitutional court rulings on the entity's territory. This ongoing dispute increases legal uncertainty and undermines the integrity of the country's single economic space. Furthermore, due to a different speed at entity level of aligning with the EU *acquis*, Bosnia and Herzegovina's economic and legal fragmentation has further deteriorated.

The informal economy remained significant. Despite some progress in boosting formal employment by increasing labour market controls, the informal sector is estimated to still account for up to one third of GDP. The pandemic might have increased the importance of the informal economy for livelihoods, compensating for job losses in the formal economy. Thus, informality still provides substantial (unregistered) employment and income but also distorts competition and erodes the tax base. This requires rates for taxes and social security contributions to be higher than would otherwise be necessary.

It also results in lower pension benefits, increasing the poverty risk for the elderly and adds to a significant fiscal burden on labour, which in turn impedes formal employment and negatively affects Bosnia and Herzegovina's international competitiveness.

Political leaders and judicial institutions failed to tackle widespread corruption. Transparency International again ranks Bosnia and Herzegovina 110th out of 180 countries in its 2022 annual Corruption Perception Index, making it the worst performer in the Western Balkans after 6 years of declining performance. Just 14% of businesses surveyed in Bosnia and Herzegovina say that the fight against corruption there is effective, a lower proportion than any other country in the region, and a higher proportion of businesses than in any other Western Balkans country said that they had to make irregular payments. There was no progress on necessary reforms to strengthen legislation on anti-money laundering and countering the financing of terrorism, and Bosnia and Herzegovina risks being listed as a jurisdiction under increased monitoring by the international standard-setting body in this area, the Financial Action Task Force.

State influence on product markets

There was limited progress in reducing the still-strong footprint of the state in the economy. During 2022, some temporary measures related to COVID-19 were discontinued. However, the impact of the public sector on the factor allocation remained high, in particular in the labour market, for example by continuing to support the oversized public administration and poorly performing state-owned enterprises (SOEs). Ineffective service delivery and poor human resource management and accountability have major implications for efficiency, quality and access to public services. Many public companies continue to rely on state support or accumulate payment arrears to the social security systems or to private suppliers (4% of GDP according to the IMF). Public procurement represents a significant share of public spending and thus plays an important role for the private sector, but procedures are complex and administrative capacity and competition remain low. This facilitates corruption and leads to a preference for domestic suppliers which is incompatible with the EU *acquis* (see also Chapter 5 – public procurement). There is still a wide range of regulated prices.

While recorded state aid is relatively low, significant indirect state support continues to undermine the level playing field. Available data on official state aid points to a rather low level (1.2% of GDP in 2021, according to the latest available report). However, this dataset appears to be rather incomplete. State aid control is still hindered by only partial legal alignment with European standards and the lack of consistent enforcement of state aid rules throughout the country. The competences of the State Aid Council continue to be limited. This leaves room for unfair distortions of competition. Many of Bosnia and Herzegovina's SOEs are in poor financial shape; close to half of them experience shortfalls in liquidity and require both explicit and implicit budgetary support. Monitoring and managing fiscal risks in ministries of finance is not sufficient. The cost of supporting public companies and guarantees, which often translate into substantial contingent liabilities, is a heavy burden on public finances and thus on taxpayers. SOEs' total debts are around 26% of GDP (IMF, 2019).

Privatisation and restructuring

No progress was achieved on privatisation and restructuring of publicly owned companies. According to IMF estimates, there are over 550 SOEs at entity and municipal level employing around 80 000 people, accounting for around 11% of total employment (about a quarter of public sector employment). They control assets worth an equivalent of 100% of GDP. Whereas legislation partially provides for open and transparent selection procedures, appointments to SOE boards are highly politicised in practice. Ownership responsibilities are usually exercised in a decentralised manner by various line ministries, subject to no central coordination. The rationale for public ownership is not based on clearly defined policy objectives. Actual steps to restructure or dissolve public enterprises remained very limited. Vested interests are largely responsible for the slow privatisation process and attempts to sell shares in public companies were largely unsuccessful. However, there have been some initial steps towards strengthen the SOE oversight at entity level.

Functioning of the financial market

Financial stability

The banking sector remained stable but the financial sector's supervisory and regulatory framework continues to be fragmented. Key elements of banking supervision and regulation are decentralised, while the central bank's role remained limited to coordinating the local regulatory and supervisory agencies, which might be challenging for financial stability. Despite some international financial sector turbulence, the stability of Bosnia and Herzegovina's financial sector was maintained. A few days after Russia's war of aggression against Ukraine, the two entity-level banking agencies had to take over the subsidiaries of Russian-owned but EU-based Sberbank when their liquidity deteriorated rapidly due to quickly accelerating deposit withdrawals. Banking sector profitability improved during the last year, for example with the return-on-equity (ROE) ratio reaching 15.9% in 2023-Q2. The banking system's overall capital-adequacy ratio stood at 19.5% in 2023-Q2, well above the regulatory minimum of 12%. The non-performing loans ratio decreased to 4.1% at the end of 2023-Q2, and the ratio of foreign-denominated loans to total loans also continued to decline. However, there are sizeable differences among Bosnia and Herzegovina's 21 banks, with pockets of vulnerability remaining, especially among smaller, domestically owned banks.

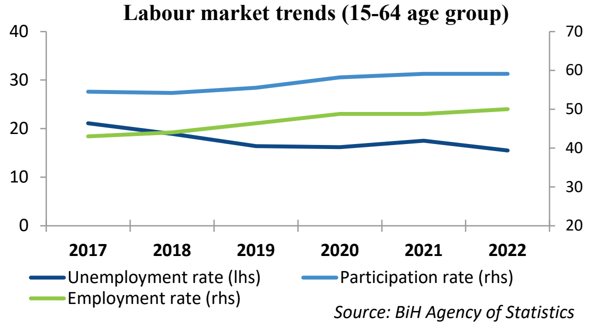
Access to finance

Banking intermediation was adversely affected by high inflation and increasing international interest rates. Nominal bank loans rose by 4.2% and 4.4% on average in 2022 and the first half of 2023, which is rather low given the underlying double-digit inflation rates. Credit demand was negatively affected by declining real disposable income, the highly uncertain outlook on inflation and interest rate dynamics and rapidly increasing real estate prices. Nominal deposit growth slowed to 5.9% in 2022, but accelerated again to 7.4% in the first half of 2023. The five largest banks accounted for about 80% of the sector's assets. Private-sector debt declined to 56.5% of total debt at the end of 2022, which is markedly above Bosnia and Herzegovina's 5-year average before the pandemic. Financial literacy is limited in particular among small enterprises. The size of the non-bank alternative financing sector and of the capital markets remained small, with market capitalisation of Bosnia and Herzegovina's stock markets of about 17% of GDP at the end of 2022. The use of venture capital continued to be very limited. For many micro and small companies, gaining access to those guarantees appears to have remained difficult.

Functioning of the labour market

Despite a fall in unemployment, the labour market continues to be held back by lack of economic dynamism and structural problems such as skill shortages, a significant brain drain and work disincentives. Employment growth slowed down in the second half of 2022 and the first half of 2023, to 1.3% year-on-year in both periods, compared to 2% the year before. The number of registered unemployed declined by some 3.6% (13 000 persons) between June 2022 and June 2023. This brought the administrative unemployment rate to 29.2% in June 2023 compared to 30.0% the year before. The Labour Force Survey (LFS) registered a decline in the LFS unemployment rate from 17.5% in 2021 to 15.5% in 2022. In the first half of 2023, the average LFS unemployment rate continued to decline to 13.4%. The registered labour force continued to decline, by 1.3% in the second half of 2022 and 1.1% in the first half of 2023. Due to the high share of informal employment, in particular in trade and tourism, administrative data provides only a partial picture of Bosnia and Herzegovina's labour market dynamics. Due to methodological changes, the comparability of labour-force survey data over time is limited. Official data registered an increase in

Graph 2.4: **Bosnia and Herzegovina - Labour market trends (15-64 age group)**



Source: BiH Agency of Statistics

labour participation from 2020 onwards, which could potentially be explained by government measures to counter external shocks and better registration of employment. However, this is coupled with a fall in the overall labour force, partly due to persistent labour out-migration of qualified, but also less qualified workers leaving. This has a negative impact on the country's medium-term growth potential.

Youth unemployment (age group 15-24) returned to pre-COVID-19 levels, dropping to a still high rate of 29.1% in the second quarter of 2023, reflecting structural problems. Long-term unemployment also remained high, with about 75% of the unemployed looking for a job for more than 1 year. High unemployment has persisted for years due to challenges associated with skills mismatches, the insufficient pace of job creation and a high tax wedge, both, impeding job creating, but also reducing the financial attractiveness of wages on the lower end of the scale.. A large proportion (38%) of firms surveyed by the OECD identified applicants' lack of skills as a reason for unfilled vacancies. There is also a significant gender gap, with women's activity and employment rates around 25 pps lower than those for men. Reforms to make the public employment service more client-oriented are ongoing but provided budget and human resources are very limited. The still-substantial discrepancy between unemployment data according to administrative and according to survey-based data points to the need to improve Bosnia and Herzegovina's labour market statistics.

2.2. THE CAPACITY TO COPE WITH COMPETITIVE PRESSURE AND MARKET FORCES WITHIN THE UNION

Bosnia and Herzegovina has made **limited progress**, and is between an **early stage and some level of preparation** concerning its capacity to cope with competitive pressure and market forces in the EU. The overall quality of education remains inadequate despite relatively sizable spending on the sector. The country continues to lag behind in the energy and digital transition. However, in response to changes in global demand, some structural adjustment took place, with the focus of value-added moving towards services such as trade, IT and tourism. Economic integration with the EU remains high, but overall trade is below potential. The higher uncertainty due to Russia's war of aggression against Ukraine probably had an adverse impact on investment and thus on capital stock modernisation. The implementation of last year's recommendations has remained very limited. The 2022 recommendations remain valid.

To support long-term growth, Bosnia and Herzegovina should in particular:

→ improve the quality of education and training, in particular accelerate the modernisation of curricula with a view to better alignment with labour market needs;

→ increase the share of government capital spending in GDP, in particular by focusing on transport and energy infrastructure and on improving environmental standards. Improved management of public investment and accelerated implementation of investment projects that have been subject to a clear positive cost-benefit assessment are of particular importance in this respect.

Education and innovation

Education continues to be of low quality and there is a continuing skills mismatch. According to data from 2021, public spending on education accounted for some 4% of GDP. When adding private spending and support by foreign donors, the overall amount stands at nearly 5% of GDP. However, the education system fails to provide Bosnia and Herzegovina's labour force with the skills and knowledge necessary for smooth integration in the labour market. Inadequate education is one important factor for a particularly high LFS youth unemployment rate (30.1% in 2022-Q1), twice the country's overall unemployment rate**.** Insufficient coordination among the numerous stakeholders results in a lack of common standards for various levels of education and differences in the quality of teachers' training and performance evaluation. Teaching curricula continue to be outdated and are still not sufficiently aligned with the country's needs. The average achievements of students in mathematics, reading and natural sciences are below the OECD average (Pisa 2018). The country has not confirmed participation in the 2025 PISA evaluation exercise. There has been little change in levels of educational attainment in recent years. There is a large share of low-skilled people in the population. Upskilling strategies to increase the skill levels of the workforce are not sufficiently developed and also lack sufficient providers. Participation in early childhood education and care is significantly lower than in the EU and elsewhere in the region. The illiteracy rate continues to be around 3%, largely as a result of a relatively high illiteracy rate among women.

Spending on research and innovation is limited and impeded by the low degree of cooperation and coordination among the various levels of government, leading to poor efficiency of the overall system. The lack of an efficient funding system is another factor preventing Bosnia and Herzegovina's innovation policy from achieving better results for the funds spent. However, in the area of establishing Science and Technology Parks some progress has been achieved recently. Research capacities remain limited, while brain drain continues, most notably in the health, medical, and IT sectors with no systematic measures having been introduced so far to address the issue.

Physical capital and quality of infrastructure

Investment in Bosnia and Herzegovina's capital stock remained behind the country's needs, partly due to uncertainties related to COVID-19 and the impact of Russia's war of aggression against Ukraine. Persistent political stalemates and uncertainties also have a negative bearing on investment. Gross fixed capital formation recovered from a low base in 2022, increasing by 6.6% in real terms. As a result, the investment's share in GDP rose slightly to 21.9% in 2022, but remained still below pre-pandemic levels, when it reached 23.1%. Public investment remained low, reflecting political disputes and administrative bottlenecks. Inflows of foreign direct investment (FDI) reached 2.5% of GDP in 2022, which is slightly higher than in the 5 preceding years but significantly lower than in other countries in the region. A large share of those FDI inflows continue to be re-invested earnings of foreign investors in the financial sector and in tourism. As in the case of gross fixed investment, the low level of FDI inflows is impeding Bosnia and Herzegovina's ability to achieve a higher growth trajectory. Environmental standards have remained low and are often neglected, leading to high levels of pollution, impeding the health (and thus productivity) of the labour force and constituting an additional factor supporting brain drain.

Moving away from coal-based electricity and improving energy efficiency requires legislation and investments. Bosnia and Herzegovina features one of the most energy-intensive output generation processes in the region and remains heavily reliant on lignite coal. Thus, the level of emissions from coal-fired power plants is a major concern. A reliable and secure energy supply is still impeded by the lack of a single regulatory framework to attract investment in a low-carbon energy sector. Adopting laws on renewable energy and energy efficiency should be a priority, as should state-level legislation on electricity and natural gas with which the entities must comply. Bosnia and Herzegovina should also design and implement a comprehensive building renovation strategy to improve energy efficiency. Lack of progress in these areas contributes to the poor business environment and will prolong the path to decarbonisation, transition to renewables and improved energy efficiency that the current energy crisis has made even more urgent.

Bosnia and Herzegovina is lagging behind in the digital transition. Businesses there are the least satisfied of any in the Western Balkans with the digitalisation of public services. Only around 60% of small businesses have a webpage and only 18% are active in e-commerce. Economy-wide implementation of service digitalisation is still hampered by the lack of political ownership and coordination between different levels of the government, which also leads to the insufficient allocation of budgetary resources for implementation. The lack of interoperable information and domestic support systems across entities and different levels of government in Bosnia and Herzegovina is a major obstacle to developing economy-wide digital government services (OECD, 2021). Despite repeated requests, there is still no countrywide harmonisation of the e-signature and the related coordination, cooperation and data exchange between different administrations is still needed. Furthermore, Bosnia and Herzegovina has yet to adopt a new law on electronic identification and trust services for electronic transactions with a single supervisory body for the whole country in line with the EU *acquis*.

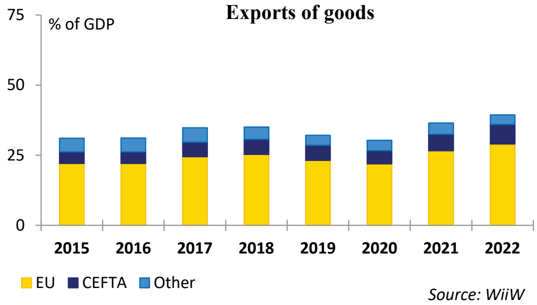
Sectoral and enterprise structure

Bosnia and Herzegovina's production structure shifted slowly over the last 5 years from industrial activities towards trade, transport and IT services. Between 2017 and 2022 the share of value-added in the trade, transport, tourism and IT sectors rose slightly from 19.9% to 20.6% and from 4.4% of GDP to 5.1% respectively, while the share of the manufacturing sector dropped, from 12.5% to 11.9%. Public administration's share in value-added dropped from 17.1% to 15.7%. Furthermore, the company structure registered some increase in the share of micro companies (0-9 employees), and medium-sized companies employing between 50 and 249 employees. However, the majority of new companies were often trading companies with lower value-added. Some 93% of all companies are in the category of small and micro businesses, i.e. those with less than 50 employees. Overall, the speed of structural change has been rather limited.

Economic integration with the EU and price competitiveness

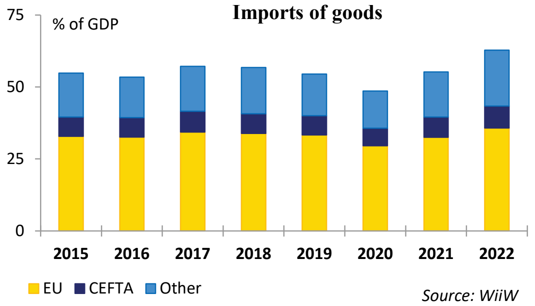
Trade and investment integration with the EU remained high but overall trade is below its potential. The main export destinations continued to be the EU (Germany, Italy, Croatia), but also CEFTA countries, such as Serbia. Over the last 5 years, trade shifted towards the neighbouring region, in particular Croatia and Serbia. The share of exports to the EU-27 in total merchandise exports rose from some 71.4% in 2017 to 73.5% in 2022. Exports to CEFTA countries also increased their share in total exports, from 16.1% in 2017 to 18.3% in 2022. Bosnia and Herzegovina's openness to trade (exports and imports as a percentage of GDP) recovered from a pandemic-induced low of 82.1% in 2020 to 107% of GDP in 2022. Nevertheless, Bosnia and Herzegovina's openness to trade is still relatively low when taking into account the small size of its economy. The export structure is not very diversified and relies mainly on basic metals, furniture, and textiles. The integration of Bosnia and Herzegovina's financial and capital markets with the EU is also still rather low, although a large part of the banking sector is owned by European banks. About two thirds of the country's stock in FDI originates from EU countries. Annual FDI inflows largely show a similar pattern.

Graph 2.5a: **Bosnia and Herzegovina - Exports of goods**



Source: WiiW

Graph 2.5b: **Bosnia and Herzegovina - Imports of goods**



Source: WiiW

Bosnia and Herzegovina's overall price competitiveness has continued to deteriorate slightly. After a long period of gradual depreciation during 2017-2020, its real effective exchange rate started to appreciate in the second half of 2022 and the first half of 2023 by 4.7% and 0.6%, respectively. The key underlying factor was a rising positive inflation differential with its trade partners. In nominal effective terms, the currency appreciated by 1.6% and 1.5% during those two periods, mainly reflecting exchange rate movements of the Turkish lira, the Chinese yuan and the British pound against the euro, to which the Convertible Mark is pegged.

3. GEORGIA

3.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Georgia is **moderately prepared** for establishing a functioning market economy. In 2022, the country continued its strong recovery from the 2020 pandemic-induced recession. Real GDP growth exceeded 10% for the second year in a row, where the outturn in 2022 was positively affected by the indirect impact of Russia's war of aggression against Ukraine, including the inflow of migrants from Russia and their spending. Georgia's external position improved significantly in 2022, following high deficits in previous years. While inflation remained elevated in 2022, it fell sharply in early 2023. The combination of high economic activity, elevated inflation and a stronger currency, accompanied by the unwinding of the pandemic-driven support measures by the authorities, led to a significant reduction in Georgia's fiscal deficit and public debt ratios in 2022, to 2.7% and 39.8% of GDP, respectively.

Georgia demonstrates a satisfactory track record in carrying out sound macroeconomic policies. Prudent fiscal policy before the pandemic (with deficits averaging 1.5% of GDP in 2014-2019, and public debt below 40% of GDP in 2019) allowed the authorities to provide significant fiscal stimulus after the outbreak of COVID-19. The central bank has a track record of successfully containing inflationary pressures (inflation averaged 3.8% in 2014-2019) and its policy response to the crisis appears appropriate in view of the size of the shock. The macroeconomic policy mix in 2022 helped building resilience and supported a balanced and strong economic recovery that helped the country weather well the sizeable external shocks related to the war in Ukraine. It also contributed to some consolidation of the country's fiscal position.

The institutional and regulatory environment is favourable overall. Some challenges persist, in particular as regards the unfinished judicial reform, the adverse impact of political polarisation on business confidence, and a large degree of political control over public institutions and their limited transparency. The strong economic activity in 2022 led to significant improvements in the labour market which, however, continues to be characterised by a very high unemployment rate and a high share of informal employment. The share of state-owned enterprises in the economy is relatively low and the authorities continue to pursue important reforms of corporate governance. The banking sector is well capitalised and shows high liquidity and profitability, although the non-banking segments of the financial sector remain underdeveloped.

In the coming year, Georgia should in particular:

→ continue to implement prudent fiscal, monetary and other policies underpinning macroeconomic and financial stability, in particular in view of a potential reversal of the financial flows related to the new Russian migrants;

→ address the main weaknesses in the Georgian labour market, such as the low employment rate, high level of informal employment, as well as significant gender disparities and regional differences;

→ further develop the non-banking segments of the financial sector.

Economic governance

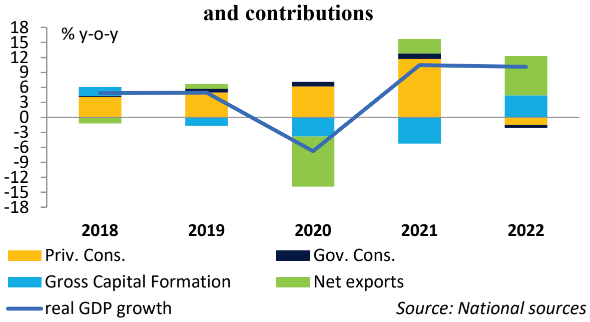
The authorities continued to implement sound fiscal and monetary policies and to advance economic reforms. Georgia has a good track record in carrying out prudent macroeconomic policies, which have helped it address various recent external shocks. In 2022, the authorities weathered well the fallout from Russia's war of aggression in Ukraine by preserving macroeconomic stability, as reflected by strong economic activity, amid lower inflation than in many peer countries and a contained budget deficit. The National Bank of Georgia (NBG) has been instrumental in safeguarding macroeconomic stability during recent shocks. In June 2023, the Parliament adopted amendments to the Law on NBG that could weaken its institutional independence, which is critical for sustaining the credibility of the institution.

Georgia has progressed on implementing the three-year stand-by arrangement with the IMF that started in June 2022. The first review was completed in December 2022. Although a staff-level agreement was reached for the second review in May 2023, the review remains on hold as IMF staff consider the implications of recent amendments to the NBG law for achieving the objectives of the programme. The programme aims at entrenching macroeconomic stability by reducing fiscal and external deficits and bringing inflation to target, further enhancing financial sector resilience, and stimulating agreed reforms in the governance of state-owned enterprises, public financial management, and tax and customs administrations. The authorities treat the arrangement as precautionary, i.e. with disbursements envisaged only in case of a deterioration of Georgia's external position.

Macroeconomic stability

Economic activity recovered strongly in 2021 and 2022 from the recession induced by the COVID-19 pandemic in 2020. Real GDP growth reached double-digit levels in both 2021 (10.5%) and 2022 (10.1%). As a result, by the end of 2022, economic output was more than 13% higher than its pre-pandemic level. This translates into still low GDP per capita in purchasing power parity of 37% of the EU average in 2022. While 2021 GDP growth was driven by household and government consumption, the 2022 expansion was the result of a strong positive impact from net exports, to a large extent driven by the services sector due to the ongoing recovery of tourism, the inflow of Russian migrants, as well as by a delayed rebound in investment activity. Despite the increase in real wages, household consumption declined in real terms in 2022, on account of the high base but also the elevated inflation during the year. Government consumption also contracted as the authorities continued to phase out support measures introduced as a response to the pandemic.

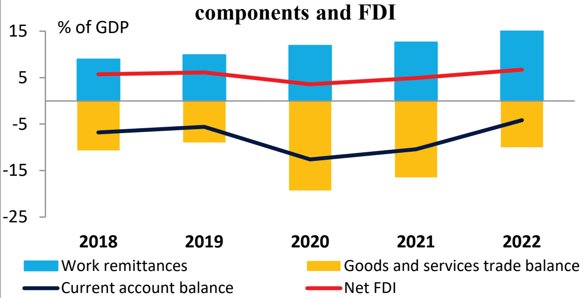
Graph 3.1: **Georgia - Real GDP growth and contributions**



Source: National sources

Georgia exhibits a high (albeit decreasing) current account deficit due to its significant deficit in trade with goods. The current account deficit averaged 9.0% of GDP in 2014-2019. It then widened to above 10% of GDP in 2020-2021, before narrowing to a record-low 4.0% of GDP in 2022. In particular, the surplus in services increased sharply to 10.9% of GDP in 2022 from 3.9% of GDP in 2021, thanks to the recovery of the tourism sector and a strong rise in exports of IT services. Georgia's merchandise trade deficit remained high at 20.7% of GDP in 2022, a reflection of its relatively narrow export base. While the deficit on the primary account rose on the back of an increase in reinvested earnings by foreign companies, the surplus on the secondary account increased thanks to growing remittances. Money transfers from Russia surged fivefold.

Graph 3.2: **Georgia - Current account selected components and FDI**



Source: National sources

Georgia managed to increase its foreign exchange reserves to USD 4.9 billion at the end of 2022 from USD 4.3 billion at the end of 2021 thanks to the narrowing current account deficit and a sizeable FDI inflow, as well as foreign exchange purchases by the NBG. This meant that reserves exceeded the 100% level of the IMF's Assessing Reserve Adequacy metric. Supported by the strong nominal GDP growth and the appreciation of the local currency, the share of gross external debt in GDP declined by more than

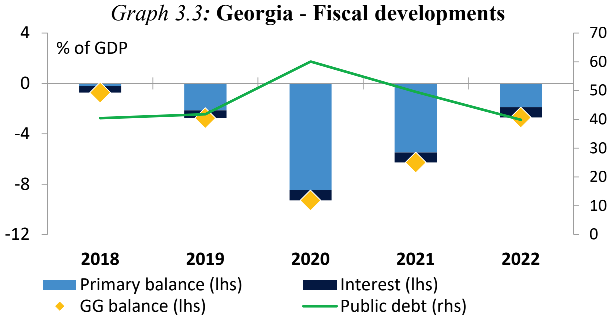
20 percentage points on the year in 2022 and dropped below 100% for the first time since 2014.

Table 3.1: **Georgia - Key economic figures**	**2014-19** average	**2020**	**2021**	**2022**
GDP per capita (% of EU-27 in PPS)[1)]	31.9	33.6	34.5	37.1
Real GDP growth	4.2	-6.8	10.5	10.1
Economic activity rate of the population aged 15-64 (%), total	53.9	50.5	50.9	51.9
female	*44.8*	*40.4*	*40.5*	*41.5*
male	*64.5*	*62.0*	*62.9*	*64.0*
Unemployment rate of the population aged 15-64 (%), total	20.8	18.5	20.6	17.3
female	*18.6*	*16.2*	*17.8*	*14.6*
male	*22.6*	*20.2*	*22.7*	*19.3*
Employment of the population aged 15-64 (annual growth %)	0.1	-4.2	-2.0	5.4
Nominal wages (annual growth %)	6.5	5.4	9.5	22.0
Consumer price index (annual growth %)	3.8	5.2	9.6	11.9
Exchange rate against EUR	2.82	3.55	3.81	3.08
Current account balance (% of GDP)	-9.0	-12.4	-10.4	-4.0
Net foreign direct investment, FDI (% of GDP)	8.0	3.6	4.9	6.7
General government balance (% of GDP)	-1.5	-9.3	-6.1	-2.7
General government debt (% of GDP)	39.5	60.1	49.4	39.8

Notes:
1) IMF
Source: national sources

While consumer price inflation remained elevated in 2022 (11.9% on average), it eased sharply in 2023 to 0.9% year-on-year in August, well below the central bank's 3% target. Before the pandemic, inflationary pressures were muted and largely neutralised by the sound policies of the central bank. The disinflation in 2023 reflected the pass-through from the sharp appreciation of the local currency in 2022 (it gained 10% against the USD and 24% against the EUR), the tight monetary policy by the central bank and the stabilisation, and in some cases decrease, in global food and energy prices. The introduction of a price cap on pharmaceutical prices in early 2023 also supported the downward trend. Despite the lower consumer price growth, the central bank kept its tight policy stance unchanged at 11.0% for a long time before it started a cautious easing cycle in May 2023, when it reduced the key policy rate by 50 basis points, followed by cuts of 25 basis points each in August and in September. This tight monetary policy together with macroprudential measures, has led to a slowdown in credit growth in 2022, in particular for households. Credit activity was mainly driven by domestic currency loans, as the central bank raised the reserve requirements for loans in foreign currency in order to reduce risks to financial stability. This slowdown ended a drawn-out credit boom, during which the stock of loans to the national economy in local currency had risen by nearly 20% on average annually in 2014-2021.

Graph 3.3: **Georgia - Fiscal developments**



Source: National sources

In 2022, public finances benefited from strong revenue growth supported by robust economic activity and elevated inflation, and from the fiscal consolidation efforts including unwinding pandemic support and saving some of the revenue windfall. This followed two years (2020 and 2021) of high budget deficits, when the state intervened intensely to contain the impact the COVID-19 pandemic. Before the pandemic, the budget deficit was low at 1.5% of GDP on average in 2014-2019, in line with the cautious fiscal stance taken by the authorities. In 2022, reflecting the high economic growth and inflation, general government revenues increased by 30% in nominal terms. At the same time, current expenditure grew by 9% and capital outlays by 24%. As a result, the general government deficit narrowed to 2.7% of GDP and thus returned below the 3%-of-GDP ceiling envisaged by Georgia's fiscal rules. This outturn was more favourable than had been planned in the fiscal consolidation path for 2022 (a deficit of 4.3% of GDP). After a sharp increase of approximately 20 percentage points during the pandemic, Georgia's public debt-to-GDP ratio declined rapidly in 2021 and 2022. At 39.8% of GDP at the end of 2022, it returned to its pre-pandemic level and was well below the 60% of GDP ceiling set by the country's fiscal rule. The improvement of the debt ratio in 2022 was mainly the result of the high nominal GDP growth and the substantial appreciation of the local currency.

The public finance governance framework was further strengthened. The 2022 Public Expenditure and Financial Accountability assessment, using an international methodology, showed that the public finance system performed well, especially as regards transparency of public finances, predictability and control in budget execution, external scrutiny and audit. Based on these results, a new Public Finance Management (PFM) strategy for 2023-2026 was prepared. The new strategy focuses on public asset management, revenue arrears monitoring, implementation of international public sector accounting standards, consolidation of central government financial statements, as well as gender-responsive budgeting. In February 2023 a public debt management strategy for 2023-2026 was adopted. It provides for a further shift to financing in local currency to minimise foreign exchange risks and deepen the local financial market. The authorities have also further developed green budgeting mechanisms.

In sum, the macroeconomic policy mix has been adequate in terms of coping with sizable external shocks, helping to mitigate the impact on people and businesses, while supporting a strong economic rebound following the pandemic. The authorities phased out pandemic-related spending and increased capital expenditures. They also used the opportunity to rebuild fiscal buffers. The reduction of the fiscal deficit and the public debt ratios suggests a considerable improvement in the fiscal space, which is essential in view of the high investments needs in infrastructure and education. Further improvements in revenue mobilisation and in managing public investments, including better prioritisation, could improve expenditure efficiency. The tight monetary policy helped manage inflationary pressures in 2022 and was among the key factors for the sharp slowdown in inflation in early 2023.

Functioning of product markets

Georgia's business environment has been liberalised and the barriers to market entry are low. For instance, registering of a company requires just one single procedure and is completed within one day at a very low cost. In mid-2023, the number of active business entities was 32% higher than in 2021, and the number of active solo entrepreneurs was 39% higher. The insolvency legislation from 2020 has facilitated insolvency proceedings, made them more transparent and reduced their duration and costs.

The institutional and regulatory environment is favourable overall, but some challenges persist. Georgia scored very well on regulatory quality (close to EU average) and government effectiveness (better than some Member States), as measured by the 2022 World Bank's Worldwide Governance Indicators. Georgia has a comparatively low level of perceived corruption. It was ranked 41st out of 180 countries in the 2022 Transparency International's corruption perception index. However, some challenges related to the business environment persist. They include reduced business confidence due to deep political polarisation and political control over many public institutions and the prevalence of vested interests. Stalled judicial reform and inefficiencies of the court system are also considered as weaknesses in terms of protecting property rights, and thus constitute obstacles to Georgia's investment climate.

The authorities introduced or expanded a number of business support programmes, aimed in particular at small and medium enterprises (SMEs), in line with Georgia's SME development strategy and its action plan. These measures included providing micro-grants to SMEs, introducing growth hubs (business incubators) to provide local SMEs with advisory and digital services, and providing export promotion and assistance to foreign investment projects in some sectors.

The state footprint in the economy is modest. State-owned enterprises (SOEs) accounted for 3.5% of the value added of Georgian companies and 8% of employment in 2022. Three SOEs were privatized in 2022, four were liquidated and two filed for bankruptcy. The total amount of state aid issued by public bodies in Georgia and reported by the Georgian National Competition Agency was very low at GEL 3 million (below EUR 1 million). The scope of state aid reported in Georgia diverges from the EU *acquis* and is much narrower.

Corporate governance reform for the remaining SOEs is among the government's priorities and is progressing well. In December 2022, the government adopted the public corporation reform strategy for 2023-2026 and a respective action plan for its implementation. The strategy envisages a dual model for SOE ownership (50% of shares in each SOE for the Ministries of Finance and Economy, respectively), operation on the basis of commercial principles, selection of independent supervisory boards and avoiding quasi-fiscal activities unless explicitly mandated and compensated, in line with international best practices. The implementation of the strategy started with a pilot project covering three public corporations: Georgian Railways, United Airports of Georgia and Gas Transportation Company.

The share of the informal sector in Georgia's economy is considered to be substantial, but is difficult to measure12**.** A significant part of workers are employed informally, most of them in agriculture or in seasonal jobs. Informality significantly reduces the country's tax revenues, exacerbates poor working conditions and distorts competition. Further efforts are needed to promote formalisation, adjust tax policy measures and stimulate digital payments.

Functioning of the financial market

The Georgian banking sector remains sound. It is strongly concentrated in the two largest domestic banks, out of 14 in total. At the end of the first quarter of 2023, the banking system's capital adequacy ratio stood at a comfortable 20.8% and most lenders remained very profitable (29% return on equity). Asset quality continued to improve as the ratio of non-performing loans decreased from 5.2% at the end of 2021 to 3.8% at the end of the first quarter of 2023. Due to measures undertaken by the central bank (such as non-remuneration of the minimum reserves in foreign currencies kept by banks at the national bank) coupled with rising USD and EUR interest rates, the share of loans and deposits in foreign currencies (dollarisation) declined substantially from 51% and 58% respectively at the end of 2021 to 44% and 52% in the first quarter of 2023. The inflow of Russian migrants contributed to a substantial increase in deposits in Georgian banks.

Non-banking segments of the financial sector remain underdeveloped. Georgia's insurance sector is small with 18 insurance companies and at total insurance premium of GEL 910 million in 2022 (1.3% of GDP). The largest part of this is health insurance. Car insurance is expected to grow fast after the introduction of mandatory third party vehicle liability insurance, where the respective legislation is being currently finalised by the authorities. In 2022, only 7% of cars in the country were insured. The capitalisation and liquidity of the Georgian Stock Exchange (GSE) are limited, with stocks of 8 companies admitted for trading and a total market capitalisation of GEL 2.3 billion (3.2% of GDP) in April 2023. Since its peak in 2007, trading activity for stocks listed on the GSE has been decreasing, and a number of Georgian companies have chosen to list on international stock exchanges. In December 2022, the government adopted its 2023-28 capital market development strategy, which focuses on two main goals: developing capital market instruments and deepening of the investor base.

Access to finance has improved in recent years but is still considered as a major obstacle by many SMEs. The central bank has made substantial efforts to improve the regulatory framework and the infrastructure for digital financial services. The size of financial intermediation, measured by the ratio of loans to non-financial sector and households to GDP, has increased over the last five years from 55% at

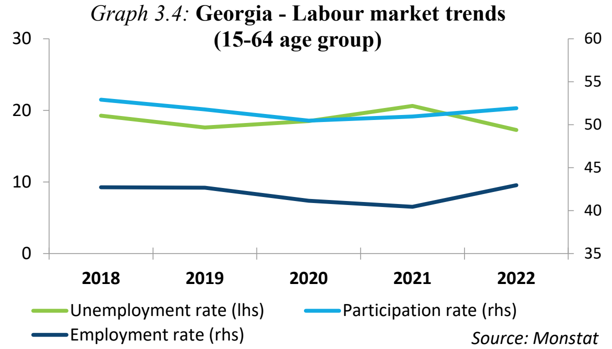
[12] According to World Economics (2022), which uses an average of the latest estimates from economists around the world, the informal economy represents about 46% of GDP in Georgia, versus an EU average of 16.9 %. Such estimations need to be take with caution given the variety of methodological approaches.

the end of 2017 to 62% at the end of 2022, as against 90% of GDP in the EU. Credit growth reached 12.1% year-on-year at the end of 2022 (excluding the effect of exchange rate fluctuations) and was faster for corporate than for retail loans. Nonetheless, access to bank loans continues to be a major obstacle for many small and medium enterprises, for instance due to substantial collateral requirements, while non-bank sources of finance are largely absent, and the existing financial products and services fail to meet the diverse needs of enterprises throughout their lifecycles. To overcome this obstacle, Enterprise Georgia, a government agency, facilitates access to finance for the private sector through credit guarantees, subsidising interest rates on bank loans and other instruments, while the Georgia Innovation and Technology Agency provides targeted support for start-ups. As a new measure aimed at stimulating lending to very small companies, especially in agriculture, the Parliament approved a law on micro banks which entered into force in July 2023.

Functioning of the labour market

The situation on the labour market improved in 2022 but remains characterised by many weaknesses. The unemployment rate increased from the pre-COVID average of 19.5% in 2017-19 to 20.6% in 2021 and then decreased by over 3 percentage points year-on-year to a still high 17.3% in 2022. The structurally low employment rate rose from 40.4% in 2021 to 42.9% last year. These rates, calculated by the national statistical office (Geostat), are based on ILO definitions covering the population aged 15 years or older and are not directly comparable with Eurostat labour indicators for EU countries. The positive trends on the labour market in 2022 can be attributed to high economic growth, the arrival of qualified migrants following the outbreak of the war in Ukraine, but also to more active labour market services provided by the State Employment Support Agency. These included vocational training, internships, career guidance, intermediary services and, since March 2022, public works. To analyse the existing mismatch between labour skills and business needs, the Ministry of Economy conducted in 2022 a survey of business demand for skills on a big sample of large and small companies. Despite these improvements, numerous structural weaknesses in the Georgian labour market persist. A large share of employment is still focused on traditional sectors with low value-added (such as agriculture), and the ability of more productive sectors to create opportunities for high-skill employment remains limited. Georgia has considerable levels of informal employment (estimated by Geostat at 28% of non-agricultural employment), gender disparities and regional differences. For instance, the employment rate in 2022 was 52% for men and only 35% for women. The share of young people who are neither in employment nor in education or training (NEETs) was also very high at 30.7% in 2022, as against the EU average of 11.7%. While Georgia's labour market regulation is not considered as distortive, there is some room to improve labour market intermediation channels, facilitate flexible working arrangements to improve employment of women, and enhance vocational training.

Graph 3.4: **Georgia - Labour market trends (15-64 age group)**



Source: Monstat

In 2022, the average monthly wage increased by 9% in real terms (22% in nominal terms) and amounted to GEL 1592 (EUR 517). As in the case of employment indicators, wage levels displayed large gender and regional disparities, with men earning on average over 20% more than women.

3.2. THE CAPACITY TO COPE WITH COMPETITIVE PRESSURE AND MARKET FORCES WITHIN THE UNION

Georgia has **some level of preparation** to cope with competitive pressure and market forces within the EU. While the country has a strong track record in attracting foreign direct investment from the EU, which remains its largest trade partner, the EU's share in trade has been gradually decreasing, in favour of geographically closer economies. The structure of the economy is relatively well diversified, albeit with a high share of low value-added sectors. Its high exposure to tourism and the low value-added base of its exports makes Georgia particularly vulnerable to external shocks.

Despite some progress, the limited level of educational achievement, quality and labour-market relevance of education weighs on the development of Georgia's human capital and holds back its potential growth. Spending on research and innovation is low and very few firms innovate. The level of investment is broadly comparable to EU, but the quality and density of the transport network remains low, despite recent investment in this area. While it has developed a stable and reliable energy sector, the country remains heavily dependent on imported energy sources. Access to digital infrastructure has improved substantially in recent years and is in line with EU levels.

In the coming year, Georgia should in particular:

→ further develop its transport and energy infrastructure, in compliance with international Public Investment Management standards.

→ stimulate innovation and make concerted efforts to support both public and private investment in R&D, also with a view to promoting exports.

→ improve the quality of education and training to ensure that their outcomes align with labour market needs.

Education and innovation

Despite the reforms, the outcomes of the educational system are poor. Public spending on education represented 3.6% of GDP in 2021, below the EU average of 5%. While 93% of the population has at least upper secondary education, a higher share than the EU average, only 35% have completed tertiary education, as against 41% in the EU. However, available indicators point to the quality of education as being rather low. For instance, Georgia was ranked only 70th out of 77 countries participating in the 2018 PISA assessment measuring reading outcomes in secondary education, well behind all EU countries. The unified strategy for education and science (2022-2030), adopted in August 2022, lays out priorities for improvements in this area. They include increasing access to early childhood education, development of a methodology and standards for vocational qualification system, improving the quality of higher education and making it more international.

Spending on R&D was very low at some 0.3% of GDP in the last five years (EU average: 2.2% of GDP in the same period). Georgia ranked 74th (out of 132 economies) in the 2022 Global Innovation Index compiled by the World Intellectual Property Organisation. In particular, the country exhibits weaknesses in domestic industry diversification, high-tech manufacturing, software spending, intellectual property receipts and logistics performance, among others. According to a 2022 World Bank report, very few Georgian firms innovate. The reasons include, a limited innovation ecosystem, lack of dedicated finance and advisory services supporting innovation, limited managerial capabilities, a small market and a low number of engineers and scientists. As a result, only 7% of firms introduce new or significantly improved goods or services into the market.

Physical capital and quality of infrastructure

Investment in Georgia represented 22.3% of GDP in 2022, similar to the EU average, having increased by 20% in real terms on the year following significant declines in 2020 and 2021. However, only a part of this amount was spent on infrastructure. There is a need for continued investments in a range of transport and energy infrastructure projects to enhance transit trade potential, energy independence, and connectivity with neighbouring countries and the EU. There are also some issues regarding the efficiency of public investment, operations and maintenance, and challenges to leverage public-private-partnerships. To address these challenges, the authorities work on improving the institutional framework for public investment. For instance, since 2023 all new investment projects over a specified threshold have to be selected according to internationally recognised public investment management guidelines.

Georgia has developed a stable and reliable energy sector. However, the country is heavily dependent on imported energy. In spite of a very high share of electricity generation coming from domestic hydropower (81%), almost all other energy sources, including gas, oil products and coal, are imported. The government is focused on securing private investment to construct new hydropower stations, wind and solar power generation, increase energy efficiency and diversify fossil fuel supply sources and routes. In 2022, Georgia developed a support scheme for renewable power generation based on competitive bidding. The first auction took place in February 2023.

In transport, the quality and density of road and rail network remains weak despite gradual improvement. Poor transport infrastructure hampers internal and external connectivity and leads to poor road safety. The efforts on road infrastructure focus on the construction of the missing part of the East-West Highway (part of European route E60), with one of the sections completed in late 2022. Apart from roads, ports and railways also remain underdeveloped and face capacity constraints, in part due to lack of sufficient investment.

Access to digital infrastructure has improved substantially in recent years and is in line with EU levels. 92.3% of Georgian households have fixed broadband internet access at home, in line with the EU average.

Sectoral and enterprise structure

Tourism and low value-added sectors account for a sizeable share of Georgia's economy. The services sector accounts for approximately 60% of GDP. This share has been relatively stable since 2014. Within services, tourism has been playing an increasingly important role over the years. It was severely hit by the COVID-19 pandemic but has been steadily recovering since then. The number of international visits in 2022 was some 40% lower than the peak recorded in 2019 but tourism revenues have reached an all-time high. Industry, including construction, is the second largest sector of the economy with a share of 24.6% of GDP in 2022. Industrial production is dominated by low value-added sectors: commodities (predominantly metals), agricultural products and food processing. These are also Georgia's key export items. IT and communication was the sector witnessing the strongest expansion in 2022 and increased its share in GDP by more than one percentage point to 4.7%. While still sizeable when compared with the EU average (1.4% of GDP in 2022), agriculture has been steadily losing ground and accounted for 7.0% of GDP in 2022, down from 9.6% in 2014.

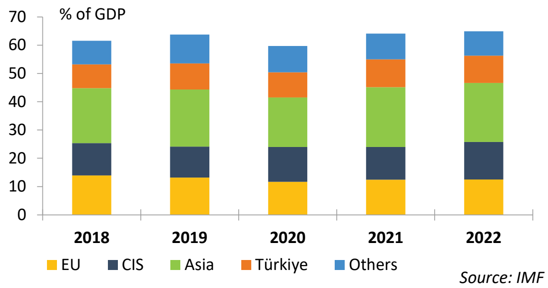
As regards employment, the share of people working in agriculture is disproportionately high, even if this has decreased in recent years. This suggests continued low productivity in the sector, which seems to be a reflection of the still high reliance on small-scale farming that hinders economies of scale. People employed in agriculture amounted to 17.9% of the total in 2022, thus making the sector the biggest employer in the country. It is followed by wholesale and retail trade (15.0%), industry (11.9%) and education (11.7%). Construction and transportation are among the sectors that have witnessed the sharpest rise in employment in the last five years, and the information and communication sector grew very fast in 2022.

SMEs remain key for the Georgian economy despite a gradual decline in their role in recent years. In 2022, they accounted for 37.3% of the turnover and 52.8% of the value added by all companies. This is well below the 55.1% and 59.2% respective average annual values for the 2014-19 period. At the same time, the number of employees at SMEs went down to 58.3% from 67.6%. Access to finance remains a key constraint for the development of the sector.

Economic integration with the EU and price competitiveness

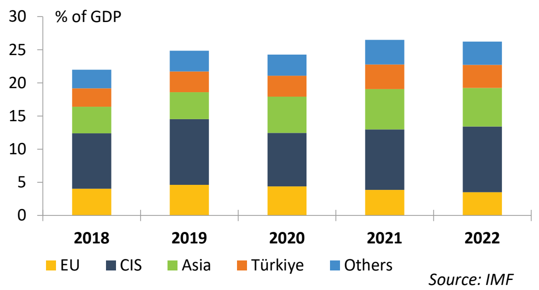
Georgia is an open economy with a persistently high merchandise trade deficit driven by a relatively weak domestic export base; its trade integration with the EU is moderate. Following the sharp contraction caused by the COVID-19 pandemic due to the hit on the sizeable tourism sector, Georgia's trade openness as measured by the ratio of trade with goods and services related to GDP recovered strongly to 117.2% of GDP in 2022. The EU is the country's main trading partner but its share in the total turnover in merchandise trade has been gradually declining due to a stronger increase in nominal trade with non-EU countries. After peaking at nearly 28% in 2016, it has gradually eased to 20.5% in 2022. The decline was particularly pronounced for Georgia's exports of goods. The EU's share in them fell to 15.4% in 2022, down from 28.7% in 2015. Georgia has strong links with all its neighbours - Türkiye and Russia are the next two biggest trade partners besides the EU.

Graph 3.5a: **Georgia- Imports composition**



Source: IMF

Graph 3.5b: **Georgia - Exports composition**



Source: IMF

Georgia remains an attractive destination for foreign investments. In 2014-2019, FDI inflows amounted to nearly 10% of GDP each year on average. Following a short-lived drop with the pandemic, they rebounded strongly in 2022 to exceed for the first time USD 2 billion (8.3% of GDP). While, similarly to previous years the majority of the FDI reflected re-invested earnings that are supported by the favourable tax regime, there was also a significant increase in equity investments in 2022. The EU is traditionally the biggest source of FDI for the country. In 2018-2022, the EU-27 accounted for 37% of total FDI inflows, followed by the UK (27%), Türkiye and the US. The sectoral breakdown of FDI is diversified. The financial sector was by far the biggest recipient of FDI (30% in 2018-22), while the real estate, energy, manufacturing, trade, entertainment and other sectors also attracted significant investment.

The real effective exchange rate has appreciated strongly following the pandemic, implying that Georgia's competitiveness has weakened. Supported by the recovery of the tourism sector and the large money transfers associated with the relocation of Russian citizens and businesses following the start of the war in Ukraine, it appreciated by nearly 40% in cumulative terms in 2021 and 2022 and continued this upward trend in the first four months of 2023. In particular, the real exchange rate of the local currency against the euro appreciated by 53% over the course of 2021 and 2022.

4. KOSOVO

4.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Kosovo is **between an early stage and some level of preparation** and has made **some progress** in developing a functioning market economy.

Kosovo's economic rebound moderated significantly in 2022 as investment contracted and household consumption growth slowed owing to high inflation, which surged to double-digits in the wake of rising energy, food and transport prices. Russia's war of aggression against Ukraine had mainly indirect effects, through higher import prices and uncertainty. Supported by high revenue growth and a significant under-execution of public capital spending, the headline budget was close to balance in 2022 and the public debt ratio fell. However, the investor base for government debt remains narrow. Social benefits remain poorly targeted. The Assembly passed the new law on the minimum wage, which decoupled the level of war veterans' pensions from the minimum wage. The financial performance of publicly owned enterprises represents a fiscal risk. The current account deficit rose significantly on the back of strong increases in energy import prices. The financial sector remained well capitalised and stable, and bank lending continued to expand in nominal terms. However, sustained supervisory vigilance is required in the context of slowing economic growth, tightening financial conditions and the rapid rise in mortgage lending to households. The economy remained resilient during recent crises, but the private sector continues to be hindered by long-standing structural challenges such as a widespread informal economy, a high prevalence of corruption and the overall weak rule of law. The business environment improved somewhat. Labour market formalisation continued, but labour market participation and employment rates, especially among woman and young people, remain very low, while unemployment remains high.

Last year's recommendations were partly addressed and remain mostly valid. In order to improve the functioning of the market economy, Kosovo should in particular:

→ continue to mitigate the impact of the energy crisis by well-targeted and temporary support measures if needed, while complying with the fiscal rule's deficit ceiling of 2% of GDP;

→ ensure compliance with the legal ceiling on war veteran pensions and with the wage bill rule, and undertake a review of tax expenditure, quantifying the size of the revenue forgone from all exemptions, preferential rates and special regimes;

→ improve the quality of public spending by reforming the social security system and addressing weaknesses in public investment management;

→ implement relevant business environment measures, in particular on the fight against the informal economy and the simplification and digitilisation of licences and permits.

Economic governance

Kosovo's economic policies focused on providing policy support to cushion the impact of higher energy prices and on re-establishing fiscal buffers. In 2022, the government allocated and implemented around EUR 316 million (3.5% of GDP) in temporary support to vulnerable households and firms, and wage and pension bonuses and subsidies to the energy and agricultural sectors. The 2023 budget includes an allocation for contingencies of 3.5% of GDP, of which 2.7% of GDP is a blanket allocation, which undermines fiscal transparency. There was limited progress in improving the planning, selection and management of public investment, and the public capital budget was significantly under-executed. The government took fiscally prudent decisions by rejecting a proposal to withdraw more funds from the Kosovo Pension Savings Trust (KPST). The Assembly passed the new law on the minimum wage, which decoupled the level of war veterans' pensions from the minimum wage. The new Law on public-sector salaries, combined with a suitable value of the wage coefficient set by the government, ensures that the public wage bill does not exceed its legal ceiling. On 25 May, the IMF Executive Board approved a 24-

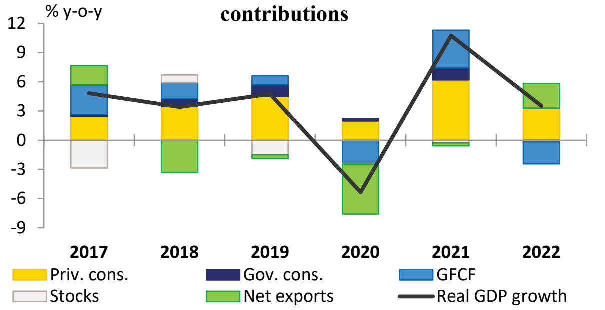
month precautionary Stand-By-Arrangement in the amount of EUR 100 million for Kosovo and a EUR 78 million support from the IMF's newly established Resilience and Sustainability Facility, to be used for investments in renewable energy and energy efficiency.

The policy guidance jointly agreed at the May 2022 Economic and Financial Dialogue between the EU and the Western Balkans and Türkiye has been partially implemented. Tax revenue grew strongly on the back of high inflation and a reduction in the informal economy, but there was little progress on reviewing tax exemptions. The financial oversight of publicly owned enterprises (POEs) has improved but work to set up a fiscal oversight body has not advanced. For 2023-2025, Kosovo's Economic Reform Programme (ERP) aims to maintain stable public finances and comply with fiscal rules, while supporting the economic recovery mainly through higher capital spending.

Macroeconomic stability

Kosovo's economic rebound moderated significantly in 2022 due to the fallout from Russia's war of aggression against Ukraine. Real GDP growth eased markedly from 10.7% in 2021 to 3.5% in 2022, which is below the pre-pandemic (2015-2019) average rate of GDP growth of about 5%. The key factors behind the economic slowdown were a decline in gross fixed capital formation and a deceleration in private consumption growth. The slower growth in private consumption was due to high inflation and the resulting fall in real disposable income as well as a moderate drop in net inflows of remittances as a share of GDP. Still, household consumption remained one of the main drivers of growth on the back of government support measures and higher bank lending. Moreover, a strong increase in exports of goods and services, together with a sharp slowdown in real imports growth, resulted in a positive contribution of net exports to GDP growth. Economic growth accelerated slightly to 3.9% year-on-year in the first quarter of 2023, up from 3.6% in the previous 3 months. Despite some gradual improvement, the lack of economic diversification, high import dependency and an unreliable energy supply render Kosovo vulnerable to adverse external shocks. Kosovo's per capita GDP remains the lowest in the Western Balkan region, standing at 27% of the EU average in 2022 Income inequality is high due to a large informal sector and high inactivity rates, especially among women.

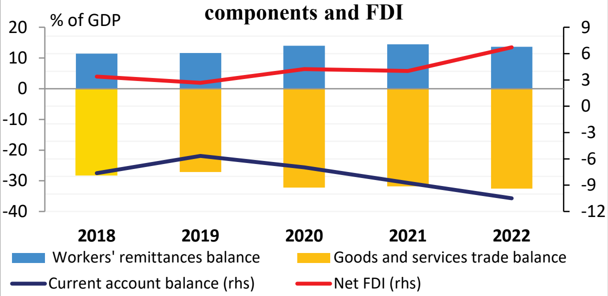
Graph 4.1: **Kosovo - Real GDP growth and contributions**



Source: WiiW

The negative terms-of-trade shock led to a substantial deterioration in the current account balance. The current account deficit widened significantly to 10.5% of GDP in 2022, up from 8.7% in 2021. A key factor was the energy-balance-induced surge in the merchandise trade deficit, which outpaced the continued rebound of services exports, resulting in an increase in the overall trade deficit to 32.5% of GDP, up from 31.8% a year before. Affected by the economic slowdown in the EU, remittances decreased to 13.7% of GDP in 2022, down from 14.5% in 2021, while the primary income surplus fell to 1% of GDP, down from 1.9% a year earlier. Further unofficial services exports and remittances were reflected by large errors and omissions in the balance of payments (equivalent to 2.7% of GDP) in 2022. The four-quarter moving average current account deficit narrowed to 9.2% of GDP in the first quarter of 2023.

Graph 4.2: **Kosovo - Current account selected components and FDI**



Source: IMF and Central Bank of Kosovo

Table 4.1: **Kosovo - Key economic figures**	**2014-19** average	**2020**	**2021**	**2022**
GDP per capita (% of EU-27 in PPS)	24	25	27	27
Real GDP growth	4.6	-5.3	10.7	3.5
Economic activity rate of the population aged 15-64 (%), total	40.4	38.3	39.3	38.6
female	*19.6*	*20.8*	*22.0*	*22.0*
male	*60.9*	*56.0*	*56.6*	*55.5*
Unemployment rate of the population aged 15-64 (%), total	30.3	25.9	20.7	12.6
female	*30.6*	*32.3*	*25.0*	*16.5*
male	*24.4*	*23.5*	*19.0*	*11.0*
Employment of the population aged 15-64 (annual growth %)	1.4	-4.4	10.4	5.4
Nominal wages (annual growth %)	3.6	-2.3	3.9	7.6
Consumer price index (annual growth %)	0.9	0.2	3.3	11.6
Exchange rate against EUR*	1.0	1.0	1.0	1.0
Current account balance (% of GDP)	-7.1	-7.0	-8.7	-10.5
Net foreign direct investment, FDI (% of GDP)	3.2	4.2	4.0	6.7
General government balance (% of GDP)	-2.0	-7.6	-1.2	-0.5
General government debt (% of GDP)	14.9	22.4	21.5	19.9

** The euro is used as a de facto domestic currency*
Source: Kosovo statistics, World Bank and IMF

Net foreign direct investment (FDI) inflows increased strongly to 6.7% of GDP in 2022, covering around two thirds of the current account deficit. The key drivers for the 88% year-on-year increase were continued investment by the diaspora in the real estate sector, as well as higher inflows in mining and quarrying, financial and insurance activities, and manufacturing. In 2021, Kosovo issued its first diaspora bonds totalling EUR 10.4 million, most of them 5-year bonds, in an effort to tap additional sources of financing. Otherwise, Kosovo remains absent from international debt markets. The four-quarter moving average of net FDI inflows increased slightly to 7% of GDP in the first quarter of 2023, while official reserve assets amounted to 2.3 months of imports of goods and services.

After peaking in 2022, annual inflation started to gradually decline since the last quarter of that year. Annual average consumer price inflation accelerated significantly to 11.6% in 2022, up from 3.3% in 2021. The main drivers were rising energy, food and transport prices. However, in the last months of the year inflation started to moderate, reaching an average of 10.1% year-on-year in the first quarter of 2023 and decreasing further to 2.4% in July on the back of gradually decelerating global commodity prices. Most energy prices are regulated in Kosovo. Following a request by KEDS, Kosovo's energy distribution company, in early December 2022, the Energy Regulatory Office increased electricity tariffs by 15.4% for all consumer categories in late March 2023. The government continued subsidising tariffs for households and businesses consuming up to 800 Kwh.

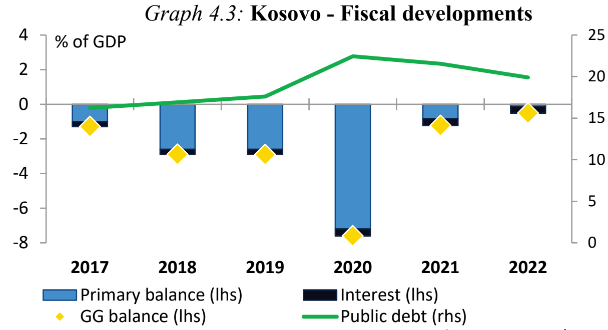
Fiscal consolidation continued in 2022 with a further reduction of the headline deficit on the back of high revenue growth and underexecution of the capital investment programme. The headline budget deficit fell to 0.5% of GDP in 2022 (from 1.2% of GDP in 2021), which corresponds to a surplus of 0.2% of GDP under the fiscal rule's definition13. Government deposits fell slightly to 3.5% of GDP, down from nearly 4% in 2021. The fall in the government deficit resulted primarily from a higher-than-

[13] The fiscal rule places a cap on the fiscal deficit of 2% of forecast GDP, excluding capital projects financed by privatisation proceeds and donors ('investment clause'). This exemption for donor-financed investments can be invoked until 2025, provided the public debt ratio remains below 30% of GDP. A further rule stipulates that the increase in the public wage bill cannot exceed nominal GDP growth. Government deposits used as fiscal buffers are legally required to stay at 4.5% of GDP as long as the government uses privatisation proceeds. The debt rule provides that public and publicly guaranteed debt cannot exceed 40% of GDP.

projected increase in budgetary revenue, which rose by nearly 14% year-on-year, on the back of high inflation and some formalisation gains. Tax revenue increased by 14.3%, with direct and indirect tax income growing healthily by 21% and 12% respectively in 2022. Public expenditure grew by 10.5% year-on-year. The largest increase took place in the category of transfers and subsidies (26.3% year-on-year), mainly driven by energy subsidies. The execution of overall current expenditure was roughly in line with the revised budget plan. Wages and allowances recorded an annual decrease of 2.2%, while spending on goods and services rose by 9.4%. Capital spending practically stagnated compared to 2021, and only reached around 60% of the revised budget allocation, affected by weak public investment management capacity and higher input prices, which have led to a surge in project costs.

On the back of the improved budget balance and high nominal GDP growth in 2022, the public debt-to-GDP ratio declined, but the domestic investor base for government debt remains narrow. The public debt ratio fell to a revised 19.9% at the end of 2022 and further to 17.3% in June 2023. These figures do not include the liability for the State from COVID-19-related tax-free withdrawals of 10% of pension savings from the Kosovo Pension Savings Trust, which the government promised to reimburse from 2023[14]. Domestic debt, which is held by a narrow investor base, increased only by 0.5% in nominal terms in 2022. In March 2023, the share of domestic debt held by the KPST rose to 49%, up from 44% in 2021, while the Central Bank of Kosovo and commercial banks hold a further 20% and 24% of domestic debt respectively. In the absence of a sovereign credit rating and very limited access to international bond markets, foreign financing has been provided by international donors. Foreign debt rose by 11.2% in 2022. This includes loans from the World Bank (EUR 60.1 million), the European Investment Bank (EUR 23.8 million), the European Bank for Reconstruction and Development (EUR 14.5 million) and the Council of Europe Bank (EUR 10.8 million). The new Law on public debt and state guarantees, aligning the legal framework with EU standards and international practices, was adopted at the end of 2022, and the secondary legislation will be reviewed and approved by the end of 2023. Under this new law, the definition of public debt will also include debt issued on behalf of municipalities. The law regulates municipality borrowing (including the power to borrow), reporting requirements and debt limits.

Graph 4.3: **Kosovo - Fiscal developments**



Source: IMF and MoF

Progress with public investment management and adressing fiscal risks has been mixed. Budgeted public capital spending is expected to increase by 3.6% of GDP compared to the 2022 outturn, despite weak planning and implementation capacities and recurring under-execution of the capital budget in the previous years. Some steps were taken to unlock project implementation, including through paid land expropriations and making the Procurement Review Body board operational again in the second quarter of 2022. Furthermore, the Law on public works support, adopted at the end of 2022, compensates contractors up until mid-2023 for higher project costs resulting from very high inflation. The implementation of the Law on salaries of public officials is expected to increase the wage bill by 11.1% in 2023. This is lower than the nominal GDP growth in 2021, meaning that the wage bill rule is being respected. The issue of recurring spending overrun on war veteran pensions has not been resolved due to the absence of a reclassification of beneficiaries. The 2023 budget again includes a large blanket allocation, which undermines fiscal transparency and budget planning unless it is justified as part of a concrete risk assessment framework. The fiscal risk analysis of the main central publicly owned enterprises in the medium-term expenditure framework (MTEF), annual budget and the ERP has been expanded beyond the POEs overseen by the Ministry of Economy. However, the analysis is limited to high-risk POEs, excluding other companies. Implementation of the Energy Roadmap reached on 21 June

[14] The IMF estimates the liability to the Kosovo Pension Savings Trust at 1.8% of 2020 GDP.

2022 between Kosovo and Serbia in the EU-facilitated dialogue to address electricity billing issues in four municipalities in the north of Kosovo is yet to move forward. Fiscal risks related to billing and payment of invoices remain. In 2022, the financial obligations of KOSTT, the Kosovo transmission operator, for the losses caused by the energy consumed (but not paid for) in that part of Kosovo reached EUR 63 million.

After 2 years of substantial fiscal consolidation, the planned strong fiscal impulse in 2023 is appropriate. In 2022, the government adopted temporary support packages that helped to mitigate the impact of the energy crisis, including energy subsidies and transfers to vulnerable households and firms. However, the measures could have been better targeted and more transparent. Budget revenue relies on a narrow tax base, mainly from indirect taxes, weakened by numerous tax exemptions, preferential tax rates and special regimes, while public spending is burdened by category-based specific transfers, leaving little space for means-tested benefits and employment policies. The 2023 budget provides for a strong fiscal stimulus, which is largely appropriate after 2 years of substantial fiscal consolidation. This would mainly be implemented through an increase in public spending on wages and investment. However, there is a risk of the latter facing constraints due to weak public investment management.

Functioning of product markets

Business environment

The gap between newly registered and terminated firms has widened over the last 5 years. The difference between new (11 049) and terminated firms (1 775) widened to 9 274 in 2022, up from 8 066 in 2018, mainly due to a higher number of newly registered companies.

Some progress was made in improving the business environment. In July 2022, the government approved the concept document for the Register of Beneficial Owners. The Commercial Court became fully operational in August 2022, which is expected to increase the efficiency of the judicial system in settling commercial disputes, but the court still faces a large backlog of cases. In September 2022, the government adopted an improved programme to reduce and prevent the administrative burden on citizens and businesses. The e-Kosova platform has increased the number of services available through the platform from 21 in 2021 to 140 in 2023. In October 2022, the government approved the concept document for business organisations and the secondary legislation on the Business Registration Agency. In November 2022, an assessment of the agency's database compatibility with the requirements of the Business Register Interconnection System (BRIS) was finalised. The Kosovo Investment and Enterprise Support Agency (KIESA), whose task is to support foreign and domestic businesses including SMEs, promote exports and attract foreign direct investment, lacks capacity and resources to execute its broad mandate, while its restructuring and reform are long overdue. For this reason, in January the government approved the Law on sustainable investments, which is awaiting the Assembly's approval. Its purpose is to regulate the protection, promotion and encouragement of sustainable investments. The law also envisages to replace the KIESA by a new agency, which would facilitate foreign investment and report directly to the prime minister's office.

Despite some progress in reducing the informal economy, it still accounts for more than 30% of GDP. Formalisation efforts by the government, Kosovo's Agency of Statistics, and the Customs administration have borne fruit, contributing around 35% of the cumulative change in tax revenues in 2020-2022[15]. The government subsidies for registered employees to mitigate the negative impact of the COVID-19 pandemic on households and firms helped shift more employees from the informal to the formal sector. Increased labour demand at the time of the economic rebound contributed to an increased number of formal employees. During the reporting period, the Secretariat of the Government Working Group for the implementation of the 2019-2023 National Strategy for the Prevention and Combating of Informal Economy, Money Laundering, Terrorist Financing and Financial Crimes, published a report covering the first half of 2022, which showed that only 50% of the planned actions were implemented. A

[15] IMF Country Report No. 23/55, January 2023.

second action plan covering the period 2022-2023 was adopted in 2022, while the Secretariat has started drafting the new national strategy for 2024-2028. To tackle corruption, a set of new anti-corruption laws was adopted in 2022. These aim at strengthening criminal proceedings, the anti-corruption agency, and asset declaration. According to Transparency International's corruption perceptions index, Kosovo improved its index score in 2022, ranking 84 out of 180 countries, 3 positions higher than in 2021.

State influence on product markets

The State aid policy framework is at an early stage of development. The current framework lacks a coherent approach to State aid or a comprehensive strategy and cost-benefit evaluations for aid and subsidies granted. In the reporting period, the State Aid Department developed an online monitoring system for State aid. Training of the competent staff on recording and monitoring State aid in the system is in progress. The State Aid Commission has still not been appointed by the Assembly and remains without a decision-making quorum. In 2022, in the context of higher energy and crop prices amid Russia's war of aggression against Ukraine, about 1% of GDP was allocated for subsidies to firms operating in the agricultural and energy sectors.

Privatisation and restructuring

Kosovo took further steps to set up a sovereign fund. In June 2022, the government adopted a concept document on the sovereign fund, and a public consultation was launched in March 2023 on the draft law on its establishment. The sovereign fund is expected to take over socially owned enterprises[16] and assets managed by the Privatisation Agency of Kosovo (PAK), as well as some publicly owned enterprises managed by the Ministry of Economy after these improve their financial performance. However, setting up the fund will not be sufficient to address the long-standing issues of poor financial performance and management, which reflect weaknesses in corporate governance and oversight of publicly owned enterprises. In June 2023, the government approved the draft law on the sovereign fund, which will be discussed in the Assembly. During the reporting period, the PAK initiated liquidation procedures for 3 socially owned enterprises. In total, 582 socially owned enterprises are under liquidation procedures. The process of dismissing and appointing new board members of publicly owned enterprises continued, with more women being appointed.

Functioning of the financial market

Financial stability

The financial sector showed resilience amid continued challenges. The predominantly foreign-owned banking sector accounts for 68.4% of financial system assets, followed by pension funds, micro-financial institutions and insurance companies, with 24.5%, 4.1% and 2.7% respectively. The banking sector's profitability improved in nominal terms, with the average return-on-equity ratio rising to 20.6% in 2022, up from 17.6% in 2021, and increasing further to 21.1% in July. At the end of 2022, the non-performing loans ratio stood at a historically low 2% and remained unchanged at end-March 2023, partially supported by the denominator effect of high nominal credit growth. The banking sector has to be closely monitored due to non-negligible risks from a weaker economic outlook, higher commodity prices and lower-than-projected remittances. Furthermore, as new mortgage lending to households has been growing relatively strongly, it appears appropriate to strengthen surveillance of the housing market. The ratio of banks' regulatory capital to risk-weighted assets stood at 14% in 2022 and increased to 15.3% in July, comfortably exceeding the regulatory minimum of 12%. Banks continued to be financed by deposits, predominantly from households. The loan-to-deposit ratio increased to 78.3% in 2022, up from 76.5% in 2021, and rose further to 81.1% in March. In 2022, the net profit of micro-financial institutions increased to EUR 17.2 million, up from 14.1 in 2021. The insurance sector's net profit fell by 44% on an annual basis, reflecting the increase in operating expenses, namely the cost of purchasing goods and services, administrative expenses and claims incurred.

[16] The ownership of socially owned enterprises was considered as shared social property in the former Yugoslavia.

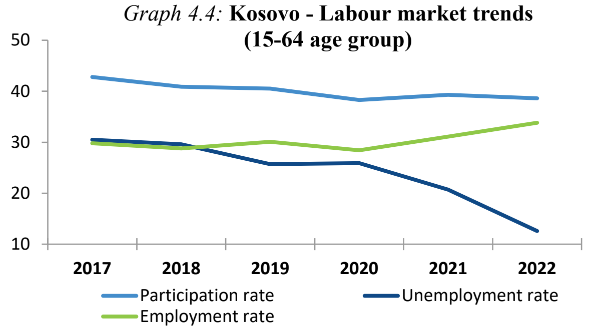
Access to finance

Lending to the private sector continued to expand in 2022. Driven by both business and household lending, bank loan growth accelerated to an average of 17.4% in 2022 up from 11.2% in the previous year, before slowing to 15% year-on-year in the first quarter of 2023. The average interest rate on loans increased to 6.3% in 2022, up from 5.8% in 2021, and remained at 6.3% in March, reflecting tighter financing conditions in the euro area. Deposits' average growth eased to 10.8% in 2022, down from 13.8% a year earlier, before picking up to 16.3% year-on-year in the first quarter of 2023. New loans issued to businesses with a focus on investment grew by 9.6% in 2022. Despite some new initiatives undertaken by the Kosovo Credit Guarantee Fund, the lack of easily accessible and affordable credit continues to be a barrier to SME growth. This is partly due to the existing disparity between the market value of collaterals and their legally assigned value taken into account by banks. The capital market remains at an early stage of development. Microfinance has gained momentum in recent years[17], but shortcomings in the legal framework regulating micro-financial institutions hinder the industry's long-term growth and sustainability.

Functioning of the labour market

Despite some progress, the labour market continues to suffer from very low participation, high unemployment and large gender gaps. Labour Force Survey results continue to be published with large delays. The latest available data refer to the last quarter of 2022. In line with the continued rebound of economic activity, the employment rate increased to 34%, up from 31.7% in the last quarter of 2021. Meanwhile, the unemployment rate declined markedly from 19% to 11.8%, while the labour force participation rate decreased from 39.2% to 38.5% in the same period. The wide gap between male and female employment rates (50.8% and 17.1% respectively) persisted. In the last 3 months of 2022, the share of young people (aged 15-24) not in employment, education or training decreased somewhat to 33.7%, down from 34.8% in the same period a year before. To improve the situation, the government adopted a multiannual youth guarantee implementation plan, and there are ongoing reforms to public employment services. Tax administration data suggest that official employment in the private and public sector increased by 4.9% in 2022. In December 2022, the number of registered job seekers decreased by 1.5% compared to the same period a year before.

Graph 4.4: **Kosovo - Labour market trends (15-64 age group)**



Source: Kosovo Agency of Statistics

Despite some recent formalisation gains, an overall poorly targeted system of social assistance creates disincentives to joining formal employment. In 2022, spending on transfers and subsidies reached nearly 12% of GDP, of which expenditure on poverty-targeting social assistance was less than 0.5%. Category-based social transfers, such as the war veteran pension scheme, undermine the soundness and fairness of the social benefit system. The lack of social and other benefits in formal employment – given the lack of structures to provide them – discourages many informal employers and employees from formalising working arrangements. According to estimates, 40% of the workforce is not declared or is under-declared. Relatively high public-sector wages and remittances increase reservation wages, restricting labour supply, while the lack of jobs fuels the emigration of young people. Increasing private-sector productivity would improve export competitiveness, increase job opportunities and allow for higher wages. The lack of childcare and elderly care facilities hinders female employment.

[17] Despite the expansion of the microfinance sector, the interest rate on loans was around 18%, which is nearly three higher than the rate on bank loans.

4.2. THE CAPACITY TO COPE WITH COMPETITIVE PRESSURE AND MARKET FORCES WITHIN THE UNION

Kosovo is at an **early stage** and has made **limited progress** in terms of its capacity to cope with competitive pressure and market forces in the EU. The education system does not sufficiently teach the necessary key skills and is not adequately aligned with labour market needs. Limited progress was made in improving transport infrastructure. The energy sector remains a major bottleneck for Kosovo's economic development, and the ongoing energy crisis underlined the urgency of ensuring a reliable and clean energy supply and diversifying energy sources. Kosovo made some progress on digitalising the economy. Structural changes are advancing slowly, as the economy remains highly reliant on small and micro firms, which cannot compete internationally. At the same time, the export structure has somewhat diversified, although it is still dominated by base metals. Trade openness increased as both exports and imports grew robustly. The recommendations from 2022 were not fully implemented and remain mostly valid.

In order to improve competitiveness and sustain long-term growth, Kosovo should in particular:

→ improve the quality of education at all levels, and align education, particularly higher education programmes and vocational education and training, with labour market needs by closely cooperating with the business community;

→ strengthen energy security and increase energy efficiency incentives in the residential and private sectors and increase the share of renewables in power generation in a cost-efficient way;

→ advance tailored financial and non-financial support for SMEs to improve their competitiveness and export capacity.

Education and innovation

Little progress has been achieved on reforming the education system and aligning it with labour market needs. Public spending on education amounted to 4.1% of GDP in 2021 (down from 4.6% in 2020 and 4.3% in 2019), which is broadly in line with the EU average. However, in terms of outcomes, Kosovo performs worse. The enrolment rate of children in early childhood education stands at 6.7%, the lowest in the region, while for primary and secondary education the combined enrolment rate of 88.1% is very similar to those of regional peers. To address an insufficient participation in early childhood education, the government has approved the draft Law on early childhood education, which is with the Assembly for adoption. The absence of quality learning materials (including a lack of digital resources) in schools and the lack of teachers' initial training and continuous professional development have a negative impact on the quality of education. Learning materials were adapted in the light of the Programme for International Student Assessment (PISA) 2022[18] test, after Kosovo registered its lowest-ever ranking in 2018. Kosovo students' scores were lower than the OECD average in reading by the equivalent of 5 years of schooling, and in mathematics by a little over 4 years. The education system is not geared to developing the necessary key skills and is not adequately aligned with labour market needs. The 2022-2026 education strategy, adopted in October 2022, aims to raise the quality of pre-university education and, in particular, to harmonise education and professional training. It also fully recognises the need to develop a real-time information system and forecasting on labour market needs, as well as a standardised methodology for labour market research. This commitment has yet to be translated into action. In September 2022, the Kosovo Accreditation Agency (KAA) was granted the status of affiliated member of the European Association for Quality Assurance in Higher Education (ENQA). The agency is currently in the process of applying for membership in the ENQA and the European Quality Assurance Register. Kosovo adopted the Law on KAA, which aims to increase the agency's operational independence and transparency of management appointments.

[18] PISA 2022 test results will be published in December 2023.

Kosovo's performance lags behind in research and innovation. This is true for policy governance, the public research system, public-private linkages, innovation in firms and human resources for innovation; overall Kosovo has one of the lowest scores in the Western Balkan region[19]. Budget allocation for research and development, at 0.1% of GDP, is far below the 0.7% of GDP required by law (compared to an average of 2.2% in the EU), in particular for business innovation. There is chronic fragmentation in implementing innovation policy and no overall coordination among line ministries and the SME support agency, KIESA. In 2022, the Kosovo National Science Council managed successfully to develop the National Science Programme as the main strategic document on science and research. Kosovo has successfully completed negotiation with the EU to become a fully associated member of the Horizon Europe programme, although there is a need to improve performance in accessing grants.

Physical capital and quality of infrastructure

Foreign direct investment (FDI) has not led to an increase in domestic productivity. Kosovo has primarily attracted investment in areas with limited scope for productivity spill-overs, such as construction and real estate, which represent 80% of FDI[20]. In 2022, 67% and 7% of all FDI inflows were directed to real estate and financial and insurance activities respectively. Additionally, FDI is limited to a handful of countries, namely states where a sizeable, well-established Kosovo diaspora exists. Export-oriented FDI has been very scarce, and overall figures are relatively low, passing the EUR 300 million figure only once in the past 7 years.

Kosovo made limited progress in improving road and railway infrastructure, delaying the implementation of major projects. The government submitted a loan request to the EBRD and EIB for Route 7 *Peace Highway*. The rehabilitation works for Railway Route 10 continued at a slow pace, with the first segment expected to be completed in the first quarter of 2024. The works on the second segment started at the end of 2022, while the related signalling and telecom works have yet to start. The transport system still faces several challenges in terms of safety, inadequate maintenance, and weak administrative capacity of regulatory institutions.

An unreliable and undiversified energy supply and an extremely fragile energy sector remain major bottlenecks for Kosovo's economic development. The reliability of energy supply is still below the average for Europe and Central Asia. Despite some improvements, Kosovo ranks 90th in the world for ease of getting electricity[21]. The lack of energy security gives rise to significant costs for business and represents one of the biggest obstacles to attracting high-quality foreign direct investment. Energy demand and consumption continue to grow quickly, and have doubled since 2000. Kosovo also suffers from high technical and commercial losses in the distribution and transmission grids due to poor infrastructure (around 20%).

Kosovo's electricity generation relies heavily on coal-fired plants. More than 90% of electricity is produced by two outdated, unreliable and highly polluting lignite power plants, which the government plans to refurbish. Renewable energy sources account for just over 5% of electricity supply. The roll-out of renewables is expected to accelerate through the newly adopted 2022-2031 national energy strategy and the law on renewable energies due to be adopted by the Assembly in Q3-2023. The draft law provides for a competitive bidding process to support renewable energy projects, replacing the previous system of feed-in tariffs. In May 2023, Kosovo launched a pilot auction for 100 MW of solar power. There has been an increase in renewable energy investments, and several projects to develop significant wind and solar energy sources are already planned. (*See also Chapter 15 – Energy*).

The digital transformation of the economy is gradually advancing, but the digitalisation of public services is still at an early stage. 100% of households nationwide now have access to fixed broadband electronic communications infrastructure. Fixed access internet penetration is estimated to be 125% of

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[19] OECD (2021), Competitiveness in Southeast Europe – a policy outlook 2021.
[20] IMF (2023), Republic of Kosovo, Selected Issues Paper.
[21] World Bank (2020b), Doing Business 2020: Comparing Business Regulation in 190 economies.

households, compared to 89% in the EU, and mobile telephony penetration is around 95% of the population. Kosovo has a small but rapidly growing ICT sector, particularly in the export of software development, smart phone application development and web design. More needs to be done to train skilled workers in this sector, where demand for employees outstrips supply. Since 1 July 2021, Kosovo has constructively engaged in high-level regional dialogue on digital transformation and the implementation of the Regional Roaming Agreement. Despite some improvements in implementing e-commerce programmes, there seems to be little progress in increasing the adoption of e-commerce practices among SMEs. The Digital Agenda strategy covering the period up to 2030 has been submitted for public consultation. The policy document is expected to provide a comprehensive framework for digital transformation, including 5G technologies and the digital transformation of businesses and public services.

Sectoral and enterprise structure

The services sector continues to dominate the economy in terms of GDP and employment. The sectoral structure of gross value added (GVA) shows a steady increase in the share of wholesale and retail trade to nearly 14% in 2022, up from 12.5% in 2018. This has been followed by slight growth in the share held by agriculture (7.4% in 2022, up from 6.5% in 2018). At the same time, the share of real estate activities in GVA fell by 1.2 pps to 5.9% compared to 2018, followed by shrinking contributions from public administration and education. Despite its slight decline compared to 2018, the services sector continued to dominate economic activity in 2022, providing around 45% of GVA. The contribution of construction remained virtually unchanged at around 8% compared to 5 years before, while employment in the sector fell to 11% in 2022, down from 11.9% in 2018. For the same period, the proportion of employees in the services sector increased slightly from 70% to 73%.

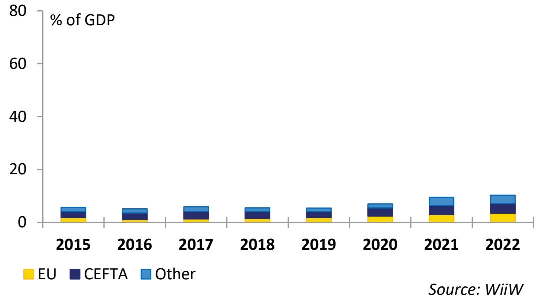
Kosovo's private sector is dominated by very small firms with difficult access to finance. Although SMEs represent over 99% of registered enterprises, almost all of them are micro firms employing 1-9 employees, while the proportion of larger companies (10-249 employees) is less than 1%. SMEs and family-run businesses account for 80.4% (2020) of employment in non-financial businesses (significantly above the EU average of 65.2%) and generate 81% of the country's total value added. Access to finance remains an obstacle to growth due to banks' stringent loan requirements, affecting mostly smaller enterprises. Within almost 7 years, the Kosovo Credit Guarantee Fund (KCGF) portfolio has reached the cumulative value of approved loans of around EUR 550 million, while the value guaranteed by the Fund has reached EUR 290 million, distributed in almost 13,000 loans.

Economic integration with the EU and price competitiveness

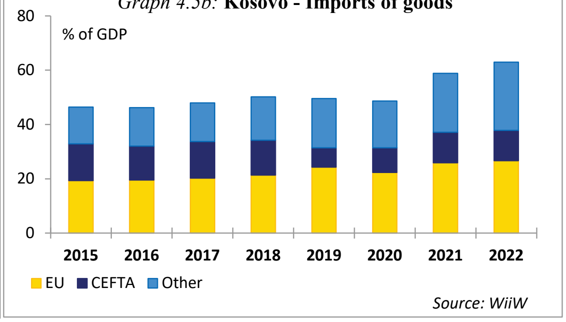
Over the last 5 years the EU remained Kosovo's largest trading partner, while the share of CEFTA countries declined. In 2022, the EU accounted for 42.4% of Kosovo's total imports of goods, marginally lower than in 2018, while the CEFTA partners' share fell by around 8 pps to 17.7%. On the other hand, the proportion of goods imported from Türkiye increased to nearly 15%, up 5 pps on 2018. The EU's share in Kosovo's merchandise exports increased to 33.9% in 2022, up from 27.5% in 2018, while the proportion of CEFTA countries decreased to 36.2% from 47.2%. Among CEFTA partners, North Macedonia and Albania are the main destinations for Kosovo's exports of goods. The share of base metals[22] in goods exports fell to 23.1% in 2022, down from 34.1% in 2018, but they still account for the largest part of merchandise exports. The proportion of various manufactured articles increased significantly to around 20% in 2022, up from 4% in 2018.

[22] This is partly because Ferronikeli (Kosovo's largest exporter) halted production in the last quarter of 2021 on the back of higher energy prices.

Graph 4.5a: **Kosovo - Exports of goods**



Graph 4.5b: **Kosovo - Imports of goods**



Trade openness improved significantly in 2022, in line with the robust performance of trade in goods and services. Overall, trade openness (i.e. the total value of exports and imports) increased to 109.2% of GDP in 2022, up from 98.6% in 2021 and 86.3% in 2018. The improvement took place for both merchandise and services trade. The increase in goods exports (21.8%) in 2022 was mainly driven by mineral products as well as plastic, rubber and their manufactured articles. Services exports continued to grow robustly, by 31.3% in nominal terms, mainly driven by diaspora tourism from Western Europe. In addition to travel services, which currently account for the largest share of service exports (74.4%), there were positive developments in exports of telecommunications and computer and information services. Imports of goods rose quickly (20.4%) mainly due to higher energy imports.

The EU Member States remain the main investors in Kosovo. Net FDI inflows surged by 88% in 2022, mainly on the back of significant diaspora investment in real estate, followed by financial and insurance activities. Heavy concentration in these sectors (around 75% of FDI inflows) contributes little to improving export capacity. The EU's share in Kosovo's net FDI stock reached 40.5% in 2022, up from 32.1% in 2018. The shares of Germany and Switzerland (two countries with large diasporas from Kosovo), increased to 17.5% and 16.4% respectively in 2022, up from 11.8% and 11.4% in 2018.

5. MOLDOVA

5.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Moldova is in **between an early stage and some level of preparation** in establishing a functioning market economy. Despite the difficult economic and social environment caused by Russia's full-scale invasion of neighbouring Ukraine, the authorities have remained committed to pursuing macroeconomic stability and economic reforms. During the past ten years, Moldova has been able to sustain economic growth of about 3.1% per year on average despite the pandemic and other economic headwinds. Public finances have been stable with a low deficit (at about 1.5% of GDP on average over 2014-2019) and a comparatively low debt level. The National Bank of Moldova has been generally successful in keeping inflation within the target range set at 5% (+/− 1.5 percentage points).

After a strong rebound from the COVID-19-crisis, growth contracted sharply in 2022 due to the fall-out from Russia's war against Ukraine, the energy crisis and a severe drought that caused output in agriculture and related industries to plummet. High inflation, caused by soaring energy and food prices, depressed households' disposable incomes and consumption, while war-related uncertainty contributed to weaker investment. On the external side, the already high current account deficit widened further, also reflecting the weak export base and low productivity. As a result of the deep recession and the increase in social spending to alleviate the energy price shock, the budget deficit widened in 2022 and is set to widen further in 2023. Public debt remains low and is largely extended on concessional terms.

Despite significant progress, Moldova's business environment is characterised by widespread corruption, a weak rule of law, weak institutional capacity and low quality public services. These factors hamper entrepreneurship and give rise to a large informal economy. The state still has considerable influence in key sectors of the economy, including telecommunications, energy and transport as well as in price setting. The authorities are carrying out a screening of state-owned enterprises, some of which are loss-making, in order to restructure and/ or privatise them. At the same time, they are working to improve corporate governance and accountability in the sector. Despite the recession, the financial sector remains stable, reflecting the impact of previous reforms and prompt regulatory action to curb the rapid increase in household lending. The labour market recovered from the pandemic and was relatively robust in 2022, despite rising unemployment towards the end of the year. However, it continues to be characterised by a very low participation rate, which is linked to the high share of people working or only willing to work abroad.

In order to improve the functioning of the market economy, and taking into account the difficult external environment, Moldova should in particular:

→ further improve the management of public finances, and in particular the planning and execution of public investment;

→ continue improving the business environment, reduce state interference in price setting and maintain a rapid pace of reforms to restructure and/ or privatise state-owned enterprises;

→ address the main weaknesses of the labour market, in particular by increasing incentives for labour force participation, and take measures to tackle informal employment.

Economic governance

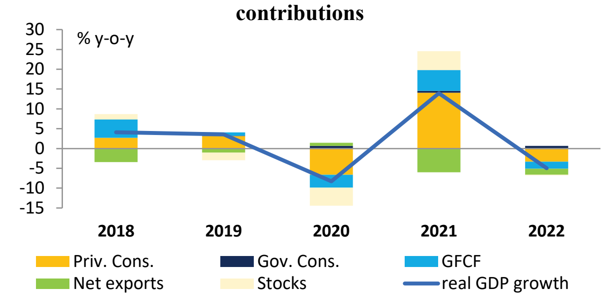
The authorities remain committed to pursuing macroeconomic stability and economic reforms despite the difficult external environment. The government continued to introduce reforms to cushion the impact of the energy crisis and supported those fleeing Russia's war of aggression against Ukraine. Structural reform measures focused, in particular, on ensuring energy security, further fighting corruption and increasing the transparency of the justice sector as well as reforms of state-owned enterprises (SOEs). The authorities also adopted a new public finance management strategy, aiming to improve revenue mobilisation and expenditure allocation as well as making budgeting more transparent. Therefore, progress on reforms continues, although weaknesses remain, for example in budget planning and execution, especially capital expenditure.

Moldova continued to progress in implementing macro-financial assistance from the EU, with disbursements in 2022 and 2023. There was also progress on the IMF Extended Fund Facility/Extended Credit Facility, adopted in December 2021 and augmented in May 2022. In April 2023, the IMF concluded its third programme review, assessing overall policy implementation as positive, ensuring a new disbursement. Among others, the programme aims to improve the transparency of and governance framework for anti-corruption institutions, strength the independence of the central bank, improve the fiscal governance framework and implement further SOE reforms. The IMF concluded that although the risks to the programme are high, the authorities' ownership of the programme and commitment to reforms remain strong.

Macroeconomic stability

Russia's war of aggression against Ukraine further aggravated Moldova's vulnerable energy situation and, together with yet another drought depressing the agricultural sector's output, brought a sizeable economic shock and cost-of-living crisis. Following a strong rebound in 2021 of 13.9%, real GDP contracted sharply by 5.0% in 2022. The 2022 recession was driven by a steep fall in household consumption and investment, down by 6.3% and 6.8% respectively. High inflation (averaging 28.7% in 2022), driven by high energy and food prices, eroded households' disposable incomes, while war-related uncertainty contributed to weaker investment. Weak agricultural performance due to the drought and the decline in construction and manufacturing activity (partly due to war-related supply chain disruptions) further contributed to Moldova's depressed economic performance. Net exports also negatively contributed to growth despite the better-than-expected export performance in 2022, which largely reflected re-exports to and from Ukraine due to the reallocation of regional trade routes. After remaining broadly unchanged for about a decade, the income gap with the EU has slightly narrowed in recent years as per capita GDP in purchasing power standards rose to 31.7% of the EU average in 2021, up from 29.2% in 2020 and 25% in 2013.

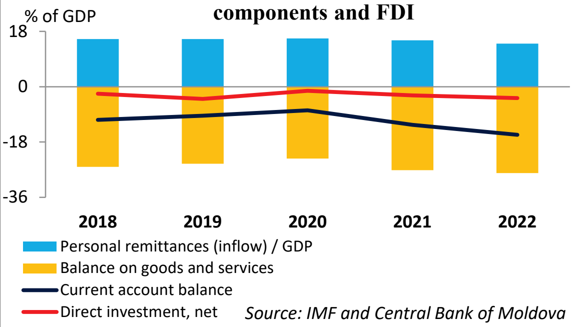
Graph 5.1: **Moldova - Real GDP growth and contributions**



Source: Vienna Institute for International Economic Studies, own calculations

The current account deficit further widened in 2022 to 15.7% of GDP compared with 12.4% of GDP in 2021 due to the high trade deficit. Moldova's current account deficit was already large between 2017-2021, averaging 8.9% of GDP. Its recent widening largely reflects Moldova's protracted energy crisis and weak export base. A considerable share of Moldova's imports (about 17%) are mineral products, including oil and gas, and the country's exports are heavily reliant on agricultural products as well as low value-added manufacturing, such as textiles and food. Moldova's high trade deficit at 29.5% of GDP on average between 2018-2022 is partly balanced by high and stable remittances

Graph 5.2: **Moldova - Current account selected components and FDI**



Source: IMF and Central Bank of Moldova of about 15% of GDP as well as financial transfers. Its recent deterioration was fuelled by high energy import prices and weaker exports in the second half of 2022, also on the back of the poor agricultural output. In 2022, net foreign direct investment flows recovered strongly at 3.7% of GDP, jumping back to their pre-pandemic levels (which averaged 2.8% between 2018-2022). In 2022, Moldova's external debt increased to 67.7% of GDP from 64.2% in 2021, largely on account of the higher financing needs caused by Russia's war against Ukraine and the energy crisis. At the same time, external debt metrics point towards a low level of distress. Moldova's debt is largely extended by international donors on concessional terms. The country's foreign currency reserves experienced significant volatility in the first half of the year, prompting central bank interventions to support the local currency. By year end, the reserves were back to a stable and high level of USD 4.5 billion, equivalent to 5 months of imports of goods and services.

Table 5.1: **Moldova - Key economic figures**	**2014-19** average	**2020**	**2021**	**2022**
GDP per capita (% of EU-27 in PPS)	27	29	32	n.a.
Real GDP growth	3.6	-7.4	13.9	-5.0
Economic activity rate of the population aged 15 and above (%)	44.2	40.3	41.1	41.8
female	*40.6*	*36.1*	*36.4*	*37.8*
male	*48.2*	*45.1*	*46.5*	*46.3*
Unemployment rate of the population aged 15-74 (%), total	4.6	3.8	3.2	3.1
female	*3.2*	*3.2*	*2.5*	*2.6*
male	*4.9*	*4.3*	*3.8*	*3.5*
Employment of the population aged 20-64 (annual growth %)	-3.9	-4.4	1.1	2.2
Nominal wages (annual growth %)	12.0	9.8	13.1	n.a.
Consumer price index (annual growth %)	5.9	3.8	5.1	28.7
Exchange rate against EUR	20.3	19.7	20.9	19.8
Current account balance (% of GDP)	-6.9	-7.7	-12.4	-15.7
Net foreign direct investment, FDI (% of GDP)	2.4	1.3	2.8	3.7
General government balance (% of GDP)	-1.5	-5.1	-1.9	-5.2
General government debt (% of GDP)	32.9	35.2	32.2	35.7

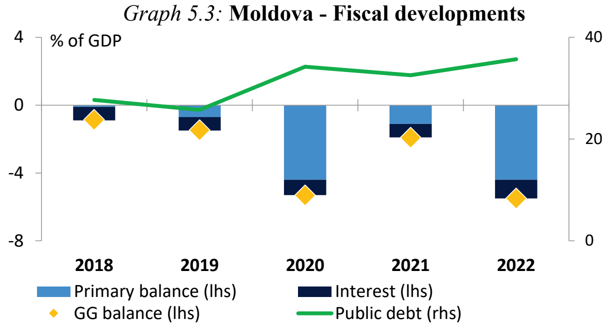
Consumer price inflation surged in 2022, peaking at 34.6% in October. This was followed by a gradual deceleration to 30.2% by year end, remaining well above the central bank's target range of 5% +/− 1.5 percentage points. The surge followed a relatively stable inflation of 4.7% on average between 2017-2021. The large increase in prices in 2022 (by 28.7% overall) was driven chiefly by the rise in energy import prices, including gas and electricity as well as food prices. The central bank tightened the monetary policy stance by a cumulative 13 percentage points between January and August 2022, bringing the benchmark interest rate to 21.5%. In December 2022, when inflation began to decelerate, falling below 10% in August 2023, the central bank started easing its monetary stance, bringing the key rate gradually down to 6% as of September 2023. Following the Moldovan leu's depreciation against the US dollar by about 7% (and a more limited depreciation against the euro by 0.8%) in the first half of 2022, the currency recovered, helped by restored confidence and considerable external support.

As result of Russia's war of aggression against Ukraine and increased social spending to alleviate the energy shock, the budget deficit widened to 5.5% of GDP in 2022 (including the recapitalisation of Energocom) up from 1.9% of GDP in 2021. Except for 2020 when the pandemic started, Moldova maintained relatively low deficit levels (below 2% of GDP) between 2016-2019. In 2022, revenues were robust on account of inflationary effects. They grew by 16%, driven by higher VAT outturns, corporate income tax and, to a lesser extent excise duties. Expenditure rose by 28% driven largely by current spending on targeted transfers to households, partial wage indexation and outlays for securing gas supplies. The government successfully introduced and implemented the Energy Vulnerability Reduction

Fund, which provided targeted compensation to the most vulnerable households, and recapitalised the state-owned energy company, Energocom (amounting to about 2.2% of GDP) to secure gas reserves. Nonetheless, Moldova continues to struggle with significant budget under-execution, especially on capital investment projects. Ongoing reforms to improve capital investment planning should help improve budget execution. In 2023, the deficit is projected to remain high at 6% of GDP, according to the State Budget Law. It will be further driven by higher outlays for social assistance programmes as well as partial salary and pension indexation. In 2022, Moldova's public debt-to-GDP ratio increased to a still relatively low 35.7% of GDP (having averaged 32.3% of GDP between 2018-2021). This increase was due to the large budget deficit and the marked weakening of the local currency in the first half of the year. Most of the country's debt has been extended by international creditors on concessional terms.

The macroeconomic policy mix has remained appropriate and sustained macroeconomic stability and the resilience of economic activity despite the multiple domestic and external shocks. Supportive fiscal policy and an appropriate monetary policy stance helped mitigate the impact of high energy prices, while gradually curbing inflation. The authorities have also made effective use of contingency planning, especially to ensure adequate resources to strengthen the long-term security of the energy supply. Nonetheless, Moldova's economy grapples with the medium-term challenges of low productivity and competitiveness, as well as external imbalances linked to the high current account deficit.

Graph 5.3: **Moldova - Fiscal developments**



Source: National sources, IMF

Functioning of product markets

Business environment

Moldova continued to make progress in improving its business environment despite the fallout from Russia's war against Ukraine and a strong decline in economic activity. Moldova's business environment and capacity to attract foreign direct investment are negatively affected by corruption, an inefficient judiciary and low-quality public services. In 2022, the authorities started implementing an ambitious agenda to strengthen the rule of law and combat corruption which remain key obstacles to investment and productivity growth. In November 2022, the government set up a working group to reduce the regulatory burden on businesses. The body proposed a legislative package to amend the Labour Code, reduce red tape and simplify inspections. The legal framework for e-commerce and digitalisation of government services was upgraded, which should strengthen institutional capacity, the quality of public services and productivity.

Moldovan firms are smaller, less productive and have fewer exporters than in the EU. In addition to the strong presence of SOEs limiting domestic competition, the private sector has been negatively affected by the dual shock of the COVID-19 pandemic and Russia's war against Ukraine. In response, the government launched the Fund for Entrepreneurship and Economic Growth of Moldova, which offers low-interest loans to small and medium-sized enterprises (SMEs). The government also initiated a series of other programmes supporting SMEs' digital transformation, energy efficiency and technological improvements. Moldova has liberalised foreign trade policy in recent years, but gaps remain in customs procedures, logistics services and infrastructure. In 2022, Moldova approved a new Customs Code and made progress on harmonising sanitary and phytosanitary standards with the EU, which should facilitate export activity. At the same time, only a little progress was made on upgrading the transport and logistics infrastructure which hinders export-oriented businesses.

The share of the informal sector in Moldova's economy remains substantial partly as a result of a heavy regulatory burden, weak law enforcement and a general lack of trust in government institutions.[23] the corresponding tax evasion also negatively impacts budget revenues while distorting competition to the detriment of regular firms. Formal market entrance and entrepreneurship are further hampered by a shortage of skilled labour and a high reservation wage for Moldovans searching for work abroad, either permanently or on short-term contracts.

State influence on product markets

State influence remains significant in key sectors of the economy, including in telecommunications, energy and transport, primarily through about 900 state-owned enterprises (SOEs). Moldova's restrictive product market regulation also hampers competition. Overall, SOEs own assets worth about 26% of GDP and employ around 6% of the active labour force. They suffer from a lack of adequate corporate governance practices, inefficiency and poor oversight. This further undermines private sector investment and the economy's competitiveness and poses fiscal risks. The SOE sector still requires State-aid support, as around 40% of SOEs recorded losses in 2021, 5 percentage points more than in 2019. Moldova's product market regulation lags behind most EU countries, hampering competition. The country has some of the most restrictive product market regulations and barriers to entry in services and network industries (for example, electricity and gas, telecommunications, transport and regulated professions). Price controls in a broad number of sectors, including network industries, food, fuels and pharmaceuticals, are also more widespread in Moldova than in EU countries. This hampers competition, innovation and productivity gains.

Privatisation and restructuring

In December 2022, Moldova approved a strategy for 2023-2030 on the administration of state property to reduce the number of SOEs, improve their financial performance and increase market competition. As a next step, the authorities have started a selection process by categorising SOEs at the central government level according to which companies either remain in state ownership or will be liquidated, restructured or privatised. A privatisation strategy for small and large companies is under preparation, including identifying the optimal conditions for launching privatisation efforts. In parallel, the authorities submitted regulations to Parliament to improve selection procedures for supervisory board members, SOE audits and SOE corporate governance codes. The Ministry of Finance is also improving the methodology for SOE fiscal risk reporting. Privatisation was suspended in 2022 due to the fall-out from Russia's war against Ukraine and the adoption of the SOE strategy; however, several SOEs were reorganised or liquidated. The concession agreement for Chisinau International Airport to a private entity was terminated due to alleged breaches of contractual obligations.

Functioning of the financial market

Financial stability

The financial sector remained broadly stable despite significant challenges posed by the pandemic, economic recession and Russia's war of aggression against Ukraine. The stability is also due to the comprehensive corrective measures taken after the 2014 banking crisis. Banks are well-capitalised and have preserved adequate liquidity buffers. The average capital adequacy ratio stood at 29.5% at the end of 2022, about 350 basis points higher than a year before (vs. the 10% regulatory minimum). The liquidity coverage ratio was around 280%, well above the prescribed 100% limit. The Russian war against Ukraine led to liquidity pressures in the financial system and bank deposit withdrawals in both foreign currency and the Moldovan leu accelerated to close to 8% year-on-year by the end of March 2022. As confidence was restored, the total amount of deposits recovered to about 5% above the pre-war level at the end of 2022. Economic headwinds and slowing lending activity triggered a modest increase in the non-

[23] According to World Economics (2022), which uses an average of the latest estimates from economists around the world, the informal economy represents about 40% of GDP in Moldova, versus an EU average of 16.9 %. Such estimations need to be taken with caution given the variety of methodological approaches.

performing loans (NPLs) ratio to 6.4% at the end of 2022. Banks have benefited from a relatively high coverage with prudential loan loss provisions. In 2022, the return on equity and return on assets were 15.7% and 2.8%, respectively. Although this shows favourable profitability, it is expected to weaken due to elevated credit risk and falling remuneration on reserves in the 2023 monetary policy easing cycle.

Prompt regulatory action by the Moldovan authorities helped preserve financial stability. In response to a rapid increase in household lending, in May 2022 the National Bank of Moldova (NBM) introduced responsible lending requirements, loan-to-value and debt service-to-income limits for banks, and the National Commission for Financial Markets (NCFM) issued similar regulations for non-bank lenders. The NBM also set an additional systemic risk buffer of 2% for banks' exposure to the household sector. Since 2019, the NBM has carried out the Supervisory Review and Evaluation Process to check the soundness of banks on an annual basis. In March 2023, a draft law to increase and further align deposit guarantees with EU levels was submitted to Parliament. Moreover, the authorities are strengthening the supervisory framework for insurers, savings banks and non-bank lenders by transferring regulatory and supervisory powers to the NBM. This requires more staff and better technical capacity.

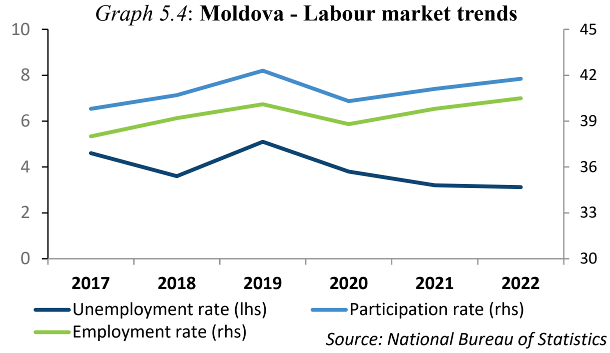
Access to finance

Financial intermediation in Moldova remains underdeveloped and access to finance was further constrained by the COVID-19 pandemic and then the fallout from Russia's war against Ukraine. Banking sector assets declined from about 52% of GDP in 2020 to a modest level of around 48% of GDP at the end of 2022 (vs an average of about 280% of GDP in the EU in 2021). Credit to the private sector represented a relatively low share of 21% of GDP as of December 2022. This decelerated significantly throughout the year following NBM and NCFM measures to tighten lending standards for households, the fallout of Russia's war of aggression against Ukraine and a drop in output, which all affected corporate lending. The government's stimulus for lending to SMEs and micro-enterprises could alleviate credit constraints, while the easing of monetary policy and an improved economic outlook for 2023 may contribute to a more favourable environment. According to the World Bank, more than 80% of firms report financing their working capital from their own financial sources. The need to improve access to finance for the corporate sector, while preserving financial stability, is also underlined by the relatively modest role played by capital markets in Moldova.

Functioning of the labour market

Despite economic headwinds, the labour market recovered from the pandemic, although significant structural challenges persist. The number of employed people increased by 1.8% in the fourth quarter of 2022 from a year before. The country saw job creation in industry, services and construction, whereas employment in agriculture declined. The structurally low employment rate (among the population aged 15 years and over) rose slightly to 40.5% in 2022 from 39.8% in 2021. However, it remains well below the EU average of 54.1% in 2022. This primarily reflects the low participation in the labour force of people working or only willing to work abroad. Informal employment in agriculture, construction and trade is estimated to be more than 22% of the total. At the same time, the creation of well-paid jobs is hampered by insufficient private and foreign investment. This investment in turn is held back by, among other factors, companies' limited access to skilled labour and persistent net emigration. Some rigidity in labour market regulations, in particular regarding the ease of hiring and firing practices, still hamper a smooth allocation of the workforce. Moldova's unemployment rate has been persistently low, which partly reflects the low participation in the labour force and the substantial share of self-employed workers. Due to the economic decline and the increase in the size of the labour force in 2022 (including people fleeing Russia's war of

Graph 5.4: **Moldova - Labour market trends**



Source: National Bureau of Statistics

aggression against Ukraine), the unemployment rate rose to 4.6% in the fourth quarter of 2022, up from 2.6% a year before. Depressed by high inflation, real wages contracted by over 10% year-on-year in the last quarter of 2022. However, the government has taken measures to mitigate the erosion of purchasing power of civil servants and pensioners through a partial indexation.

Moldova needs to accelerate structural reforms to increase formal job creation and the availability of skilled labour. Further reforms are needed to reduce gaps in the education system and the large share of young people who are not in education, employment or training (NEETs). This would help break the vicious circle of the shortage of skilled labour and high reservation wages (driven by very large inflows of remittances and labour emigration) and the relatively low investment in higher added-value sectors. The government adopted a national employment programme for 2022-2026. In addition, it took measures to reduce the high level of undeclared work in the labour market by strengthening checks and incentives to bring jobs into the formal economy. In 2022, the National Employment Agency provided labour market information and counselling services to more than 90% of people registered with the agency, 38% were offered job matching services and close to 24% were placed in a job. Yet, employment services and labour market programmes lack adequate funding, and progress to reduce the mismatch between skills and job requirements is slow.

5.2. THE CAPACITY TO COPE WITH COMPETITIVE PRESSURE AND MARKET FORCES WITHIN THE UNION

Moldova is in **between an early stage and some level of preparation** in terms of its capacity to cope with competitive pressure and market forces in the EU. Despite large investments in education, outcomes remain well below those in the EU. This contributes to the persistent mismatch between the skill level of the workforce and what employers require, which is one of the key business environment obstacles for firms. Investment in research and development remains low and has been falling despite the government's strategy to increase it. Moldova's physical infrastructure remains underdeveloped in part due to the lack of government investment. The stock of foreign direct investment is also low, reflecting weaknesses in the business environment and continuing problems with corruption and the protection of property rights. Digitalisation is lagging behind: just over two thirds of housholds are connected to the internet and about 40% of government services for businesses are available online. The Moldovan economy remains heavily reliant on the agricultural sector, and there is a large productivity gap compared with the EU. Moldova is a relatively open economy and is closely integrated with that of the EU. Economic links between the two have strengthened since the entry into force of the Deep and Comprehensive Free Trade Area in 2016, and the EU is the country's largest trading partner and source of foreign investment.

In order to improve its competitiveness and support long-term growth, Moldova should, in particular:

→ take steps to improve the quality of education and training to ensure outcomes align with labour market needs, including ICT skills and digital literacy;

→ increase investment in infrastructure, especially to improve energy security and facilitate international trade and digitalisation;

→ implement measures to attract foreign direct investment, including addressing issues related to corruption and the rule of law as well as investment incentives and promotion.

Education and innovation

Moldova consistently invests a substantial amount in education, at levels equal to or higher than in many EU Member States (5.3% of GDP in 2022 compared with an EU average of 4.8% in 2021). The share of education in public spending, at around 21%, is more than double that of the EU average but has been declining in recent years.

The traditionally high level of spending has not led to corresponding educational outcomes, which continue to reflect the country's relatively low level of economic development and point to inefficiencies. Although Moldova's PISA reading scores have improved over time, the country scores below the OECD average, ranking 51st out of 77 countries, and almost all EU Member States in the most recent edition. Moldova had relatively low net enrolment rates, at 90.6% for primary education and 86.9% for secondary education in 2018. Tertiary enrolment levels were relatively low compared with other European countries (with a gross enrolment rate of 62.9%) although they have increased by nearly 10 percentage points since 2015. In 2022, 18% of the working-age population had an advanced (tertiary) level of education, compared with about 30% in the EU.

These outcomes are reflected in a mismatch between the level of skills of the labour force and those required by employers. A poorly educated workforce was cited as the biggest obstacle for businesses in Moldova in the last Enterprise Survey in 2019, with one-third of firms citing this as a major constraint, a much higher proportion than other comparable countries in Europe and Central Asia. These outcomes exacerbate existing challenges related to demographic change, namely an ageing and declining population.

Investment in research and development remains low, amounting to 0.2% of GDP in 2022 compared with an EU average of 2.3%. The country has a 4-year strategy for boosting research and innovation, which runs until the end of 2023, though over the first three years of the strategy the relative size of expenditure on R&D declined, amounting in 2022 to 0.86% of public spending. The lack of technical advisory services in fostering innovation in the agricultural sector is of particular concern.

Physical capital and quality of infrastructure

Investment (gross fixed capital formation) has accounted for an increasing share of GDP in Moldova, but the level of public investment has not been enough to maintain the public capital stock. Overall investment rose from 23% of GDP in 2017 to 27% in 2020 before declining sharply to 22% in 2021. Public investment has failed to keep up with the country's needs due to frequent budget revisions and under-execution, leading the public capital stock to fall from 75% of GDP in 2000 to 58% in 2018. Foreign direct investment has fluctuated around a relatively modest level in recent years, amounting to about 3.7% of GDP in 2022, but the total stock of FDI remains low at about 25% of GDP reflecting weaknesses in the business environment and persistent problems with corruption and property rights. Moldova's physical infrastructure, including roads and rail, is still underdeveloped with the country ranking jointly 132nd in the World Bank's 2023 Logistics Performance Indicator, an index that captures the quality of trade-related infrastructure. Moldova faces climate-related vulnerabilities which new infrastructure investment would need to account for.

Moldova has relied almost exclusively on imports from Russia for its supply of natural gas. However, it has accelerated energy sector reforms and investments to ensure security of supply and energy diversification, and its electricity grid is now synchronised with that of the EU. This underlying continued dependence gives rise to significant vulnerabilities. In May 2023, Moldova signed an agreement allowing the country to apply for EU funding under the Connecting Europe Facility to improve transport, energy and digital links with its European neighbours. As of December 2022, Moldova started importing natural gas from Romania and plans to further expand the interconnection of natural gas and electricity networks.

Moldova is also lagging behind in digitalisation. While nearly the entire population is covered by at least a 4G mobile network, just 67.5% of Moldovan households have internet access at home compared with 92.5% of households in the EU. Among urban households, 80% have access to internet at home, against only 58% of rural households. In 2021, there were about 88 active mobile-broadband subscriptions per 100 inhabitants. According to the authorities' own estimates, in 2022 only about 21% of the population had used at least one online public service in the previous 12 months compared with 58.5% in the EU, though this represented an increase of nearly one third compared to the year before.

Sectoral and enterprise structure

The Moldovan economy remains heavily reliant on a low-productivity agricultural sector compared with the EU, with agriculture accounting for 12.1% of GDP in 2021 compared with 1.6% in the EU. While this share has been declining in recent years, agriculture still accounts for one fifth of employment. This indicates continued low productivity in this sector: half of output is produced by small farmers (fewer than 10 hectares) most of whom are strongly subsistence-oriented. The effects of Russia's war of aggression against Ukraine such as higher prices for energy and agricultural inputs like fertiliser further threaten the competitiveness of Moldovan agriculture, as does Moldova's vulnerability to climate change and droughts. The share of services in the economy has slowly gained ground over the last 5 years, reaching 63.9% of GDP in 2021, while that of industry has correspondingly declined to 14.2%. Industry is dominated by the production of relatively unsophisticated goods, namely food and beverages followed by textiles and clothing. The share of services (56.4%) and industry (14.4%) in employment has remained largely steady since sharp increases caused by statistical adjustments that took effect in 2019.

Most businesses in Moldova (about 95%) are SMEs. While SMEs account for just under 50% of output, they employ just under 60% of workers, a share which has been gradually declining over the last 5 years. In the latest Enterprise Survey in 2019, access to finance was cited as a major constraint by about 29.4% of businesses. Other indicators from the same survey show that the proportion of surveyed businesses in Moldova in need of loans is much higher compared with the average in EU. The reported loan rejection rates and value of collateral as a percentage of the loan amount are also much higher than in the EU.

The government recently expanded the definition of a 'small and medium-sized enterprise' so that more businesses to qualify for support programmes including those managed by the Organisation for the Development of Entrepreneurship, a government agency. The Digital Transformation Programme, approved in 2022, sets out measures to support SMEs to invest in digitalising their operations.

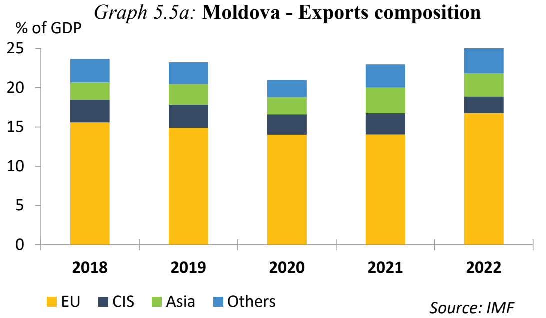
Economic integration with the EU and price competitiveness

Moldova is a relatively open economy, closely integrated with that of the EU. Economic links between the two have strengthened since the entry into force of the Deep and Comprehensive Free Trade Area in 2016. The country's trade-to-GDP ratio was 78% in 2022, an increase of 12 percentage points over the previous five years. The stronger export performance in 2022 partly reflects re-exports to and from Ukraine as a result of reallocated trade routes. The EU is Moldova's largest trading partner, accounting for about 58.8% of the country's exports and 43.9% of its imports, which is above its regional peers. The EU's share of imports has remained steady over the last 5 years, though its share of Moldova's exports has declined from 69% in 2018 primarily as a result of the surge in exports to Ukraine in 2022 following Russia's war of aggression in February that year. Trade with other countries in the Central European Free Trade Agreement (CEFTA), of which Moldova has been a member since 2007, has remained steady at about 1% of total trade. The country has been a member of the World Trade Organization since 2001.

In 2021, the EU accounted for 36% of foreign direct investment inflows into Moldova. The EU accounts for 86.7% of the stock of foreign direct investment in Moldova.

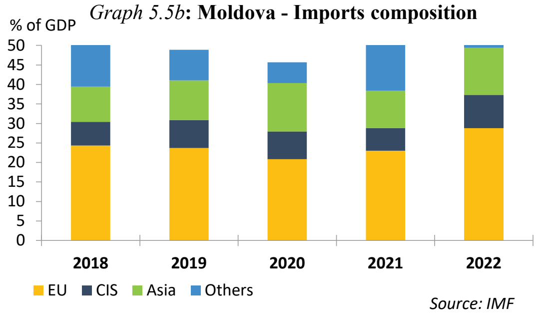
In terms of competitiveness, while unit labour costs remain below those of its neighbours and EU Member States, low and stagnant relative productivity, rising nominal wages and currency appreciation have partly eroded this advantage in recent years.

Graph 5.5a: **Moldova - Exports composition**



Source: IMF

Graph 5.5b: **Moldova - Imports composition**



Source: IMF

6. MONTENEGRO

6.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Montenegro has made **limited progress** and is **moderately prepared** in developing a functioning market economy. Economic expansion continued at a strong pace in 2022, supported by private consumption and strong growth in tourism, partially due to a large influx of Russian and Ukrainian nationals following Russia's war of aggression against Ukraine. The main headwind came from inflationary pressures on the back of higher global commodity prices. The current account deficit increased as both exports and imports expanded rapidly. An expansionary fiscal policy fueled domestic demand and contributed to very high net wage growth. The budget deficit increased significantly and a comprehensive medium-term consolidation plan to address mounting fiscal challenges has not been developed. The labour market situation improved, but structural problems persist, including large regional disparities and gender gaps, and high youth and long-term unemployment. The banking sector remained well capitalised and liquid. Efforts to improve the business environment and the governance of state-owned enterprises (SOEs) slowed down due to political uncertainty, even though the number of new businesses increased.

Last year's recommendations were addressed to a limited extent and remain mostly valid. In the coming year, in order to improve the functioning of the market economy, Montenegro should in particular:

→ design and implement a medium-term fiscal consolidation plan targeting the achievement of a non-negative primary balance from 2025, and a reduction of the public debt ratio in the medium term;

→ implement the Law on budget and fiscal responsibility to set up a fiscal council, while ensuring full transparency in selecting the council members;

→ prepare an analysis of the economic and fiscal impact of current tax exemptions and provide specific budgetary recommendations to reduce tax expenditure such as exemptions, deductions, credits and deferrals;

→ prepare a roadmap for reforming SOEs, prepare a framework for the monitoring and management of SOEs, and develop objective criteria for the selection of management bodies of SOEs;

→ develop and implement specific measures to reduce the informal economy.

Economic governance

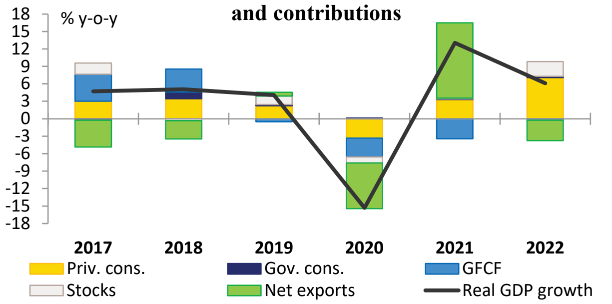
An unstable political situation led to lax fiscal policy and a slowdown in structural reforms. In August 2022, the incumbent government lost a vote of no confidence. The ensuing caretaker government was not in a position to advance priority reforms to address economic challenges. The reforms of SOEs were downscaled. The caretaker government did not adopt a medium-term fiscal consolidation strategy to address vulnerabilities in the light of forthcoming large debt repayments. By reducing taxes on basic consumption goods and fuels, the government tried to contain inflationary pressures and protect the most vulnerable. The caretaker government adopted several revenue strengthening measures in early 2023 and revised the 2023 budget in May. The controversial economic citizenship programme, which supported public revenue but clashed with the country's EU commitments, expired at the end of 2022. However, numerous pending applications were still processed well into 2023.

The policy guidance set out in the conclusions of the Economic and Financial Dialogue of May 2022 was implemented to a limited extent. Progress was made in setting up an independent body for fiscal oversight and strengthening financial stability, but only limited improvement was achieved on structural reforms aiming to address informality and improve the business environment and the labour market situation.

Macroeconomic stability

Economic expansion continued at a strong pace in 2022 despite slowing investment. Overall, real GDP grew by an estimated 6.1% in 2022 and the first quarter of 2023, following a 13% rebound in 2021 from the deep COVID-19-induced recession. The strong economic growth in 2022 was mainly driven by a surge in private consumption, on the back of increases in disposable income, employment, household lending, and remittances. Private consumption was also supported by Ukrainian and Russian nationals taking up temporary residence. While export growth benefited from ongoing recovery in tourism as well as good performance of merchandise exports, a strong surge in imports led to a negative contribution of net exports to growth. Capital investment remained weak and contracted due to a slowdown in private investment. Overall, the rebound of the economy brought Montenegro's per-capita income in purchasing power standards to 50% of the EU-27 average in 2022 (the highest in the Western Balkans), up from 45% in 2020, bringing it back to the level registered in 2019.

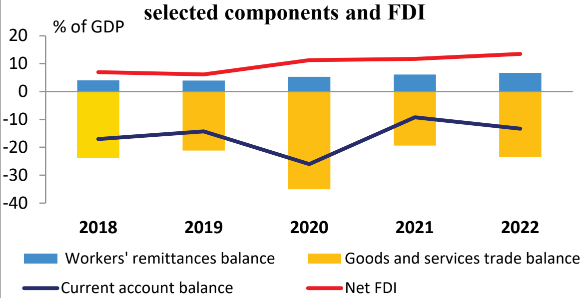
Graph 6.1: **Montenegro - Real GDP growth and contributions**



Source: WiiW

Despite the strong export performance, the current account deficit widened in 2022. Following a record low in 2021, the current account deficit widened again to 13.3% of GDP in 2022, as high growth of exports of goods and services was outweighed by rapidly rising imports due to price effects. Supported by good performance of aluminium and electricity, merchandise exports increased by 60% compared with 2021, while a successful tourism season led to a strong increase in exports of services (43%). However, goods imports, which are much larger than exports, also surged (by 41.3%), and the overall trade deficit rose to 23.4% of GDP, compared with 19.4% in 2021. This was partially offset by surpluses in the primary and secondary income accounts, which increased due to higher compensations of employees working abroad and higher remittances. The current account deficit was fully financed by net foreign direct investment (FDI) inflows, which increased by 34.6% year on year and amounted to 13.5% of GDP, with a large share going into real estate. In early 2023, international reserves stood at EUR 1.9 billion, covering 4 months of imports of goods and services. The current account deficit deepened in the first quarter of 2023 to 14% of GDP in annualised terms, compared to 9.3% of GDP gap registered a year before. Net FDI declined slightly to 12.2% of GDP compared to 12.9% over the same period.

Graph 6.2: **Montenegro - Current account selected components and FDI**



Source: IMF and Central Bank of Montenegro

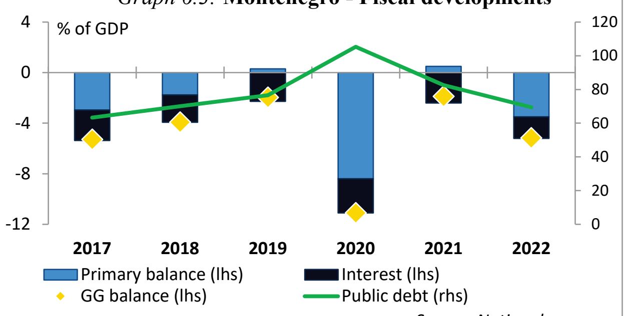
Impacted by price rises following Russia's war of aggression against Ukraine, inflation peaked at a record high level in 2022. Driven by global inflationary pressures, especially on food and fuel, as well as large domestic policy-induced wage increases, average inflation jumped to 13% in 2022. Annual inflation peaked at 17.5% in November 2022 and eased to 6.9% in July 2023. The government adopted numerous and not always well-targeted support measures for households and firms to counterbalance the impact of higher inflation, including reduced value added tax rates for basic foodstuffs and a lower excise duty on sales of unleaded gasoline and gas oils. Based on regular and extraordinary adjustment to inflation, the government decided to raise pensions by 8.5% from June onwards.

Table 6.1: **Montenegro - Key economic figures**	**2014-19** average	**2020**	**2021**	**2022**
GDP per capita (% of EU-27 in PPS)[1)]	46	45	48	50
Real GDP growth	3.7	-15.3	13.0	6.1
Economic activity rate of the population aged 15-64 (%), total	63.7	61.5	59.2	67.7
female	*57.0*	*54.7*	*52.9*	*61.4*
male	*70.4*	*68.3*	*65.5*	*73.9*
Unemployment rate of the population aged 15-64 (%), total	16.9	18.3	16.8	15.0
female	*17.0*	*18.8*	*16.1*	*13.1*
male	*16.8*	*17.8*	*17.3*	*16.6*
Employment of the population aged 15-64 (annual growth %)	2.9	-10.1	-2.4	17.2
Nominal wages (annual growth %)	1.1	1.3	1.4	11.2
Consumer price index (annual growth %)	1.2	-0.8	2.5	11.9
Exchange rate against EUR	1.0	1.0	1.0	1.0
Current account balance (% of GDP)	-14.5	-26.1	-9.2	-13.2
Net foreign direct investment, FDI (% of GDP)	10.2	11.2	11.7	13.5
General government balance (% of GDP)	-4.3	-11.1	-1.9	-5.2
General government debt (% of GDP)	66.2	105.3	82.5	69.5

Notes:
1) Eurostat
Source: national sources

The budget deficit increased substantially in 2022. The general government deficit increased significantly, to 5.2% of GDP, from 1.9% in 2021. Total revenues dropped markedly, by 4.5% of GDP, mainly due to the government's tax reform, which abolished mandatory health contributions and introduced a non-taxable part of wage income. Revenues were also weakened by the temporary reduction of excise taxes on fuel and the reduction of VAT rates on basic foodstuffs and pellets. Public expenditure increased due to ad hoc spending decisions, such as the granting of additional allowances for all children and for mothers of three and more children; large increases in minimum pensions; wage increases in the public sector; and additional financing for the health insurance fund. Nevertheless, the 2022 budget outcome was better than envisaged in the October amendment to the Budget Law, which targeted a deficit of 8.3% of GDP. This was due to a combination of higher-than-projected revenue, mainly from VAT; and lower-than-expected spending, mainly on investment and on wages as there were delays in planned employment. Nominal GDP was also higher than previously projected. At the end of December 2022, the Parliament of Montenegro adopted the 2023 Budget Law with a projected deficit of 5.9% of GDP. In May 2023, however, the 2023 deficit target was revised to 3% (which would be in line with the rule on fiscal responsibility) as a result of higher assumed revenues (due to the EU energy support package, higher-than-expected inflation, and improved tax discipline) and some additional spending items related to early parliamentary elections and employment subsidies for people with a disability.

Graph 6.3: **Montenegro - Fiscal developments**



Source: National sources

The debt ratio recorded a substantial decline, but vulnerabilities remain high in view of large upcoming repayment needs amid tightening financing conditions. The public debt stock declined substantially, to 69.5% of GDP at the end of 2022 after peaking at 105% of GDP at the end of 2020. This large fall was driven by strong GDP growth in 2021-2022 and the use of government deposits to repay maturing debt. As a result, the stock of government deposits declined to 1.9% of GDP at the end of 2022, down from 9.4% in 2021. Large repayments of public debt, amounting to 11% of GDP, are due in 2025 and will require substantial new borrowing. With global financing conditions worsening, debt-related vulnerabilities remain high.

While Montenegro's macroeconomic policy mix is constrained by the lack of an autonomous monetary policy, an expansionary fiscal policy contributed to widening budget and current account deficits and surging inflation. As the unilateral use of the euro means that the Central Bank of Montenegro cannot influence interest rates and money supply, prudent fiscal policy remains a key tool to manage the economic cycle. While global commodity prices had a substantial impact, higher wages and pensions added to rapidly rising inflation. Even though inflation is gradually abating, debt-related vulnerabilities, including large debt repayments in 2024-2027, require careful fiscal management in the years to come. Vulnerabilities in the health sector require a close monitoring.

Functioning of product markets

Business environment

A growing number of registered businesses was supported by the improving economic outlook and the influx of foreign citizens. Although electronic registration is still only available for single-member limited liability companies, but not for larger firms, the number of businesses had increased by 11.8% to 73 358 by the end of 2022. The number of newly registered businesses reached 10 096 in 2022, compared with 5 559 in 2021. Around 80% of new companies were set up by foreign citizens. Following the adoption of a scheme to attract digital nomads in July 2022, the Parliament amended the Law on foreigners, which regulates the stay of digital nomads, as part of the broader efforts to attract foreign teleworkers to Montenegro.

Efforts to improve the regulatory business environment decelerated. The dynamic development of local companies and foreign investors' activities is hindered by weaknesses in the regulatory environment, such as inefficiencies and delays in dealings with the administration, excessive complexity of the legal framework, and the administrative burden of local taxation and parafiscal charges. Further obstacles are related to insufficient transparency in decision-making, arbitrary interpretation and law enforcement by public authorities, and access to finance for SMEs. Systematic involvement of business partners in designing and drafting measures that affect businesses remains the focus of the Competitiveness Council, but in 2022, the level of activity declined due to the political stalemate and uncertainty. The standstill in the decision-making of public administration also played a part in the slowdown in digital transformation reforms, which already suffered from a series of large-scale cyberattacks on the state's IT infrastructure in the second half of 2022. Due to the cyberattacks, the single online portal for SME support, which provides all necessary information and contacts regarding advice and assistance for businesses, has been disabled since August 2022, and its update is ongoing. At the end of 2022, 382 services were available on the eGovernment Portal, of which 73 were electronic, 254 for businesses, 109 for citizens, and the rest for the public administration.

The government is yet to develop specific reform measures to reduce the informal economy, which is a major obstacle to Montenegro's competitiveness. Deficiencies in the institutional and regulatory environment, weaknesses in the labour market, insufficient enforcement capacity of public authorities, corruption and tax non-compliance are conducive to informality, which is especially harmful to legally operating SMEs and microenterprises in the service sector. In July 2022, the Ministry of Finance published the results of a survey on informality, estimating the size of the informal economy at 20.6% of GDP, considering businesses and employees working in the formal sector. However, this estimate increases to 37.5% of GDP when including the fully informal sector. The government has yet to act on the survey's recommendations. The adoption of a comprehensive action plan on informality was postponed again, to the end of 2023.

State influence on product markets

While the most recent tax measures aimed to contain price increases, a broader issue relates to ensuring transparency and efficiency of State aid in Montenegro. The government reduced excise duties on the sale of unleaded fuel and gas oils by 50% in June 2022. When global oil prices stabilised, this reduction was revised, and finally abolished. The decision to reduce the VAT rate on the sale and import of basic foodstuffs (flour, sunflower oil, and salt) expired at the end of 2022, while the decision to reduce the VAT rate on bread (to 0%) and heating pellets (from 21% to 7%) is valid until the end of 2023. In March 2023, the government launched a 'Stop Inflation' programme in cooperation with the country's largest supermarket chains, in an effort to address the problem of surging staple food prices and to lower inflation expectations. The Agency for Protection of Competition (APC) carried out fewer State aid investigations in 2022 than in 2021. In August 2022, the APC issued a third decision ordering further recovery of illegal State aid to the major State aid beneficiary, Montenegro Airlines. The responsible Ministry of Capital Investments is still to adopt a plan and take action to recover the funds. In January 2023, EPCG, a state-owned national electric power company, notified the APC of the purchase of the troubled steel producer Niksic, only after the contract was signed in late 2022. The APC has not yet published any opinion or decision concerning this case.

Privatisation and restructuring

Advancing reforms and privatisation of SOEs and improving their governance and profitability remain a challenge. The caretaker government stepped back from previous plans to formulate the state's ownership strategy and set out a portfolio of key companies that should remain in state possession, and improve SOEs' management practices and financial performance. As there was no political agreement on the direction and scope of such reforms, the government also stepped back from its plans for a holding company to manage and reform SOEs and limited the scope of its 2022 measures to set up a small unit in the Ministry of Finance to monitor fiscal risks related to SOEs. The performance of Montenegro's SOEs, including those at the local level, could be enhanced by transforming SOEs' management structures, eliminating political patronage and improve financial performance to reduce fiscal risks. Privatisation did not make much progress, as the government decided to increase the state capital in some SOEs, with the revised 2022 budget earmarking EUR 25 million for this purpose for the health institute of Simo Milosevic in Herceg Novi, the Meljine hospital, and wine producer Plantaze. The government also increased its ownership in the port of Bar to ensure a two-third majority in the managing board. In December 2022, the government decided to reintegrate the bankrupt (privatised) Meljine hospital into the public health system until the ongoing court proceedings are finalised. The government is yet to decide on the restructuring of wine producer Plantaze's tax debt. In February 2023, the government assigned the operation of the only ferry line crossing the Boka bay to the public company for coastal zone management (Morsko dobro), in an apparent violation of public procurement rules and transparency. At the same time, the government annulled its 2019 decision assigning the management of the ferry line in the Boka bay to a local private company (Maritime transport).

Functioning of the financial market

Financial stability

The banking system remains stable and liquid, but the quality of banks' balance sheets needs close monitoring in a rising interest rate environment. Despite the expiry of pandemic-related support measures, the banking system maintained strong capital and liquidity buffers, both of which exceeded pre-COVID-19 levels. However, risks remain to be closely monitored, in particular in view of recent strong credit growth and rising global interest rates. The capital adequacy ratio stood at 19.3% in late 2022, well above the statutory minimum of 10%. Banks continued to fund themselves mainly through domestic deposits. Non-performing loans made up 5.7% of total loans at the end of 2022, down from 6.2% in 2021. The banking system recorded a significant profit of EUR 83.3 million at the end of 2022, compared with EUR 27.5 million 1 year earlier.

Access to finance

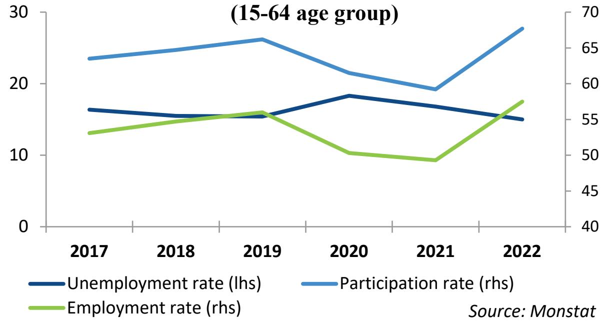
Credit activity continued to grow, supporting the corporate sector in particular. Annual loan growth decelerated slightly to 6.1% in 2022, from 6.6% in 2021, before recovering to over 10% in January-February 2023. The main driver was lending to businesses and households (rising by 9% and 6.7% year on year, respectively) throughout the whole period, while there was a rapid increase in inter-bank lending in early 2023. Loans to the public sector have been declining since the beginning of 2022. The recovery of the economy was reflected in a very fast increase in banks' deposits, whose growth rate accelerated from 12.8% year on year in 2021 to 23.3% in 2022 and continued to expand at over 20% year on year in the first 2 months of 2023. Non-resident deposits accounted for around one fourth of all deposits during this period. Borrowing costs increased with the nominal weighted averaged lending rate reaching 5.3% in early 2023, compared with 4.3% at the end of 2021.

The size of the non-bank financial sector remains very limited. Microfinance is the most commonly used source of alternative finance, with the sector's assets accounting for some 1.3% of GDP in 2022. The role of insurance in the local economy is also limited as their assets declined slightly to 1.8% of GDP in 2022.

Functioning of the labour market

With the economic recovery, labour market indicators also continued to improve and surpassed pre-crisis levels, but structural challenges remain. According to the labour force survey (LFS), the average unemployment rate declined to 15% in 2022, down from 16.8% in 2021. The number of employed rose by 18.2% and the average employment rate stood at 57.5%. Despite these improvements, the 2022 LFS results once again confirmed large regional disparities, with the unemployment rate standing at 5.6% in the tourism-heavy coastal region, at 9.3% in the central region, and at 31.6% in the poorer northern region. The gender gap widened after the pandemic, but the unemployment rate of women (aged 15-64) declined faster (by 2.3 percentage points) than that of men in 2022, while women's activity rate (61.4%) remained significantly below that of men (73.9%). Remaining major structural challenges are youth unemployment, standing at 29.4% for the population aged 15-24, and long-term unemployment, as 75.6% of all unemployed have been looking for a job for more than 12 months. Despite ongoing reform efforts, the public employment service's capacity for job mediation remains weak and lacks a continuous monitoring of active labour market policies, which in turn prevents the design of quality, targeted and effective employment activation measures. The Employment Agency of Montenegro's reform and readiness remain key challenges and are important for not only implementing the Youth Guarantee, but also for ensuring a healthy, well-functioning labour market in the long term. The average gross wage increased by 11% in nominal terms to EUR 883, while the average net wage rose by nearly 34% to EUR 793 in 2022, supported by a large decline in the labour tax wedge.

Graph 6.4: **Montenegro - Labour market trends (15-64 age group)**



Source: Monstat

6.2. THE CAPACITY TO COPE WITH COMPETITIVE PRESSURE AND MARKET FORCES WITHIN THE EU

Montenegro has made **limited progress** and is **moderately prepared** to cope with competitive pressure and market forces in the EU. The education system still faces numerous challenges, as shown by the results of international tests. Although public financing of research and development remains modest, some progress was made in attracting private investors. Efforts to advance a green and digital transition have continued, but large infrastructure gaps persist. The administrative and financial capacity to identify, prioritise and implement major public investments remains limited, hampering the use of EU support. Despite some progress in the metallurgy sector and the good performance of tourism, further efforts are needed to diversify Montenegro's narrow production base. The low value added of domestic products, the small size of local companies, and their low level of participation in exports represent obstacles to increasing the productivity and competitiveness of local firms.

The 2022 recommendations were implemented to a limited extent and remain mostly valid. In the coming year, Montenegro should in particular:

→ continue implementing digital services for micro, small and medium-sized enterprises and prioritise the development and implementation of an interactive e-government platform for transactional electronic services;

→ improve programmes for dual vocational education and training and tertiary education in close cooperation with business associations;

→ improve the institutional and regulatory environment for the green transition and increase energy resilience by adopting the national energy and climate plan and completing the implementation of the national energy action plan;

→ implement the public investment management assessment recommendations, prioritising key public infrastructure works within the available fiscal space while avoiding exceptions regarding project selection.

Education and innovation

The quality of education needs further improvements. A comprehensive 2015-2020 education sector analysis (ESA) was presented in November 2022, focusing on early childhood, primary and secondary education. It underlined a low level of education quality (based on the results of the Programme for International Student Assessment and the Trends in International Mathematics and Science Study) both in the fourth grade of primary school and in the first year of upper-secondary education. An additional concern relates to the distribution of scores, as in both tests, more than 40% of students are below the level of the international benchmark for 'low performance', i.e. not reaching the minimum levels of competency, while only a negligible share of students had high achievements (less than 2%, compared with around 10% on average in OECD countries and 20% or more in the best-performing countries). The ESA underlines the need to provide more appropriate school infrastructure (70% of children attend primary schools with insufficient infrastructure) and improve the curriculum, the qualifications of teachers, the quality of teaching, enrolment rates, and the provision of support to the most vulnerable groups. A mismatch of skills remains a significant challenge, particularly for graduates of vocational education and training or higher education, despite some recent efforts to improve the transition from education and training to the labour market. Although tertiary educational attainment is still lower than the EU average, the labour market cannot absorb the numbers of tertiary graduates in certain areas, such as business and humanities. The OECD's report on labour migration in the Western Balkans found that in Montenegro, 28% of respondents disagree with the claim that skills learned in the education system meet the needs of their job, and 51% of surveyed firms identify applicants' lack of skills as a reason for unfilled vacancies.

Public and private investment in research, development and innovation is low. In the European Innovation Scoreboard for 2023, Montenegro has a summary innovation index of 47% relative to the EU's 100%, which is below the average of the 'emerging innovators' (50.0%). While the country's index has been improving, the performance gap with the EU has widened. The links between academia, research institutes and business are still weak. Only 2.2% of Montenegrin micro, small and medium-sized enterprises invest in research and development, compared with 22% at regional level. Research staff are employed almost exclusively by the government or in the higher education sector. With a rate of 0.36% of GDP invested in research and development, Montenegro's spending was just over one sixth of the EU-28 average (2.18% of GDP) in 2019. In parallel with strengthening its capacity, the Innovation Fund continued to administer a collaborative grants programme and an innovation voucher scheme to encourage cooperation between private-sector and research institutions in developing innovative projects and products. As a result, private sector investment in innovation projects exceeded EUR 1 million in 2022. Innovation and Entrepreneurship Center Tehnopolis Nikšič continued to help start-ups through seven support programmes, and in parallel worked on strengthening cooperation with local universities. A 5-year strategic plan for the newly set up Science and Technology Park Montenegro was developed and a public call for tenants is under preparation.

Physical capital and quality of infrastructure

Productivity-enhancing investment remains low. In 2022, the share of gross fixed capital formation in GDP declined slightly to 21.7%. There was a slowdown in private investment, while public investment increased slightly to 5% of GDP. Net FDI rose to 13.5% of GDP, up from 11.7% in 2021, with more than one third of these inflows going into real estate, driven partly by purchases by Russian citizens.

Little progress was achieved in improving energy infrastructure. While the use of renewable energy sources is high, there is a lack of diversification of renewable sources and insufficient focus on environmental standards in energy infrastructure projects (some 43% of the electricity production in 2020 came from renewable sources, mostly hydropower and biomass). Montenegro needs to address a number of energy-related challenges, including energy efficiency. Montenegro needs to take a strategic decision on how to replace the thermal (lignite) power plant in Plevlja, which currently produces approximately 50% of Montenegro's electricity and is vital for security of supply and the stability of the country's power system but remains the main polluter. Finding an alternative solution for energy production did not progress, as any decisions in this regard are not expected until the government has adopted the national energy and climate plan in 2024. With regard to offshore exploration and production of hydrocarbons, two concession contracts signed in 2016 with Eni and Novatek were terminated in December 2022, following negative results of explorations, while the 2017 contract with Energean expired in July 2022.

Investment in digital infrastructure continued, albeit with some delay. While in the previous years, Montenegro made steady progress with digitalisation, the pace of digital transformation reforms slowed down in 2022, due to protracted political uncertainty, frequent organisational changes and a series of large-scale cyberattacks on the state's IT infrastructure in the second half of 2022, which interrupted the timeline of the digital transformation reforms. These cyberattacks spurred Montenegro's government to focus one of the new reforms on cybersecurity. The telecoms operator auctioned the 5G spectrum and awarded it to three major operators in December 2022. All three operators are obliged to activate 5G in every municipality by the end of 2024 while providing 5G coverage to 50% of population by 2026.

Modernising the transport sector requires broad action. The strategic steer for developing the sector should be revised, in line with the EU development priorities and Transport Community Treaty commitments (on sustainable and smart mobility), and move away from the current emphasis on road transport. Montenegro scores very low on connectivity. Progress on improving and modernising short sections of the road and rail networks is slow and mainly thanks to EU funding. The first section of the Bal-Boljare highway was finished in July 2022. For the completion of the entire Bal-Boljare highway, an outdated feasibility study needs to be updated, in line with the forecast traffic volumes and envisaging a multimodal corridor, encompassing rail, road and the port of Bar. Works on upgrading the Bar-Vrbnica railway, a core network corridor, continued during the reporting period. Further action is needed to open up the rail market to competition and to complete regulatory reforms that have been neglected for years.

The (currently suspended) tender for a concession to maintain and upgrade the country's two main airports in Podgorica and Tivat could help address the country's limited accessibility by air.

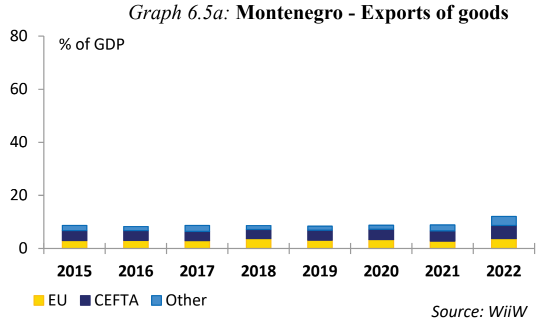
Sectoral and enterprise structure

The structure of the economy remains broadly unchanged, although certain adjustments are taking place within sectors. Micro, small and medium-sized enterprises constitute the backbone of the Montenegrin economy, accounting for 57.8% of total employees in 2022. They continue to be dominated by micro enterprises, accounting for 99% of all firms. Across sectors, the distribution of employment remained broadly stable in 2022, with the services sector absorbing 76.7% of total employment, while industry and construction (19%) as well as agriculture (4.3%) accounted for much lower shares. Employment in the ICT sector surged by 48% year on year in 2022, affected by the immigrant workers from Russia registering businesses in Montenegro, which coincides nevertheless with a severe drop in knowledge-intensive services exports. The share of agriculture in gross value added declined to 6.7% in 2021, compared with an average of 7.6% in the previous 10 years, while the shares of industry and construction were roughly stable at some 10% and 5%, respectively. Over the same period, the share of wholesale and retail trade increased to 14%, up from 12%. The metallurgy sector is undergoing a major transformation after the closure of aluminium smelter KAP and Nikšič steelworks due to unsustainable production costs. In December 2022, Nikšič steelworks was taken over by the state-owned electric power company EPCG, which plans to repurpose the plant for solar panel production.

Economic integration with the EU and price competitiveness

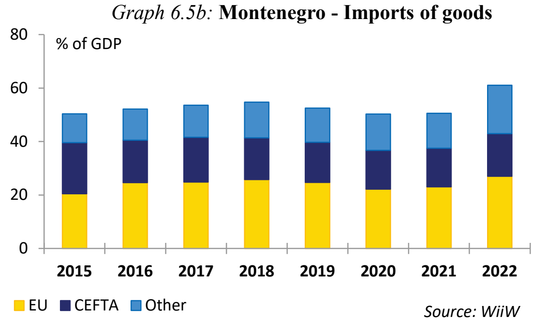
External trade surged to a record high in 2022. Montenegro's foreign trade expanded by 43.9% year on year, while bilateral trade with the EU grew by 33.7%. Overall, trade openness (the total exchange of goods and services as a share of GDP) increased significantly to 128.7% of GDP, largely surpassing pre-pandemic levels. Exports continued to be dominated by services, which at 40.6% of GDP exceeded goods exports (12.1% of GDP) by a very wide margin. The EU remains Montenegro's main trade partner, accounting for 30.3% of total exports and 44.3% of total imports of goods. CEFTA countries also constitute an important market, accounting for 41.7% of Montenegro's total exports and 26.1% of total imports of goods. The EU also remains the main source of FDI inflows for Montenegro, accounting for 33% of total FDI inflows in 2022, compared with 36.4% in 2021. Other countries with a sizeable share in Montenegro's FDI inflows include Russia and the United Arab Emirates, mainly due to active participation of investors in the controversial economic citizenship programme. Montenegro's price competitiveness was damaged by a widening inflation differential with the euro area.

Graph 6.5a: **Montenegro - Exports of goods**



Source: WiiW

Graph 6.5b: **Montenegro - Imports of goods**



Source: WiiW

7. NORTH MACEDONIA

7.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

North Macedonia has made **some progress** and is at a **good level of preparation** in developing a functioning market economy. In 2022, the economy was badly hit by the fallout from Russia's war of aggression against Ukraine, which significantly slowed down its post-COVID recovery. The government supported households and businesses through large-scale energy subsidies, tax reductions and targeted direct income support. Owing to an inflation-driven boost to tax income and under-execution of several expenditure categories, the general government deficit remained below the revised target. Capital expenditure was raised significantly, but still fell short of the revised plan. The public debt ratio dropped, but remains significantly above pre-COVID-19 levels. The central bank tightened its policy stance further in view of still elevated inflationary pressures, which began to subside gradually towards the end of 2022 and beyond. The current account deficit rose substantially as energy import prices surged, but external financing needs were met with the help of market-based and IMF borrowing.

A new Organic Budget Law (OBL) provides for the introduction of fiscal rules and a fiscal council, considerably strengthening fiscal sustainability. However, progress has been slow in implementing wider-ranging measures to improve the management of public investment, vital for underpinning the government's plans for a sizeable increase in capital expenditure.

The banking sector was resilient throughout the crises, and financial stability was bolstered by progress on some key legislation. The labour market showed some improvement, but structural problems persist, including high youth and long-term unemployment rates and a large gender gap. The business environment continued to be impeded by the large size of the informal economy, slow progress in streamlining parafiscal charges and an opaque and inefficient State aid regime.

Last year's recommendations were only partly implemented and remain partially valid. To improve the functioning of the market economy, North Macedonia should in particular:

→ provide targeted and temporary support to vulnerable households and firms to cushion the impact of the energy crisis, if needed, and at the same time start to phase out untargeted subsidies to the energy sector;

→ adopt and submit to Parliament the next set of revenue-enhancing measures, in line with the tax system reform strategy;

→ accelerate implementation of the public investment management action plan, in particular by ensuring the new Department for Public Investment Management in the Ministry of Finance becomes fully staffed and operational;

→ strengthen access to active labour market measures, in particular for the low-skilled unemployed and people in vulnerable situations.

Economic governance

The government provided fiscal support to help the economy cope with rising price pressures, but progress on important reforms was slow. While phasing out the broad-based pandemic-related support measures adopted in 2020 and 2021, the government adopted two sets of – partially – better targeted and temporary measures in 2022, to ease the burden of high food and energy prices on households and small business. These include a temporary reduction in the VAT rate on electricity for households, as well as sizeable subsidies for the state-owned electricity producer, ESM, which supplies the electricity to the universal supplier in the regulated market, to lower the price of electricity for its customers. It currently satisfies 100 percent of the demand of the regulated market, through government decision. Through the

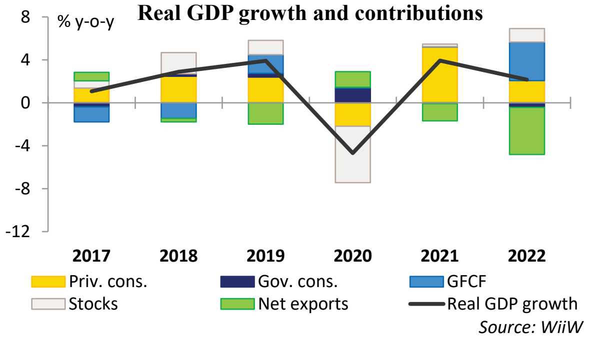
Law on financial support for socially vulnerable categories of citizens to deal with the energy crisis, adopted in November 2022, the government has provided targeted direct income support. It also introduced temporary price caps on certain food products, which were lifted on 1 June 2023. The new Organic Budget Law, enacted by Parliament in September 2022, introduced fiscal rules and a fiscal council as well as an improved medium-term budget framework. However, progress has been slow in other key reform areas. Improvements to the management of public investment are hampered by staffing and IT issues. Some of the public revenue-enhancing tax reforms adopted by the government in December 2022, which aim to reduce tax exemptions, were stalled in Parliament. The new legal framework for public-private partnerships (PPPs), which would address a number of shortcomings in the management of PPPs and of concessions, has yet to be adopted by the government. The government has advanced in implementing the green transition, notably by adopting major legislation to increase the use of renewable energies.

The policy guidance jointly agreed on at the May 2022 Economic and Financial Dialogue between the EU and the Western Balkans and Türkiye has been partially implemented. The country benefits from EU budget support worth EUR 80 million to cushion the impact of energy price increases on households, small and medium-sized enterprises and public service providers, of which EUR 72 million was disbursed in March 2023. In November 2022, the country received the first EUR 110 million tranche from an arrangement under the IMF's Precautionary and Liquidity Line (PLL)24. On 12 July 2023, in view of the country's large financing needs in 2023 and 2024, and following a request from the government, the Council and the European Parliament endorsed a Commission proposal for macro-financial assistance to North Macedonia of up to EUR 100 million.

Macroeconomic stability

GDP growth slowed, as the economy was hit by the fallout from Russia's war of aggression against Ukraine. Following a partial recovery from the recession caused by the COVID-19 pandemic, annual GDP growth slowed down to 2.1% in 2022, from 3.9% in 2021, as external demand weakened, disruptions in global supply chains persisted, and global food and energy prices rose rapidly. Trade dynamics were buoyant, but the rate of import growth exceeded the export growth rate, which meant that external trade made a negative contribution to economic growth. Investment rose strongly, partly on account of the build-up of stocks of intermediate products and raw materials, as companies anticipated further price rises. Private consumption growth slowed sharply despite being bolstered by remittances from abroad and government support measures. While industrial production and construction output declined, the service sector continued its post-COVID trend of strong annual increases. In the first half of 2023, annual GDP growth dropped to 1.6% on average. Convergence with EU income levels has been slow, with real GDP per capita increasing from 37% of the EU-27 average in 2017 to 42% in 2022.

Graph 7.1: **North Macedonia - Real GDP growth and contributions**



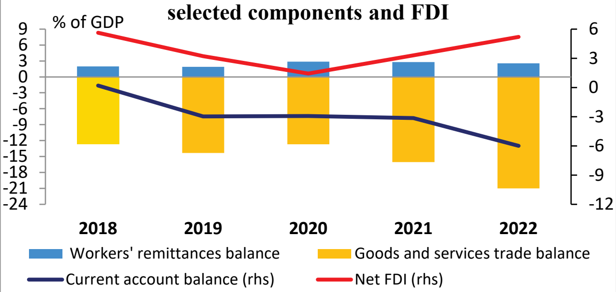
Source: WiiW

Reflecting the country's large dependence on energy imports and surging import prices, the external position deteriorated in 2022. The current account deficit rose markedly in 2022, to 6% of GDP from 3.1% in 2021, much above its average in the pre-COVID-19 period 2017 to 2019 (1.5%). This rise is accounted for by a widening energy trade deficit, which reflects the country's high dependence on energy imports and skyrocketing international energy prices. In addition, in an uncertain environment,

[24] The IMF's first review of the PLL program has been delayed from April 2023, mainly as the IMF is seeking more clarity on the fiscal implications of the (single-sourced) contract with the US-Turkish consortium Bechtel-Enka to build a EUR 1.6 billion (around 10 percent of GDP) highway section of Road Corridor 8/10d.

companies built up their inventories of imported production inputs. Deterioration in the energy and trade balance in 2022 was partly offset by a sizeable increase in private transfers (remittances) and in the services surplus, helped by a rebound in tourism. In the first half of 2023, the merchandise deficit has narrowed sharply, in annual terms, largely reflecting the drop in energy import prices and driving a large improvement in the current account balance. Foreign direct investment (FDI) inflows recovered after a fall triggered by the COVID-19 pandemic, increasing to 5.2% of GDP in 2022, and almost covered the surging deficit. External debt amounted to 84.3% of GDP at end-2022 (+2.3 percentage points (pps) year on year), with long-term debt accounting for the bulk of the total (70%). The increase was largely due to a rise in private intercompany lending, which is an important instrument for improving liquidity for foreign-owned companies in the country. About 40% of total external debt is made up of intercompany loans and trade credits, which is a less risky and more flexible category of debt.

Graph 7.2: **North Macedonia - Current account selected components and FDI**



Source: National Bank of North Macedonia and State Statistical Office

Table 7.1: **North Macedonia - Key economic figures**	**2014-19** average	**2020**	**2021**	**2022**
GDP per capita (% of EU-27 in PPS)[1)]	37	38	42	42
Real GDP growth	3.0	-4.7	3.9	2.1
Economic activity rate of the population aged 15-64 (%), total	65.3	65.5	66.8	66.4
female	*52.3*	*54.0*	*55.1*	*54.3*
male	*77.8*	*76.7*	*78.4*	*78.4*
Unemployment rate of the population aged 15-64 (%), total[2)]	23.2	16.6	15.8	14.5
female	*22.9*	*16.1*	*13.8*	*12.6*
male	*23.4*	*16.9*	*16.9*	*15.9*
Employment of the population aged 15-64 (annual growth %)[2)]	2.7	-0.5	n.a.	n.a.
Nominal wages (annual growth %)	3.2	8.3	5.7	11.1
Consumer price index (annual growth %)	0.5	1.2	3.2	14.1
Exchange rate against EUR	61.57	61.67	61.63	61.62
Current account balance (% of GDP)	-1.4	-2.9	-3.1	-6.0
Net foreign direct investment, FDI (% of GDP)	3.1	1.4	3.3	5.2
General government balance (% of GDP)	-2.8	-8.0	-5.4	-4.5
General government debt (% of GDP)	39.4	51.9	51.8	51.1

Notes:
1) Eurostat
2) From Q1-2022, the Labour Force Survey is based on the results of the 2021 population census, restricting comparability with previous year's data. In a first step, the Statistical Office has recently revised 2021 data based on census data.
Source: national sources

Foreign reserves have more than recovered following pressures in the first half of 2022. Exchange markets dropped sharply in the first half of 2022 (-14% year on year at end-June 2022), mainly on account of increased conversion of domestic denar-denominated savings into euro-denominated deposits, surging energy imports, and high external debt payments. Subsequently, however, the exchange markets stabilised, supported by a good tourism season in 2022, external market borrowing, including a EUR 250 million private placement of government securities in Germany in September 2022 and a EUR 500 million Eurobond issuance in March 2023, as well as the disbursement of the first instalment from an arrangement under the IMF's Precautionary and Liquidity Line (PLL). Inflows from foreign direct investment surged in 2022, catching up after a pandemic-related trough, but became more muted in 2023 so far. Foreign reserves declined again with the government's redemption of the 2016 Eurobond in July 2023. At the end of August 2023, they stood higher by 26% y-o-y, corresponding to around 4 months of prospective imports. The denar has remained in a stable, *de facto* pegged exchange rate regime with the euro.

Monetary policy was appropriately tightened in view of persistent inflation. Annual average inflation in 2022 was at a record high of 14.2%, driven by the global energy and food price shock. The annual inflation rate peaked at 19.8% in October 2022, which was more than in peer countries in the region, before abating gradually to reach 8.3% in August 2023. Core inflation, however, has remained persistent, reflecting the high transmission from the recent energy price hikes into core sectors of the economy such as industrial production, transport, and hotels and restaurants. Appropriately, the central bank continued its tightening of monetary policy throughout 2022 and beyond. It raised the policy rate by 495 basis points in ten consecutive steps between April 2022 and August 2023, to 6.15%, thereby increasing the spread to the European Central Bank (ECB) policy rate. Furthermore, it adjusted reserve requirement rates, both in June and September 2022, and again in August 2023, to dis-incentivize shifts into euro deposits, that were a significant factor behind the drop in foreign reserves in early 2022. It also eased reserve requirements for bank lending for renewable energy projects. A 2020 repo line from the ECB, intended to provide Euro liquidity to the central bank, was extended in 2022. Concerns about the operational independence of the central bank persist, as the central bank has not been exempted from the draft laws on administrative servants and the Law on public sector employees. Overall, the monetary policy stance has been in line with current economic fundamentals, responding to market expectations of further rising inflation, while mitigating the negative impact on the economy stemming from the pandemic and the energy crisis.

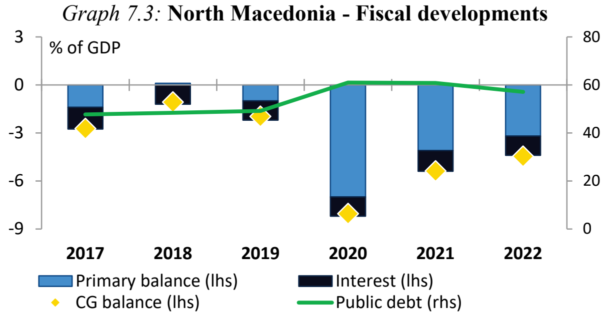
An inflation-driven boost to tax revenue and under-execution of expenditure underpinned the lower-than-projected budget deficit in 2022. The fiscal deficit came in at 4.5% of GDP, down from 5.4% in 2021 and remaining below the revised target of 5.3% of GDP adopted in the July 2022 budget revision. Central government revenue rose by 11.3% compared with 2021, driven by a 22.4% surge in VAT receipts. Current expenditure increased by 6.9% in 2022, which was less than the 8.3% increase in total expenditure. At 89.2% of budget, implementation of capital expenditure was higher than the average for the previous 5 years. The government has phased out some untargeted support measures. VAT on electricity for households was raised from the reduced 5% rate to a still reduced 10% on 1 January 2023[25] and was normalised to the standard rate of 18% from 1 July. Several expenditure categories, most notably transfers to the state-owned electricity company, ESM, and capital expenditure, on the other hand, were heavily under-implemented in 2022. In January-July 2023 the budget deficit stood at 2.9% of the projected full-year GDP, with a weak performance on the revenue side from VAT, in particular. In July, the government raised public sector wages by 10%, effective from September 2023, and subsequently adopted a budget reallocation in order to accommodate the additional expenditure within the initial deficit target of 4.6% of GDP. In the 5 years preceding the pandemic, the general government fiscal deficit declined each year, in terms of GDP, partly on the back of under-execution of budgeted capital expenditure, before jumping to 8.2% of GDP in 2020 as the COVID-19 crisis hit public finances. The revenue ratio has remained largely unchanged at a relatively low level (2022: 30.6%) in the past 5 years, suggesting the need to take further measures to increase public revenue. The expenditure

[25] The planned increase from 5% to 10% had been postponed from July 2022 to January 2023.

structure remains dominated by transfers to the pensions fund (2022: 28% of total expenditure), where a recent policy reversal back to linking annual pensions increases to both prices and average wages, has further exacerbated the financing pressures.

Inflation helped lower the public debt to GDP ratio in 2022 which however remains well above pre-pandemic levels. After having increased by some 10 pps to more than 50% in 2020, the general government debt-to-GDP ratio stabilised in 2021, and subsequently posted a slight decline in 2022 (-1.1 pps year on year to 50.9% of GDP). The public debt ratio dropped by more (-1.2 pps), to 59.8%, reflecting a decrease in the debt of public enterprises. Still, in nominal terms, the debt stock gradually increased further also in 2022 and in the first half of 2023. At the end of June 2023, the general government debt level was higher by 19.3% compared to end-21. The share of fixed interest rate debt in total debt remained high throughout 2022 (74% at end-year) but stood somewhat lower than one year earlier (-1.3 pps). External debt accounted for some 60% of total general government debt at the end of 2022, the same as in 2021. Foreign currency debt, mostly denominated in euro (92% of total foreign currency debt), accounted for 76% of total debt (also unchanged year on year). The de facto exchange rate peg to the euro limits debt vulnerabilities stemming from fluctuations in the value of the denar. In March 2023, the government successfully issued a Eurobond, its ninth since 2005, for EUR 500 million, for refinancing the 2016 Eurobond (EUR 450 million) repayment in July 2023. The country has a proven track record of timely debt repayments.

Graph 7.3: **North Macedonia - Fiscal developments**



Source: National sources

The fiscal framework has been strengthened through a new Organic Budget Law (OBL), but deficiencies in public finance management remain. In September 2022, Parliament passed the OBL, which provides for the introduction of fiscal rules and a fiscal council and strengthens the medium-term budget procedure. Key provisions, such as the fiscal rules, are due to enter into force in 2025. Preparations for setting up the new fiscal council are advancing, with the members of the council nominated and appointed by Parliament in September 2023. However, the adoption of by-laws, which is necessary for the full implementation of the OBL, is not progressing. Furthermore, shortcomings in revenue collection and a large number of tax exemptions eroding the tax base hamper a potential increase in public revenue ratios. In December 2022, the government adopted tax policy reform measures in the areas of personal income tax, corporate income tax, and value-added tax, with a view to broadening the tax base. While amendments to the Law on Personal Income Tax entered into force in January 2023, amendments to the Law on Corporate Income Tax, to the Law on Value Added Tax, as well as a new Law on the Solidarity Tax were adopted by Parliament only in September 2023[26]. Implementation of measures to improve the planning, allocation and execution of public investment projects, as presented by the government in its 2021 Action Plan, is progressing only slowly, hampered by staff shortages and IT requirements. The government set up a dedicated unit for public investment management in the Ministry of Finance in December 2022, to ensure centralised oversight of public sector investment, but it still has to become fully operational.

Fiscal risks are sizeable and not always well monitored. Risks to the government's fiscal consolidation plans have increased, notably from the government's March 2023 contract with the Bechtel-Enka consortium for the construction of part of Road Corridor 8/10d. The project is expected to cost EUR 1.3 billion (10% of 2022 GDP) and to be completed over a 6-year period, with EUR 215 million (1.7% of 2022 GDP) earmarked in the 2023 budget. A special law that replaces standard public procurement rules for this project has been adopted and enacted by Parliament. To solidify the fiscal cost

[26] Furthermore, in August 2023, the government passed tax base-broadening amendments to the Excises Law, with parliamentary adoption still pending. These changes include the introduction of ad-valorem excise for cigars and cigarillos at 9 percent and the introduction of the new excise calendar that envisages a gradual increase of specific excises over time.

and manage fiscal risks, in particular recent rises in construction costs and uncertain cost evolution of the project, the IMF requested the authorities to provide an independent due diligence study as a structural benchmark under the 2022 precautionary and liquidity line for North Macedonia, which is delayed. Further fiscal risks stem from expenditure arrears, which remain consistently above 3 percent of GDP, as well as from public sector wage growth, and the July 2023 decision by the government to link future rises in public sector wages to average wage growth, in addition to price developments. The rising pensions bill poses further risks to fiscal sustainability, also exacerbated by the recent change in the indexation formula. The steep rise in minimum wages (+12% as of April 2023), in line with the new methodology for alignment adopted in 2022, further impacts on general wage and pension developments. Some fiscal risks, such as contingent liabilities arising from PPPs and other off-budget entities are not systematically reported to the central government27.

The policy mix has been somewhat inconsistent, in addressing the challenges posed by the cost-of-living crisis and high energy imports, but financial and macroeconomic stability was secured. Monetary policy was appropriately tightened in view of soaring inflation, and measures to promote savings in domestic currency ('denarisation') were stepped up, which contributed to the stability of the exchange rate. Fiscal support to households and companies, on the other hand, could have been better targeted and fiscal consolidation plans could be more ambitious, also in order to help monetary policy to contain inflation. Energy subsidies remained large, against the background of falling market prices. Furthermore, the government's decision to revise the indexation mechanism of public wages and the minimum wage from 2024 is likely to fuel domestic price pressures and put at risk fiscal consolidation plans. Further improvements in the fiscal framework, such as monitoring and addressing fiscal risks and improving public investment management, would make a significant contribution to further safeguarding macroeconomic stability and raising the economy's growth potential.

Functioning of product markets

Business environment

Challenges in the business environment are undermining the competitiveness of domestic companies, investment and global value chain integration. North Macedonia's economy relies heavily on its integration in global value chains, in particular in the automotive sector, with export-destined production concentrated among a few firms. The reliance on imported inputs makes the economy vulnerable to external shocks. These competitive pressures are exacerbated by low productivity, partly stemming from a lack of skills and from sluggish adoption of innovation and new technology, as well as by a complex legal and regulatory environment and the large informal economy. The impact of the COVID-19 pandemic and Russia's invasion of Ukraine has intensified these structural challenges. The government's approach to simplifying the business environment is not sufficiently systematic and consistent.

The government has progressed somewhat in streamlining the array of parafiscal charges. Activities to optimise, consolidate and streamline parafiscal charges are ongoing. The government has tasked the Ministry of the Economy with coordinating the process, but the decision to streamline 100 selected parafiscal charges will have to be adopted by the government as a whole. Implementation of other key measures to improve the business environment is protracted, such as implementation of the 2019 Law on inspection supervision and implementing transparent and consistent procedures for inspections. The new Bankruptcy Law, intended to facilitate market exit by reducing the cost and duration of procedures, has not yet been adopted. The use of fast-track procedures for public consultation has not abated, while quality control and *ex post* follow-up to consultations remains deficient. Work is ongoing to upgrade the e-portal in order to develop a more user-oriented service delivery. The number of registered users and completed services on the portal is increasing, but remains below expectations. Many of these

[27] There is a requirement in the new Organic Budget Law for the government to include a description of fiscal risks (at a minimum those pertaining to the government's contingent liabilities) in the annual fiscal strategy; and for the Fiscal Council to assess fiscal risks relating to various public entities, including public enterprises and public-private partnerships.

services remain purely informational and cannot be fully performed online (OECD, 2022).

Challenges posed by the large informal economy are not addressed in a decisive manner. The informal economy continues to present a major obstacle to business operations. According to IMF estimates, it likely accounts for as much as 38% of GDP28. The number of informal employees as a proportion of total employees is estimated to have decreased from 18.6% in 2018 to 13% in 2022. Implementation of the government's 2018 Strategy and Action Plan to combat the informal economy remains sluggish, particularly regarding the formalisation of undeclared workers. In October 2022, to enable more efficient coordination between relevant institutions and stakeholders, the Ministry of Finance took over responsibility for preparing the new 2023-2027 Strategy for Formalisation of the Informal Economy with an Action Plan which were adopted by the government in September 2023. The government adopted tax legislation at the end of 2022 to strengthen the tax-paying culture and thereby fight the informal economy. The country's informal sector takes various forms, of which the most prominent are unregistered labour, partially undeclared wages and other irregularities in the enforcement of the Labour Relations Act.

State influence on the product market

The transparency and efficiency of State aid remains deficient. Instead of tackling the country's underlying structural challenges and business environment issues, the government's flagship policy to attract FDI and improve domestic firms' competitiveness relies on providing various forms of State aid to businesses. The effects of State aid on efficiency and competition have not yet been assessed. The transparency and effectiveness of State aid is affected by the high number of State aid providers, the lack of an updated registry, and the still marginal powers of the Commission for the Protection of Competition in State aid supervision. The public information provided by the government on State aid to companies remains incomplete and the criteria for the selection of beneficiaries are often unclear. As a precondition for the establishment of a State aid registry, the government is setting up a management information system connecting different institutions, but overall, the process is delayed. There is no strategy for properly determining priorities, goals and policies for investment activities in the country's technological industrial development zones.

Competition in the energy market is increasing. While the energy market was fully liberalised in 2019, almost all households and small companies remain in the regulated electricity market being provided with heavily-subsidized electricity. In the last quarter of 2022, 24 639 consumers (per metering point) purchased electricity from active suppliers in the open electricity market, according to mutually agreed (unregulated) prices. This makes up about 55% of the market, compared to some 53% at the end of 2019. In 2022, there were 18 electricity suppliers in the open market and one electricity supplier in the regulated electricity market. An increasing number of consumers have been switching electricity suppliers. In 2019, 2 350 consumers switched supplier. In 2020, that figure rose by 10.8% to 2 603 consumers, in 2021 by a further 37.1% to 3 568 consumers and in 2022 by 11.7% to 3 986 consumers.

Privatisation and restructuring

The public sector's stake in the economy remains low. In 2022, the number of companies in full-state ownership declined by two, to 15, compared to the preceding years. The number of companies in partial ownership decreased by one, to 38, most of these with a state ownership share of below 1% of issued capital29. The total value of state ownership in enterprises was unchanged, at about 10% of GDP. There are currently no plans for further privatisations.

[28] The IMF figure is at the upper range of estimates.

[29] The figures are based on information from the government. A new harmonised and internationally standardised global database of state-owned enterprises (SOEs) by the World Bank indicates that there are 88 SOEs, of which 35 are 100% owned by the government of North Macedonia.

Functioning of the financial market

Financial stability

Bank capitalisation and profitability have improved since the pandemic. The banking sector remained resilient throughout the recent crises. Banks' capital adequacy ratio increased further in 2022, and in December 2022, it was well above its level of 5 years earlier, far exceeding the regulatory minimum. Liquid assets accounted for over a third of total assets at end-2022 and covered more than half of short-term liabilities. At 12.2%, return on equity was above its pre-pandemic level at end-2019 (11.7%). The proportion of loans to the non-financial sector which were non-performing has been steadily decreasing since the end of 2013, to a record low of 2.8% at the end of 2022 (-0.2 pps year on year). However, financial diversification is progressing slowly, with banks still accounting for some 79.1% of financial sector assets at end-2021, only slightly lower than the end-2016 figure (84.7%). The share of foreign equity in total bank equity has been consistently high in the past 5 years, at about 75%.

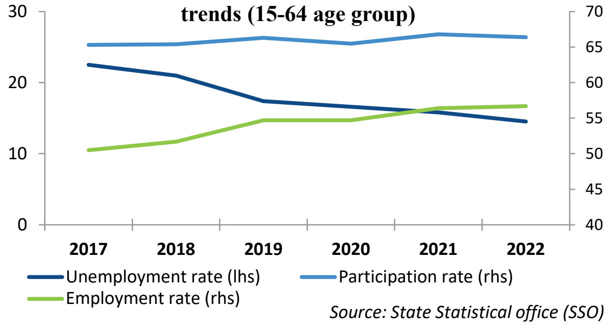
The legal and institutional framework for ensuring financial stability has been strengthened. In July 2022, the new Financial Stability Law was enacted, giving the relevant authorities in the financial sector a legal mandate to develop and implement macroprudential measures to maintain the stability of the financial system. The Law sets up the Financial Stability Council, which held its first meeting in November 2022 and submitted the first annual financial stability report to Parliament at end-March 2023. In February 2023, the Council of the National Bank adopted a new decision on the credit risk management methodology, so as to strengthen the management of non-performing and restructured loans, due to enter into force on 1 January 2024. In August 2023, the National Bank's decision to increase the countercyclical capital buffer to 0.5%, adopted in July 2022, entered into force. The National Bank has already scheduled increases in the countercyclical buffers to 0.75 by 2024Q2 and to 1% by 2024Q4. However, critical legislation including the Bank Resolution Law and the Deposit Insurance Law is not yet enacted by Parliament.

Access to finance

Growth in credit to the private sector decelerated, while deposit growth remained robust. Annual growth in loans to households and non-financial companies has also been decelerating since autumn 2022, with corporate loans particularly affected. Lending to nonfinancial corporations slowed down mainly on account of repayments of working capital loans linked to the surge in energy costs. Even so, over 2022 as a whole, private-sector credit growth accelerated by 3.8 pps to 9.6% year on year, before slowing in the first quarter of 2023 to 8.3%, and further to 6.4% in the second quarter. Foreign exchange loans are contributing most to the annual increases. The proportion of loans that were foreign-denominated rose by 0.8 pp year on year to 43.2% in the first quarter of 2023. The increase was more pronounced in the corporate sector, partly because corporations needed extra liquidity to cover their energy purchases. Overall, however, the currency denomination of domestic credit shifted further towards denar-denominated loans in the latter part of the year. While household demand for foreign currency deposits strengthened throughout the pandemic and energy crises, deposits in national currency have rebounded since early 2023, supported by the central bank's strategy of applying different reserve requirements for bank deposits in foreign and local currency. The share of foreign currency-denominated in total bank deposits amounted to 46.7% at the end of the first quarter 2023 (-0.7 pp year on year).

Functioning of the labour market

The labour market's resilience masks persistent structural problems. While fiscal support to employers was gradually withdrawn in the second half of 2022, the labour market continued to prove resilient. The employment rate has steadily increased over the last decade. The COVID-19 pandemic interrupted this trend, but in the first quarter of 2023 the employment rate stood above the pre-pandemic level, at 56.5%. For 2022 as a whole, the average unemployment rate (15-64 age group) was 14.5%, compared with 15.6% in 2021. The labour force decreased by 1.3% year on year, with the bulk of the drop accounted for by women (-2%, compared with 0.8% for men). The labour market participation rate dropped to 66.4% in 2022 (-0.4 pps year on year). Young people in particular continue to face obstacles



Graph 7.4: **North Macedonia - Labour market trends (15-64 age group)**

Source: State Statistical office (SSO)

to entering the labour market. In 2022, the government adopted a new implementation plan to strengthen the Youth Guarantee which has been in place since 2018 and which has contributed to a significant reduction in youth unemployment from 45.4% in 2018 to a still high 32.5% in 2022. The rate of inactivity in the labour market is particularly high for women and, after steadily narrowing between 2014 and 2019, the gender gap widened for the third year in a row in 2022 (by 0.8 pps to 24.1 pps.), as the participation rate for men remained stable (at 78.4%), while it dropped for women (to 54.3%). Long-term unemployment stands at around 80% of total unemployed, largely reflecting an entrenched skills mismatch. Spending on active labour market policies (0.3% of GDP in 2022) is relatively high in regional comparison, but lower than the EU average (0.6% of GDP). Given limited human and financial resources in employment agencies, the government faces the challenge of better targeting the vulnerable unemployed, with a view to their participation in the labour market. Average gross nominal wages rose by 11.1% in 2022, with the annual increase accelerating to 14.3% on average in the first half of 2023. Real wage growth turned positive as of April 2023 after raising the minimum wage according to the indexation mechanism that takes into account inflation and changes in average wages. The average tax wedge is regressive at the bottom of the income distribution: the average contribution rate therefore takes a much higher share of low-wage earners' total income.

7.2. THE CAPACITY TO COPE WITH COMPETITIVE PRESSURE AND MARKET FORCES WITHIN THE UNION

North Macedonia has made **some progress** and is **moderately prepared** to cope with competitive pressure and market forces within the EU. Integration with the EU in trade and investment remained at a high level in 2022. The share of high-value products in exports increased further and trade openness surged to a record high. There was further progress towards improving vocational educational training (VET), but major skills shortages persist relative to labour market needs, entailing long school-to-work transitions. These, coupled with large gaps in transport and energy infrastructure and low investment and innovation funding, are restricting potential growth. Digitalisation of the economy is advancing, but the competitiveness of domestic businesses could be improved through a wider offering of public e-services.

As the 2022 recommendations have not been fully implemented and remain mostly valid, North Macedonia should in particular:

→ adopt the new Law on VET, the Law on secondary education and the Law on adult education, and increase financial and human resources to speed up reforms of the VET system;

→ finish unbundling gas transmission systems, increase investment in new energy sources and enhance administrative capacity in the Energy Department of the Ministry of Economy and the Energy Agency;

→ adopt secondary legislation under the Energy Efficiency Law and operationalise the energy efficiency fund; adopt the Law on biofuels and the energy efficiency renovation strategy for buildings; and establish a renewable energy guarantee of origin scheme.

Education and innovation

Progress in reforming education curricula and reducing skills mismatches is hampered by lack of funding and capacity. While North Macedonia has progressed well in terms of the number of people with higher education qualifications, curricula are not well suited to equipping graduates with skills to match labour demand. State financial support for education is insufficient and coordination between the education sector and businesses is weak. In 2022, public spending on education and training amounted to 3.7% of GDP, about the average of the preceding 5 years. This is below both the EU-level (5%) and peer-country averages, and impedes implementation of the 2018-2025 education strategy. Moreover, spending is inefficient, mainly on account of outdated formulas for the redistribution of public education funds by the municipalities. There was substantial improvement in the 2018 PISA ranking30, compared to 2015, but the country still ranks in the lowest quartile. VET curricula have been under review since 2019 to align them with labour market needs. However, the government has not yet adopted a new VET Law with a focus on inclusion, labour market needs and a new methodology of financing VET. The envisaged annual report on the implementation of the education strategy, which should include recommendations for a new formula for higher education funding, has not yet been published. The percentage of adults participating in learning was 2.6% in 2020, which is significantly below the EU-27 average of 10.8% (2021). Further development of qualifications is key to bringing medium-skilled and low-skilled people into the labour market.

Innovation activity remains overall low. At 0.4% of GDP (including a small share from the private sector), the economy’s expenditure on research and innovation remains significantly below the EU average. Participation of the private sector in overall research spending remains particularly weak, at 0.1% of GDP. Allocations to the Fund for Innovation and Technological Development and its programmes have increased, but their effectiveness, design and methodology could benefit from an independent evaluation. Links between businesses and others involved in innovation are very weak. To overcome the lack of strategic direction towards innovation, a smart specialisation strategy has yet to be adopted and implementation measures to be developed.

Physical capital and quality of infrastructure

Investment spending remains moderate despite a major need to increase physical capital. Gross capital formation (including inventories) rose to 35% of GDP in 2022 (+1.8 pps year on year), exceeding its pre-COVID level (2019: 34.5%). Investment in fixed assets (gross fixed capital formation) increased steadily in the 5 years to 2021 (latest data), when it reached 22.5%. This is above the average of 21.9% in the preceding 5 years, and close to the EU-27 average of 22.8% (2022). Investment in construction as a percentage of total investment in 2021 (55.2%) was down on its 5-year average (58.2%), while investment in machinery and equipment rose to 35.3% of total investment, above the average (32.8%). The share of private-sector investment in total investment remained steady in the 5 years up to 2021, at around 75%. In the face of the current energy crisis and protracted works on a number of major road and rail projects, the need to modernise the country’s capital stock, in particular the transport and energy networks, appears ever more pressing.

Regional transport connectivity is progressing slowly. Road transport continues to dominate the transport sector. There is limited investment in other means of transportation and no consistent and intelligent system for managing and controlling traffic. Relatively low-quality transport infrastructure, as well as weak trade and transport logistics continue to present barriers for businesses. The joint electronic toll collection system between Serbia and North Macedonia has become operational, facilitating trade and travel between the two countries. There has been some progress on upgrading major road sections to highway level. Work has started on Railway Corridor VIII, which aims to link North Macedonia with Albania and Bulgaria and will give the country’s companies an alternative export option via Albanian and Bulgarian ports.

[30] PISA is the OECD's Programme for International Student Assessment.

The digitalisation of the economy continues to advance, but is still at a low level compared with the EU. The percentage of households with internet access at home increased by 10.1 pps. between 2017 and 2021, to 83.6%. A fixed broadband connection to the internet is used by 88% of household users, and by 92% of businesses with 10 or more employees, but smaller companies still face obstacles. Of the total number of enterprises, 54.5% had a website/homepage. Overall, there is a particular need to increase access to broadband, expand e-government services and develop digital skills.

The government is taking steps to incentive investment in energy efficiency improvements in the public sector. The economy is characterised by high-energy intensity with low efficiency in energy production and consumption. North Macedonia is a contracting party to the Energy Community Treaty and its government has committed to reducing the use of energy, which requires substantial investment. Further improving energy efficiency, including in residential and public buildings, is also important to lower the economy's dependence on energy imports and to enable a reduction in fiscal subsidies for energy. Yet, implementation of the 2020 Law on Energy Efficiency and the adoption of by-laws is lagging behind. In order to support energy efficiency investments in the public sector, which has the greatest potential to improve energy efficiency, the government is establishing an Energy Efficiency Fund (EEF). At the end of 2022, the government decided to establish the EEF within the Development Bank. The legal and regulatory framework for its establishment and operationalisation requires amendments to the Law on the Development Bank, which have been adopted by the Parliament in October 2023. Rules of procedure of the Fund and a project pipeline remain to be established.

The legal framework for investment in renewable energy sources was improved. Electricity generation is highly dependent on coal, and, with domestic coal reserves declining, on imports. The proportion of energy from renewable sources remains comparatively low, at 17.3% in 2021. The government plans to increase renewable energy to 35-45% of energy consumption by 2040, to reduce the country's high reliance on imported liquid fuel and natural gas. In November 2022, Parliament enacted amendments to the 2018 Energy Law incentivising investment in renewable energy sources, notably solar power. At the same time, the central bank began implementing a measure to encourage lending to the corporate sector to finance domestic electricity production projects from renewable sources.

The distribution of natural gas remains limited. Meanwhile, the distribution of natural gas is advancing, as an intermediate step in the decarbonisation process, with efforts made to enhance the transmission and distribution network. The natural gas market was liberalised in 2015. The number of connected users remains limited; in 2022, it increased by 10% year on year, to 550. Similarly limited are the length of the transmissions network (+5% year on year to 210 km) and the total distributed quantities. Gas accounts for some 11% of electricity production. There was little progress in the unbundling of the gas transmission system operator, now planned for end-2023. The work to connect to regional gas pipelines is making slow headway. Works on the gas interconnection with Greece have not yet started. This project would support diversification of natural gas sources and facilitate access to transit pipelines.

Sectoral and enterprise structure

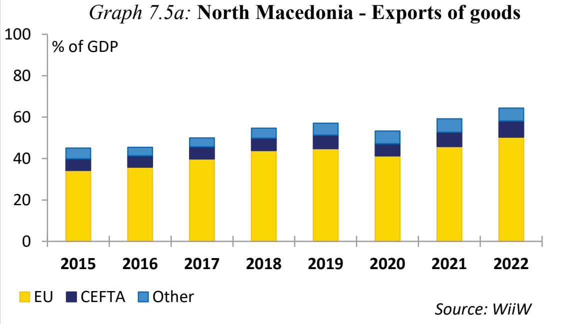
The diversification of the economy continued after the pandemic. The economy's output is strongly reliant on the manufacturing sector. Services and trade have only gradually increased their share in value added in recent years. Together, they accounted for some 66% of total value added in 2022, about the same as a year earlier, and up from 60.4% in 2016. The share of manufacturing decreased slightly for the second year in a row, to 14.6% of value added in 2022, having progressively gained ground in the pre-pandemic years. The share of construction increased somewhat, in annual comparison, in 2022, to 6.2%, reflecting a recovery of investment after the pandemic, yet remaining below its average of 7% in 2017-2021. After steadily dropping over a number of years, the share of agriculture remained at 9% of value added, as in 2021.

Trade and services increasingly dominate the employment structure. In employment, too, trade and services assume an increasingly important role, accounting for close to 60% of total employment in 2022, compared with 58.4% in 2021. The manufacturing sector's share in total employment also rose in 2022, compared to the preceding year (+0.4 pps to 19.6 %), possibly reflecting in part the post-pandemic end of short working hour regimes and a pick-up in production. The construction sector accounted for 6.5 % of all employment, as in 2021, and the share of agriculture dropped by 1.8 pps year on year, to 10%.

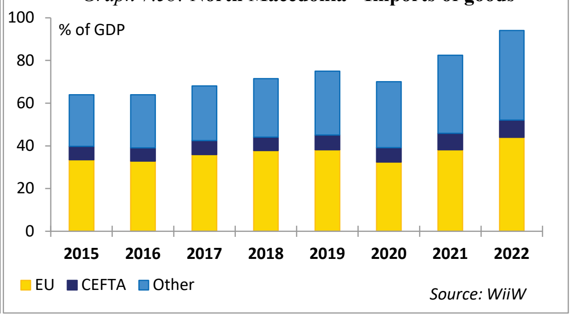
Economic integration with the EU and price competitiveness

Trade openness increased steeply as both exports and imports surged. The economy posted a large increase in trade openness (exports and imports in goods and services as a percentage of GDP) in 2022, to a record high of 171% (2021: 148.5%, 2015-19 average: 120%), which is by far the highest level in the Western Balkans. Trade values increased by more than nominal GDP in 2022, largely reflecting the steep rise in energy imports, but also a large increase in export values. The share of higher-value added products in the export structure rose further in 2022, including chemicals (32% of total exports) and machinery and transport equipment (31%), at the expense of traditional exports such as iron and textiles (below 20%). In 2022, the EU was the country's most significant trading partner, accounting for 59.6% of total trade (78.3% of total exports compared with 77.3% in 2021 and 46.8% of total imports compared with 46.2% in 2021). As the second most important trading partner region, the Central European Free Trade Agreement accounted for 10% of total trade, with the share of exports slightly higher and the share of imports lower than in the preceding year (12.1% of total exports and 8.6% of total imports). EU countries also remain the biggest investors in North Macedonia, accounting for some 50% of total FDI inflows in 2022 (2021: 56%), but the EU-27 share in the total stock of direct investment has declined to 64% at end-2021, compared to 66% in 2015.

Graph 7.5a: **North Macedonia - Exports of goods**



Graph 7.5b: **North Macedonia - Imports of goods**



External competitiveness slightly deteriorated. In 2022, the real effective exchange rate (REER) of the local currency appreciated by 2.1%, on an annual basis, due to an increase in the nominal effective exchange rate in relation to the currencies of some of the trading partner countries, with relative prices remaining stable. The rise in real wages coupled with stagnant or declining productivity erodes price competitiveness. Nominal unit labour cost rose by some 7% in 2022, reflecting the stark increase in nominal wages, while productivity growth remained muted. Over the last 5 years, the REER of the denar deflated by inflation has seen little change in either direction (on average a small appreciation of 1%). Concerns over external competitiveness have increased as wage growth has accelerated, fuelled by the 12% hike in minimum wages starting from April 2023[31].

[31] Public sector wages were increased by 10 percent in September 2023, in addition to the linear increase as a result of the minimum wage increase in March 2023, as well as several seperate decisions granting larger wage increases implemented in 2023. Higher average nominal wages accelerate the increase in pensions under the new indexation formula, thus creating additional demand pressures.

8. SERBIA

8.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Serbia is **at a good level of preparation** and has made **some progress** in developing a functioning market economy. After a strong rebound in 2021 from the contraction induced by COVID-19, the Serbian economy decelerated substantially in 2022 impacted by the economic fallout from Russia's war of aggression against Ukraine, in particular as regards rising inflation via soaring energy and food prices. Consumer price inflation surged in 2022 and continued to rise in early 2023, reaching a peak of 16.2% in March 2023, which led the central bank to steadily tighten its policy stance. After widening sharply in 2022, the current account deficit decreased in the first half of 2023, in particular due to the lower cost and the lower volume of energy imports. Banking sector stability was maintained while lending growth decelerated substantially. High inflation helped improve the budget balance in 2022, despite very substantial capital transfers to state-owned energy utilities and further ad hoc fiscal support measures that were not always well targeted. Budget revenues also benefited from progress with tax administration reforms. The public debt ratio fell and public finances are expected to be anchored by a new set of fiscal rules. The unemployment rate decreased in 2022 and vulnerable categories of workers benefited from the recovery. However, structural problems persist, including a labour supply impacted by outward migration, persistent skills mismatches, and a gender employment gap. Ensuring timely implemention of the youth guarantee plan is expected to contribute to addressing the skills mismatch.

Major reforms of public administration (such as the wage system reform) and of the governance of state-owned enterprises (SOEs) continued to advance slowly, prolonging long-standing inefficiencies. However, in 2023, there has been some acceleration of governance reforms, in particular in the energy sector. The regulatory and administrative burden for doing business has been reduced, but the private sector continues to be affected by a lack of transparency and predictability in the way business-related legislation is adopted. Structural challenges remain for State aid, competition and public procurement. The State retains a strong footprint in the economy and the private sector is underdeveloped and hampered by weaknesses in the rule of law, in particular regarding the tackling of corruption and judicial inefficiency. Last year's recommendations have been partially implemented and remain partly valid.

In the coming year, Serbia should in particular:

→ plan a gradual deficit reduction in the 2024 budget and in the medium-term fiscal framework in line with Serbia's commitments in its Stand-by Arrangement (SBA) with the IMF and the new fiscal rules;

→ continue the preparatory steps towards an appropriately designed public sector wage system reform; and

→ continue the deployment of the SOE ownership and management strategy for 2021-2027 by implementing the remaining steps of the 2021-2023 action plan and by preparing a new time-bound action plan for 2024-2027.

Economic governance

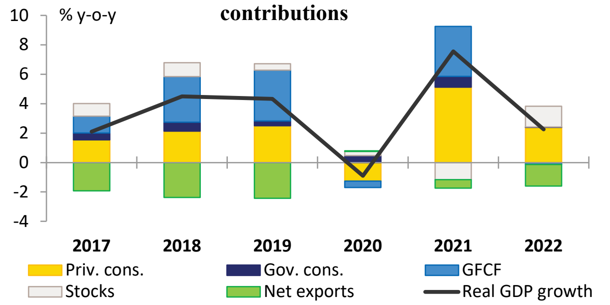
The authorities have remained committed to macroeconomic stability and economic reforms. Reacting to lower domestic energy production and higher energy import costs in the context of Russia's war of aggression against Ukraine, the government provided very significant budget support to state-owned energy utilities in 2022 to mitigate the effects on domestic households and enterprises. To address steadily rising inflation rates throughout 2022, the National Bank of Serbia (NBS) tightened monetary policy by gradually raising its key policy rate from 1% in March 2022 to 6.2% in June 2023. Good progress has been made as regards the adoption of new fiscal rules and the e-invoicing reforms. Structural weaknesses remain in fiscal governance, in particular concerning the unreformed wage system and fiscal risk assessment, the business environment, public and tax administration, and in the way the State intervenes and manages its presence in the economy, in particular concerning state-owned enterprises (SOEs). Serbia has started the implementation of a new SBA with the International Monetary Fund (IMF) running from December 2022 to December 2024, worth approximately EUR 2.4 billion conditioned on the implementation of important economic reforms. The SBA replaced the non-disbursing Policy Coordination Instrument.

The policy guidance jointly agreed at the May 2022 Economic and Financial Dialogue between the EU and the Western Balkans and Türkiye has been partially implemented. The authorities provided very substantial fiscal support in 2022 to mitigate the energy crisis and effectively planned further gradual fiscal consolidation. A new set of fiscal rules with debt-level-dependent deficit ceilings as a cornerstone was adopted. A new model of electronic fiscalisation and the transition to electronic invoicing have been successfully completed. The first steps in the action plan for the new state-owned enterprise ownership and management strategy have been substantially implemented. However, Serbia is still not prioritising investments in a harmonised manner based on relevant assessments, and issues remain in the areas of competition and State aid, as well as in the area of public procurement (see also Chapter 5 on public procurement and Chapter 8 on competition policy). The long-term energy and climate strategy is yet to be adopted in the course of 2023. The first auction on renewable energy was launched in June 2023. There was no measure to increase the adequacy of benefits under the financial social assistance scheme to reduce poverty, while partial progress was made to facilitate school-to-work transitions. Implementation of structural reforms should be speeded up with the help of well-designed measures broken down into clear activities and timelines.

Macroeconomic stability

Economic activity remained relatively resilient through successive crises but decelerated strongly in 2022. After an average GDP growth rate of 3.6% in 2016-2019, a relatively mild contraction by 0.9 % in 2020 and a strong rebound by 7.5% in 2021, output growth decelerated to 2.3% in 2022. The slowdown was especially strong in the second half of the year due the economic fallout from Russia's war of aggression against Ukraine, in particular on inflation via soaring energy and food prices. Growth was also impacted by reduced production capacity of electric utility *Elektroprivreda Srbije*, dampening industrial output and increasing imports of electricity and coal. GDP growth in 2022 was mostly driven by private consumption and inventories, which were partially offset by negative contributions to growth of net exports and gross fixed capital formation. On the supply side, the services sector accounted for the bulk of annual growth, while agriculture and construction contributed negatively, primarily due to the drought and base effects from high construction activity in 2021. In the first half of 2023, real GDP expanded by 1.3% year-on-year, mostly driven by net exports and gross fixed capital formation, largely offset by negative contributions to growth from inventories, and from government and private consumption due to high inflation. After remaining broadly unchanged for most of the last decade, the income gap with the EU slightly narrowed in recent years as per capita GDP in purchasing power standards rose from 40% in 2018 to 44% of the EU average in 2021, remaining stable at 44% in 2022.

Graph 8.1: **Serbia - Real GDP growth and contributions**



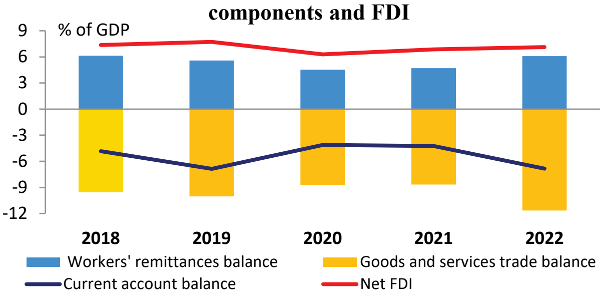
Source: WiiW

Table 8.1: **Serbia - Key economic figures**	**2014-19** average	**2020**	**2021**	**2022**
GDP per capita (% of EU-27 in PPS)[1)]	40	43	44	44
Real GDP growth	2.4	-0.9	7.5	2.3
Economic activity rate of the population aged 15-64 (%), total[1)]	64.9	66.4	70.3	71.4
female	*57.1*	*59.2*	*63.0*	*64.4*
male	*72.7*	*73.6*	*77.5*	*78.3*
Unemployment rate of the population aged 15-64 (%), total[1)]	15.4	9.5	11.4	9.7
female	*16.2*	*9.9*	*12.4*	*10.1*
male	*14.7*	*9.2*	*10.6*	*9.4*
Employment of the population aged 15-64 (annual growth %)	3.8	-0.2	2.6	2.3
Nominal wages (annual growth %)	3.9	9.4	9.4	13.8
Consumer price index (annual growth %)	1.9	1.6	4.1	12.0
Exchange rate against EUR	119.8	117.6	117.6	117.5
Current account balance (% of GDP)	-4.8	-4.1	-4.2	-6.9
Net foreign direct investment, FDI (% of GDP)	5.8	6.3	6.9	7.1
General government balance (% of GDP)	-1.6	-8.0	-4.1	-3.1
General government debt (% of GDP)	61.0	57.8	57.1	55.6

Notes:
1) Eurostat
Source: national sources

After a sharp widening in 2022, the current account deficit narrowed substantially in the first half of 2023. After an average of around 5% in the period from 2018 to 2020, the external deficit widened sharply to 6.9% of GDP in 2022, from 4.2% in 2021. A substantial increase in the merchandise trade deficit (particularly due to high energy imports) and a higher primary income deficit (mainly reflecting increases in reinvested earnings and dividends) were only partially offset by a higher surplus on the secondary income balance (reflecting in particular increased worker remittances) and on the services trade balance. The deficit was more than fully covered by net inflows of foreign direct investment that reached 7.1% of GDP in 2022 (after 6.9% of GDP in 2021). Decreased energy imports, partly related to higher domestic electricity production following the partial recovery of domestic production capacity, and the decrease in energy prices were among the main drivers of a sharp narrowing of the current account deficit by 82% year-on-year in the first half of 2023. After a gradual decline from 73.4% in 2015 to 61.4% in 2019, external debt to GDP increased to 69.4% in 2022, reflecting in particular high public financing needs in 2020-2022. Official foreign exchange reserves have remained at more than twice the level of short-term external debt and solidly covered more than 5 months of imports of goods and services at the end of 2022 and early 2023.

Graph 8.2: **Serbia - Current account selected components and FDI**



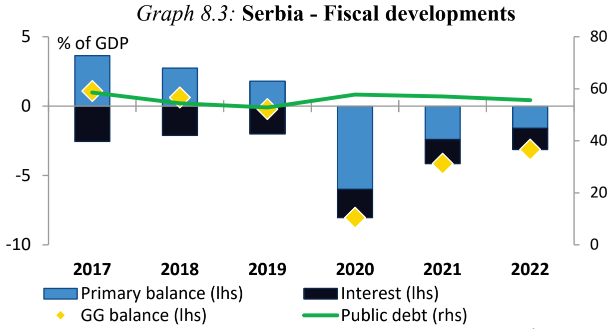
Source: IMF and Eurostat

Consumer price inflation surged in 2022 and continued to rise in early 2023 before starting a gradual decline in the second quarter of 2023. Following low and rather stable inflation for 7 consecutive years, and a pick-up to an annual average of 4% in 2021, consumer price inflation surged further to an annual average rate of 11.9% in 2022. This was the result of a steady increase throughout the year, reaching a level of 15.1% in November and December followed by a further increase to a peak of 16.2% in March 2023, well above the upper end of the central bank's target tolerance band of 3% ±1.5

pps. Inflation started to decline in the second quarter of 2023, down to 12.5% year-on-year in July. The strong increase in headline inflation continued to be driven by food and energy prices while core inflation also picked up steadily throughout 2022 and early 2023, peaking at 11.3% in March 2023. The NBS started to gradually raise its key policy rate in April 2022, bringing it up (in monthly steps of either 50 or 25 basis points) from 1.0% in March 2022 to 6.0% in April 2023, before pausing its tightening cycle in May 2023 ahead of further increases to 6.25% in June 2023. To stabilise the exchange rate in the face of alternating appreciation and depreciation pressures, the central bank continued to apply its policy of frequent interventions on both sides of the foreign exchange market.

The general government deficit decreased in 2022 as a high level of fiscal support to state-owned energy utilities and a series of ad hoc expenditure measures were largely offset by the balance-improving effects of high inflation. Following prudent fiscal policies with budget surpluses in 2017 and 2018 and a balanced budget in 2019, sizeable COVID-19 crisis mitigation measures contributed to deficits of 8.0% of GDP in 2020 and 4.1% of GDP in 2021. The general government deficit decreased to 3.2% of GDP in 2022, helped by the effects of high inflation in terms of boosting revenue and keeping spending increases below the rate of nominal GDP growth. The deficit thus turned out substantially below the revised target of 3.8% of GDP in the November 2022 amending budget, despite very substantial liquidity support to the state-owned energy utilities *Elektroprivreda Srbije* (EPS) and *Srbijagas* (amounting to a total of around 2.7% of GDP) and a series of ad hoc support measures to the private sector implemented throughout the year. This concerned in particular direct lump sum cash payments to young people aged between 16 and 30 (0.4% of GDP), increased family allowances and assistance for mothers to buy real estate (0.2% of GDP) and increased agricultural subsidies (0.2% of GDP). However, while this had been stipulated in the jointly agreed policy guidance in May 2022, no measure was taken to increase the coverage and adequacy of benefits for individuals and families under the financial social assistance scheme to reduce poverty. At the same time, the phasing-out in 2022 of the COVID-19-related 2021 fiscal support measures helped contain overall expenditure growth in 2022 at 11% year-on-year, which was lower than the 13.4% increase in revenue. Expressed as a share of GDP, total revenue increased by 0.1 pps, while total spending decreased by 0.9 pps due to very high nominal GDP growth. Part of the fiscal support could have been better targeted to the most vulnerable households and firms, also in view of the inflationary effect of non-targeted transfers. Notwithstanding the crisis context, capital spending decreased only slightly from a record level of 7.5% of GDP in 2021 to 7.2% of GDP in 2022 and was budgeted at 6.8% of GDP for 2023. The 2023 budget targets a further 0.5 pps reduction of the fiscal deficit to 3.3% of GDP (as compared to the projected 2022 out-turn of the November 2022 amending budget) which would however correspond to a slight increase as compared with the 2022 out-turn of 3.2% of GDP. The September 2023 amending budget revised downwards the 2023 fiscal deficit target to 2.8% of GDP, using the fiscal space from reduced support to state-owned energy utilities and increased excise duties for a series of expenditure measures, including higher subsidies for agriculture, a one-off lump-sum payment to children and extraordinary pension and wage increases for teachers and nurses. Two days after the adoption of the amending budget, a new one-off payment to pensioners was announced.

Graph 8.3: **Serbia - Fiscal developments**



Source: National sources

Following a crisis-induced increase in 2020 and a moderate fall in 2021, public debt continued on a downward path in 2022. The general government debt-to-GDP ratio had fallen from a peak of over 70% in 2015 to 53% in 2019 and thus moved closer to the ceiling of 45% laid down in the fiscal rules of the budget system law. After an increase to 57.8% in 2020, as a result of the high COVID-19 crisis-induced deficit, and broad stabilisation at 57.1% in 2021, the debt ratio fell to 55.6% in 2022, particularly supported by high inflation. Due to less favourable conditions on international and domestic financial markets, Serbia did not issue any Eurobonds in 2022 to cover the increased financing needs related to costly energy imports, but concluded the EUR 2.4 billion 2-year SBA with the IMF with an immediate disbursement of EUR 1 billion in December 2022 and secured a bilateral loan from the United Arab Emirates of USD 1 billion, which was also disbursed in December 2022. On 19 January 2023, in view of some stabilisation of financing conditions on international markets, Serbia issued a USD 1 billion 10-year Eurobond and a USD 750 million 5-year Eurobond at coupon rates of 6.25% and 6.5%, respectively.

Fiscal governance reforms have progressed well, particularly as regards the adoption of revised fiscal rules. Revenue collection surpassed expectations in the 2 years preceding the COVID-19 crisis and performed well throughout 2020-2022, supported by increasing inflation and continuous improvements in the tax administration. Following a delay of several years (due in part to the COVID-19 crisis), a new system of fiscal rules was adopted in December 2022. The central rule consists of a general government deficit ceiling depending on the level of debt32. The deficit rule will however only enter into force in 2025 because specific deficit targets for 2023 and 2024 had already been agreed in the SBA with the IMF. The new rules also include a cap on the general government wage bill at 10% of GDP and a modified rule for pension indexation for which the calculation methodology will vary according to the ratio of pension expenditure to GDP. While their enforcement mechanism may need to be strengthened, the new rules are reasonably credible and binding due to their relative flexibility at lower debt levels / lower shares of pensions/salaries relative to GDP. However the announcement in June 2023 of an extraordinary pension increase in October 2023 going beyond the new indexation formula seriously weakens the credibility of the new pension indexation rule already in its first year of application. The public sector wage system reform has been postponed to 2025, but the new central electronic public wage and employment registry (Iskra) became operational for some sectors in 2022 and is planned to be rolled out to most of the public sector (except military, security and higher education institutions) by the end of 2023 as an important preparation for the reform. In the absence of a comprehensive wage system reform, another ad hoc extraordinary increase (25% as against the 12.5% general increase of public sector wages) has been implemented for military personnel as of January 2023 and a further ad hoc 5.5% extraordinary increase for some categories of workers in education and health as of September 2023 has been included in the September 2023 amending budget. Progress in addressing weaknesses in budget planning and implementation has been slow. The November 2022 amending budget was adopted using the urgent procedure, but the 2023 budget adoption was broadly in line with the normal legislative procedure (albeit with some delay). The September 2023 amending budget was again adopted under urgent procedure. Neither the 2022 amending budget nor the 2023 budget provided an adequate level of transparency regarding the breakdown of capital transfers and guarantees to SOEs, in particular to EPS and *Srbijagas*. The Fiscal Strategies are subject to frequent changes, sometimes within weeks after their adoption, thereby undermining the credibility of these strategic fiscal documents. There was a meaningful parliamentary debate on the 2023 budget and the government also submitted to Parliament the final annual budget execution report for 2021. The well-established Fiscal Council has continued to function properly and produce independent fiscal assessments and recommendations.

The macroeconomic policy mix has remained overall appropriate. It helped sustain macroeconomic stability and supported the resilience of economic activity in the face of successive shocks. Prudent fiscal policy before the COVID-19 crisis created the policy space for sizeable fiscal support to mitigate the impact of the COVID-19 and energy crises while maintaining macroeconomic stability. Monetary policy reacted to surging inflation via steady gradual monetary tightening. The acceleration of economic reforms and their full implementation remain key to ensure a sustainable recovery and further strengthen the economy's potential in terms of competitiveness and inclusive growth, thereby supporting real convergence with the EU.

[32] 3% of GDP if debt is below 45% of GDP; 1.5% of GDP if debt is below 55% of GDP; 0.5% if debt is below 60% of GDP and 0% if debt is above 60% of GDP.

Functioning of product markets

Business environment

Serbia has in recent years reduced the regulatory and administrative burden on businesses, but some weaknesses remain. Some business procedures have been significantly simplified and their cost reduced, but many burdensome administrative procedures remain, especially for small and medium-sized enterprises (SMEs). Local firms have to make 33 tax payments per year, twice as many as in the regional peers. The many parafiscal charges remain high and non-transparent, lacking rationalisation, thus undermining the predictability and stability of Serbia's tax system and hampering economic development. The business community generally considers the Law on foreign exchange transactions to be too restrictive in its design and unpredictable in its application. In 2022, the number of registrations of new legal business entities rose by 16.7%, while the registrations of solo entrepreneurs rose by 21.8%. In 2022, 19.4% more legal entities and 4.8% more entrepreneurs were deleted from the register than in 2021. The implementation of the action plan for the simplification of administrative procedures further advanced through the optimisation, digitalisation or discontinuation of administrative procedures as well as the establishment of a single public register of administrative procedures. In May 2023, Serbia introduced mandatory online company registration, which should contribute to reduce the costs and the time of setting up a company.

The legal framework is prone to unexpected and significant changes, which can be detrimental to business. Business predictability is negatively affected by the lack of full transparency in the adoption of legislation. Government decisions in a number of business-relevant areas are still often taken without proper consultation with businesses and social partners and under too short time constraints. This includes numerous temporary trade restrictions and price caps introduced by Serbia throughout 2022 (*see also Chapter 30 on external relations*) with little or no notice, thus negatively impacting the stability of supply-chains, and further hampering the predictability for businesses and investors.

Further efforts are needed to improve the quality, independence and efficiency of the justice system. An efficient and independent judicial system is a prerequisite for a predictable investment- and business-friendly environment, and is necessary in order to encourage innovation, attract additional foreign direct investment, and secure tax revenues. Businesses also raise the issue of the lack of reliability in contract enforcement, as well as lack of expertise among judges, particularly in complex areas of law such as competition, intellectual property, or taxation, which leads to inconsistency in rulings. Moreover, the business environment remains hampered by red tape, political interference and limited public administration efficiency. Serbia ranked 101st out of 180 countries in the 2022 corruption perception index compiled by Transparency International, thus continuing the negative trend of rankings that have been steadily deteriorating since 2018 when Serbia ranked 87th.

Despite some progress, the widespread informal economy remains a major impediment to the development of a strong corporate sector and the consolidation of a functioning market economy. Driving forces behind the informal economy include high taxes and social security contributions on the lowest salaries leading to a notably regressive tax wedge, a lack of financial resources and favourable loans, parafiscal charges, hidden tax fees and red tape. The consequences are tax evasion, market distortion, unfair competition and inefficient resource allocation. Notable investment has been made to reduce the size of the informal sector, but the pace of reform is slow. The full entry into force of the Law on fiscalisation and amendments adopted in December 2022, as well as the full implementation of the Law on electronic invoicing as of January 2023, has finalised the introduction of the e-fiscalisation and e-invoicing systems, which provide for real-time tracking of the issuance of fiscal receipts, thereby enabling the Tax Administration to better monitor and counter tax evasion. Taxpayers fully adopted the e-fiscalisation system by 1 May 2022. The new Law on e-invoicing entered into force on 1 January 2022 and after phased introduction achieved full enforcement of electronic invoicing on 1 January 2023. In March 2023, the government adopted the 2023-2025 Programme for Combating the Grey Economy. The Programme encompasses 23 measures aimed at strengthening the capacity of inspections and misdemeanour courts, improving tax supervision and reporting procedures and fiscal and administrative relief of legal businesses. Further improvements in anti-money laundering/combating the financing of terrorism are ongoing.

State influence on product markets

The legal framework in competition and State aid is largely in line with the EU *acquis*, but implementation needs to be improved. The Commission for Protection of Competition and the Commission for State aid control are operating as legally independent bodies. However, the Commission for State aid control has yet to be substantiated by a consistent and transparent track record. In the area of State aid, well-defined rules are not always implemented due to strong political pressure for financial assistance, channelled to SOEs and large foreign investors. These resources are often substantial and may have a significant impact on competition. State support is not sufficiently transparent, including in the 2023 budget. After a strong growth of reported State aid from 2% of GDP in 2019 to 5% of GDP in 2020, the share of State aid dropped to 3.5% of GDP in 2021. The share of COVID-19-related State aid dropped from 54.4% in 2020 to 28.7% in 2021. In view of strongly rising food and energy prices, the government has maintained a series of temporary price caps for basic food and fuel prices, as well as trade restrictions, since the end of 2021/early 2022, which were regularly prolonged or adjusted throughout 2022 until the end of April 2023 with some exemptions (*see also Chapter 30 on external relations*).

Privatisation and restructuring

Albeit shrinking, the role of the State in the economy remains large and hampers competition while the governance of SOEs recorded limited progress and the restructuring of key utility companies is advancing only slowly. SOEs continue to dominate many sectors, including energy, transport, utilities, telecommunications, infrastructure, mining and extraction of natural resources. Their outsized presence deters private investment and innovation and impedes overall competitiveness. Furthermore, many of Serbia's SOEs do not apply adequate corporate governance rules and operate with low efficiency and high costs. Most public companies continue to rely on direct or indirect State subsidies, and their governance remains under strong political influence. The irregular appointment of acting managers for extended periods, instead of using the standard nomination process, which requires a public competition and certain minimum qualifications criteria, has yet to be addressed. The government continued the implementation of the 2021-2027 strategy on state ownership and management of SOEs, which aims at more sustainable and efficient management of these enterprises, albeit with significant delays. As part of the strategy and the ongoing IMF SBA, the government has committed to improve governance practices in SOEs. This is in particular expected to be tackled through the new Law on SOE management adopted in September 2023, The law has been developed in agreement with the IMF and based on OECD guidelines. The financial performance of SOEs has led to the build-up and materialisation of fiscal risks, particularly in the energy sector. *Srbijagas* is estimated to have received around EUR 1.3 billion in budget support in late 2021 and in 2022, while EPS reported to have suffered losses of up to EUR 630 million in 2022. Overall, SOEs still account for around a sixth of value added and formal employment in Serbia. In 2022, the number of SOEs yet to be addressed through either bankruptcy or privatisation was brought down from 62 to 60[33]. The implementation of the strategy for banks with state ownership continued. The State remains in control of key entities in the insurance sector. Serbia has yet to implement its action plan on gas unbundling adopted in May 2021 and to finalise the certification of *Transportgas Srbija* and *Yugorosgaz Transport* to open the wholesale gas market and third-party access to the gas transmission system.

Functioning of the financial market

Financial stability

Financial stability has been maintained and macro-prudential indicators remained sound. The banking sector's aggregate capital adequacy (regulatory capital to risk-weighted assets) stood at 20.2% at

[33] A Strategic Partnership Agreement between the Serbian Government, majority Russian-owned NIS, and HIP-Petrohemija was signed in December 2021 and the transaction was finalised in June 2023.

the end of 2022, well above the minimum of 8% set by the central bank. Liquidity remained high. The profitability of the banking system increased with improved returns on assets (1.9% at the end of 2022 compared with 1.2% at the end of 2021) and a jump in return on equity (13.9% at the end of 2022, compared with 7.8% at the end of 2021). The non-performing loan ratio further decreased by 0.6pps year-on-year to 3.0% by the final quarter of 2022 before moving up slightly to 3.2% by the end of the second quarter of 2023. The broad stability of the NPL ratio was also supported by regulatory changes in December 2022 to support the restructuring of debt, i.e. to extend the maturity of loans, for those impacted by the economic crisis. The authorities have continued to address legacy non-performing loans in the portfolio of the Deposit Insurance Agency. The central bank and the government continued to implement the 'dinarisation' strategy to boost the use of the local currency in the banking system. However, reflecting some remaining uncertainties related to the crisis, the share of dinar-denominated loans and deposits of both households and firms fell somewhat in 2022. While the share of dinar-denominated loans continued to decline in the first half 2023 (to 34.0% in June), the share of dinar-denominated deposits rose to 41.1%, thereby more than recovering from the temporary fall in 2022.

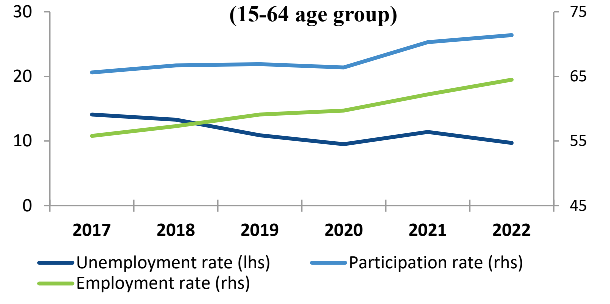
Access to finance

Impacted by monetary tightening, credit activity has slowed down. Credit activity expanded by 7.3% in 2022, but loan growth has been gradually slowing down to a year-on-year rate of 0.8% in June 2023, partly due to the significant increases in the key policy rates by the NBS and the ECB. Credit growth was mostly due to liquidity and working capital loans and housing loans respectively. Foreign-owned (EU-based) banks continued to dominate the financial system, holding around 85% of banking system assets. The continuing consolidation of the banking system via mergers and acquisitions has further reduced the number of banks from 22 at the end of June 2022 to 20 at the end of June 2023. Non-banking financial institutions continue to be largely absent, the legal framework for the leasing sector has still not been reformed, and there was no progress in establishing the legal framework for microfinance institutions.

Functioning of the labour market

The labour market confirmed its post-pandemic recovery, but outward migration and a steady population decline continue to weigh on labour supply. Following the detrimental impact of the COVID-19 pandemic, the labour market recovery continued in 2022, although at a decelerating pace. The unemployment rate decreased by 0.6 pps. year-on-year to 9.2% in Q4-2022. This marks a return to the long-term trend of gradually falling unemployment. Several categories of vulnerable workers benefited from the recovery. Thus, the long-term unemployment rate was down by 0.6pps year-on-year to 3.9% in the fourth quarter of 2022, the youth unemployment rate decreased by 4.4 pps year-on-year to 24.3% in Q4-2022. The share of young people aged 15 to 24 not in employment nor in education or training (NEET) dropped to 11.9% in Q4-2022 (-3.7pps year-on-year) while in the population aged 15-29 the NEET rate decreased to 15.2% (-2.2pps year-on-year). The youth employment-related active labour market policy programme "My first salary" continued for a third cycle starting in late 2022 with around 9,000 participants. Women benefited most from improvements on the labour market (with unemployment rates standing at 8.8% for women against 9.5% for men in Q4-2022) yet continued to be far less active than their male counterparts (47.6% participation rate for women compared with 63.2% for men in the last quarter of 2022). In parallel, the rate of total informal employment in the fourth quarter of 2022 was down 0.9 pps year-on-year to 12.8%. Total registered employment in Serbia increased by 1.6% year-on-year, also supported by the issuance of work permits to foreign workers. However, in structural terms, the labour force may have

Graph 8.4: **Serbia - Labour market trends (15-64 age group)**



Source: EUROSTAT and Statistical Office (SORS) peaked as the declining working age population is taking its toll on labour supply. A steady population decline of around 0.5% every year, along with large-scale emigration across the occupational spectrum remains a key medium- to long-term challenge for economic development. In addition, persistent skills mismatches, the gender employment gap, inadequate activation of young people, and large regional disparities have continued to weigh on the functioning of the labour market. An evaluation of the strategy on economic migration for 2021-2027 and its corresponding action plan for the period 2021-2023 is needed to assess its impact on returnees and circular migration and to identify and take appropriate action.

Real wages have stagnated, mostly due to high inflation. The average real net wage decreased by 1.5% year-on-year in March 2023 as the average nominal net wage increase of 14.5% year-on-year was more than offset by high inflation. The authorities have continued to gradually reduce the overall tax wedge by increasing the non-taxable part of salaries from RSD 19 300 to RSD 21 712 as of 2023. However, the tax wedge is still disproportionally high for people with low salaries and therefore aggravates in-work-poverty. It also continues to be an impediment for the formalisation of labour. In line with expectations for the overall increase in wages, the government increased the minimum hourly wage by 14.3% in 2023, to RSD 40 020. Around one in six registered employees receives the minimum wage.

8.2. THE CAPACITY TO COPE WITH COMPETITIVE PRESSURE AND MARKET FORCES WITHIN THE UNION

Serbia is **moderately prepared** and has made **some progress** in coping with competitive pressures and market forces within the EU. The structure of the economy improved further and economic integration with the EU remained high. However, the quality and relevance of education and training does not fully meet labour market needs. Public investment has remained at a high level with the aim to address serious infrastructure gaps after years of underinvestment. SMEs still face a number of challenges, including an uneven playing field as compared with large companies and foreign investors. Last year's recommendations have been partially implemented and remain partly valid.

In the coming year, Serbia should in particular:

→ further tailor education and training to labour market needs, in particular in the area of vocational education and training;

→ ensure a harmonised approach for prioritising and monitoring all investments and basing investment decisions on feasibility studies, cost-benefit analysis and environmental impact assessments, and apply to all projects the principles of competition, equal treatment, non-discrimination and transparency in public procurement and State aid procedures in line with the EU *acquis*; and

→ advance on the green energy transition in particular through decarbonising the industry especially in the energy sector; increase investments into renewables and energy efficiency supported by cost-recovering tariffs; accelerate implementation of the action plan on gas unbundling and decrease its energy dependence on Russia.

Education and innovation

Despite some progress, the quality and relevance of education and training does not sufficiently meet labour market needs. Public spending on education stood at around 3.3% of GDP in 2021, below the EU average of 4.7%. Pre-primary school enrolment (age 0 to 5 years) was at 47% in 2021, while compulsory education is almost universal although showing downward trends. The high proportion of early school leavers (young people aged 18-24 who at best completed primary education and did not pursue further education) continues to be a problem and amounted to 5.1% in the third quarter of 2022. Lower secondary school education results for 15-year-olds lag behind the EU average, although Serbia’s PISA rating is the best in the Western Balkans and its average scores are close to those of some EU

Member States (Bulgaria, Greece and Romania). Higher education attainment in the population aged 25-34 (ISCED levels 5-8) stood at 33.9% in 2021. The authorities are gradually updating both the general and vocational pre-university curricula to make them more relevant to labour market needs, at the same time consolidating the national qualification framework set-up. The adoption of new qualification standards and/or modernisation thereof has continued at a slow pace, with a strong focus on higher education. Efforts have been made to expose students to work-based learning under both upper secondary and higher vocational education and training. As participation rates in lifelong learning are traditionally low (4.8 % in 2021), the offer of formal and informal learning would usefully be further diversified and promoted among both the working and non-working adult population.

Serbia has a relatively good scientific base but research and development spending remains low at around 1% of GDP. Government funding was stable at around 0.4 % of GDP. The lack of human resources for research and development and weak cooperation between businesses and academia continue to present problems. To increase innovation and scientific research, Serbia continues to support the Innovation fund and the Science fund that are running numerous specialised financing instruments and grant schemes. Five years after a science and technology park was established in Belgrade, three additional ones have been established in Novi Sad, Čačak and Niš but further support services for these institutions are still needed. The smart specialisation strategy, the industrial policy strategy, the strategy for the development of start-up ecosystems and the strategy for the development of artificial intelligence are all being implemented.

Physical capital and quality of infrastructure

Investment has remained high, with significant emphasis on road and rail infrastructure, but infrastructure gaps remain. Public investment decreased slightly from a record level while private investment broadly stagnated in 2022. The economy is attracting significant net foreign direct investment flows which stood at 6.9% of GDP in 2021 and 7.1% of GDP in 2022. Outward investments of Serbian companies abroad remained very modest. The share of total investment in the economy increased to 22.8% of GDP in 2022, up from 17.7% of GDP in 2017. However, physical infrastructure needs further upgrading and expansion. A continued high level of public investments is planned in 2023, particularly in railways, roads, including local and regional roads, energy infrastructure, and also environmental investments.

The institutional framework for public investment is weak. The 'user pays' principle is not sufficiently applied when it comes to maintaining existing infrastructure and implementing new infrastructure investment plans. The legislative framework for public investment management put in place in July 2019 provides a basis for a sounder project selection process, better prioritisation and more comprehensive planning across different tiers of the government. However, the framework allows too many exemptions to the rule, which significantly reduces its effective impact. Public procurement rules are not always fully compatible with EU standards, particularly in the case of intergovernmental agreements. Moreover, the existing public procurement rules are not always fully complied with, as also evidenced by an increasing number of irregularities.

The energy sector remains largely inefficient and highly polluting; the regulatory and green transition reforms are progressing slowly. Energy infrastructure is largely outdated and many individual heating systems use wood and coal as fuel, contributing to the energy sector being the main source of air pollution in Serbia. The decarbonisation of the energy sector, the need to increase the use of more renewable sources, and restructuring of SOEs dominating the sector remain a big challenge, and investments in the green energy transition are progressing too slowly. In June, Serbia adopted amendments to the Law on renewables and launched the first call for auctioning of new renewable sources. Serbia has yet to adopt its national integrated energy and climate plan and an energy strategy. Electricity tariffs for households have been gradually increased including under the SBA agreed with the IMF. However, prices remain below market prices and should increase in line with the SBA to cover costs, and subsequently to support the necessary investment in infrastructure. Serbia remains dependent on its single gas supplier Gazprom and the Russian majority control of Serbia's gas infrastructure and oil industry continued. However, in order to reduce the dependence on Russian gas, work on the gas interconnector between Serbia and Bulgaria has advanced and construction of an interconnector with North Macedonia is under preparation. Implementation of the action plan for the unbundling of state-owned enterprise *Srbijagas* is still pending. The Balkan stream gas pipeline section in Serbia is operational but there is no third-party access.

Serbia has made good progress on digital transformation across the economy. Digitalisation remains a key priority for the government. The action plan under the 2023-2025 e-government development programme was adopted in April 2023, with the objective to improve the quality of public services by ensuring interoperability, efficient coordination, project management and legal certainty over e-government use, and to foster the use of open data. The e-government national portal is continuously upgraded with new services, serving as a one-stop shop for e-government services and as a central point of access for businesses and citizens. Serbia's communications infrastructure still requires systematic improvement of both regulation and investment. Broadband roll-out is too slow, preventing the uptake of e-government and business services, and slowing down the digital transformation of the economy. There was some progress with the connection of public institutions and 150 000 households to fast broadband and speeds of 100Mbps. Supported by the inflow of Russian citizens to Serbia, the robust growth of the information and communication sector continued, with exports of ICT services in 2022 valued at EUR 2.7 billion, an increase of 45% compared with 2021.

Sectoral and enterprise structure

Manufacturing has decreased its weight in the economy over recent years while the share of construction and some services has risen and the share of agriculture has broadly stabilised. The manufacturing industry continues to be the single largest sector in terms of its share of GDP, at 13% in 2021, although on a declining trend over the years. It is followed by wholesale, retail and vehicle repair accounting for 11.8% of GDP in 2021, on an increasing trend. Services sectors dominate the economy, together providing more than 60% of total value added. Reflecting a new investment cycle, the construction sector increased its share in GDP from 3.0% in 2013 to 6.0% in 2021 (up from 5.4% in 2020), strongly supported by capital investments in infrastructure. The weight of the agricultural sector has broadly stabilised at around 6.3% of GDP since 2017 after a downward trend over the previous few years. The share of agriculture in total employment continued to fall steadily from about 20% in 2014 to around 17% in 2017 and further to around 15% in 2021. In 2022, construction and the agriculture sector had a negative impact on GDP growth, impacted in particular by increased costs of inputs, lower credit activity and the drought.

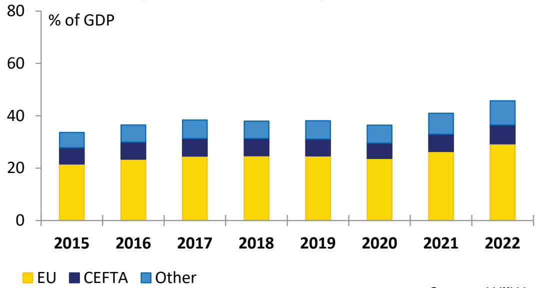
Small and medium-sized enterprises (SMEs) are the backbone of the Serbian economy. The SME sector provides close to 60% of total employment and turnover in the economy, and around 50% of the value added. SMEs are particularly active in construction, accommodation and food services, retail, and real estate. The authorities are implementing several programmes to support SME development, focusing on boosting innovation, finance, and internationalisation. Loans to SMEs accounted for about 60% of total corporate loans in December 2022. Their cost of borrowing has increased significantly due to increases in the key policy rates to combat inflation, and remains significantly higher than that of large companies. SMEs still face a number of challenges, including an unpredictable business environment, a lack of non-bank financing and high tax compliance costs. SMEs often face an uneven playing field as large enterprises and foreign investors often have direct lines of communication to the government and benefit much more from state subsidies, thus enjoying an advantage over domestic SMEs.

Economic integration with the EU and price competitiveness

Economic integration with the EU remained high. The EU remains Serbia's biggest trading and investment partner, accounting for 58.7% of its total trade and for 32.9% of foreign direct investment inflows in 2022. Total bilateral trade between the EU and Serbia increased significantly, by 27.7% year-on-year, from EUR 30.6 billion in 2021 to EUR 39.1 billion in 2022. Serbian imports from the EU grew at a somewhat faster pace than exports to the EU, with the EU registering a surplus of EUR 3.7 billion in 2022. After the EU, Serbia's main trading partners in 2022 were the signatories of the Central European Free Trade Agreement (10.3% of total trade), China (8.7%), Russia (5.8%) and Bosnia and Herzegovina

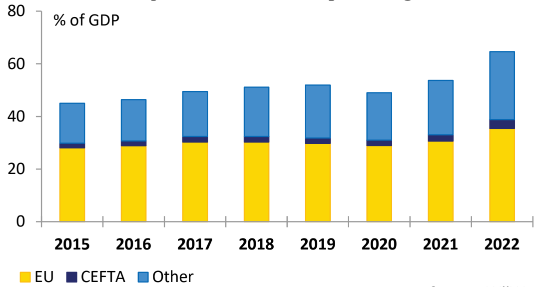
(5.3%). Foreign direct investment inflows, of which typically around two thirds originated from the EU in 2010-2020 (and close to 90% from Europe), have partially shifted towards growing inflows of around one quarter from China in 2021-2022. Notwithstanding ongoing remedy efforts via online health and customs clearance, transit facilitation through international cooperation agreements and the regional green corridor (EU, CEFTA, Western Balkans and Türkiye), there are still significant bottlenecks at border crossing points with neighbouring EU countries; these hamper the potential for deeper trade relations and economic integration with the EU. Trade openness, after a steady increase from 92% of GDP in 2014 to 111.5% in 2019, decreased to 103.9% in 2020 due to the COVID-19 crisis, before rebounding strongly to 115.6 % in 2021 and 137.6% in 2022.

Graph 8.5a: **Serbia - Exports of goods**



Source: WiiW

Graph 8.5b: **Serbia - Imports of goods**



Source: WiiW

The real effective exchange rate has been on an appreciating trend in recent years. The dinar-euro nominal exchange rate remained broadly stable in 2022 and the first half of 2023, as pressures on the dinar were successfully neutralised by the central bank. As regards the CPI-based real effective exchange rate REER, after a depreciation in the period 2014-2016 cumulatively by almost 9%, 2017-2018 saw an REER appreciation of around 7%. After depreciating slightly in real terms in 2019 (0.2%), the dinar continued to appreciate, by 3.5% cumulatively in 2020-2021 (almost in equal amounts in both years). The appreciation trend continued in 2022 (1.1%) and accelerated strongly in the first half of 2023 due to the significant inflation differential with main trading partners. The unit labour cost (ULC)-based REER depreciated cumulatively by around 8% in the period 2014-2016, while in the period 2017-2019 REER appreciated by around 17% cumulatively, mostly due to wage growth in the private sector. The trend has continued in recent years, resulting in ULC-based REER appreciation of almost 8% in 2020, 4% in 2021 and 9% in 2022. According to the latest IMF external sustainability assessment (done in June 2023), the exchange rate was considered broadly consistent with the fundamentals.

9. TÜRKIYE

9.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

The Turkish economy is **well advanced** but made **no progress** over the reporting period. Serious concerns persist over the continued proper functioning of Türkiye's market economy. There has been prolonged backsliding on important elements, such as the conduct of monetary policy and the institutional and regulatory environment over most of the reporting period. Since the May parliamentary and presidential elections, the authorities have taken some steps to revert to more stability-oriented macroeconomic policies.

Although economic growth remained robust in 2022, Türkiye moved further away from market-oriented policies, which weakened its economic fundamentals and increased vulnerabilities and risks. Inflation decreased somewhat but remained very high as monetary policy prioritised exceptionally low interest rates, which remain deeply negative in real terms and are sustained by a web of regulatory and prudential measures. After the presidential and parliamentary elections in spring 2023, monetary policy has started to tighten, also signalling a gradual simplification of the macroprudential framework. The current account deficit increased to 5.4% of GDP in 2022, driven by a negative terms-of-trade shock and large imports of non-monetary gold. The relatively good budget performance in recent years masks an underlying trend of growing fiscal risks. The authorities' commitment to fiscal discipline wavered, as the fiscal stance turned pro-cyclical in 2023, with earthquake-related expenditure pressure adding to pre-electoral budgetary largesse. However, the fiscal stance was tightened after the elections and a revised budget, including sizeable tax increases, was adopted in July.

The institutional and regulatory environment lacks predictability and transparency, and complicates the post-electoral economic policy normalisation. Market exit remains costly and slow. However, Türkiye made progress in digitalising government services to businesses. Although the size of the informal economy has fallen in recent years, it still accounts for a significant share of economic activity. State intervention in price-setting mechanisms persists. The provision of State aid lacks proper implementation rules, enforcement and transparency. The banking sector remained broadly stable but is facing financial stability challenges due to the numerous overly complex and far-reaching macroprudential and regulatory measures. The labour market strengthened further, although structural challenges remain significant, in particular for youth and female employment. Regional labour market disparities declined and reached one of the lowest levels in years. The recent net minimum wage increases were pro-cyclical.

The Commission's recommendations from 2022 were not fully implemented and remain valid. In order to improve the functioning of the market economy, Türkiye should in particular:

→ restore the independence of the central bank and tighten monetary policy in order to reduce inflation sustainably towards the target;

→ develop a credible medium-term fiscal consolidation plan that underpins a gradual return to primary surpluses, while accommodating transparent reconstruction spending and addressing fiscal risks, including from contingent liabilities;

→ further improve the business environment, including by reducing State interference in price-setting mechanisms, simplifying the macroprudential and regulatory framework, and enhancing the transparency and control of State aid.

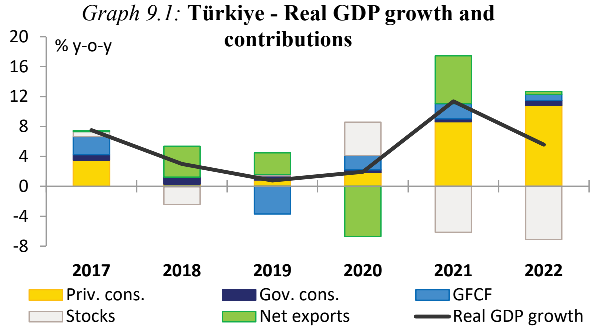
Economic governance

Türkiye moved further away from market-oriented policies, weakening economic fundamentals and increasing risks, but has taken some steps to reverse this course since the May elections. Monetary policy prioritised maintaining deeply negative real interest rates, despite soaring inflation and tightening global financial conditions. This necessitated the adoption of far-reaching macroprudential and regulatory measures that have disrupted the functioning of the financial markets and increased vulnerabilities. However, the central bank has started to tighten monetary policy after the presidential and parliamentary elections in spring 2023, also signalling a gradual simplification of the macroprudential framework. Fiscal policy turned strongly expansionary in the first half of 2023, with earthquake-related expenditure pressure adding to pre-electoral budgetary largesse. Ad hoc policy measures have increasingly become the norm, undermining, in conjunction with high macroeconomic instability, the credibility of medium-term planning. A budget rebalancing and large tax hikes in July have sought to limit the bulging budget deficit. Subsidies and transfers to curb the effects of Russia's war of aggression against Ukraine increased significantly in 2022 but are planned to decline in 2023. Türkiye has not joined the EU restrictive measures against Russia and continued to benefit from its extensive and growing trade relations with it, particularly in energy, tourism and agriculture. The implementation of the policy guidance set out in the conclusions from the Economic and Financial Dialogue of May 2022 has been limited.

Macroeconomic stability

Türkiye's economic growth remained upbeat but unbalanced. Real GDP grew by 5.5% in 2022, which was above the five-year average (2018-2022) of 4.5%, although, after a strong first half of the year, it decelerated in the second half. It expanded further in the first half of 2023 and growth even strengthened a bit, despite the devastating February earthquakes. Domestic demand, in particular very strong household consumption fuelled by pre-election expenditure, remained the main driver of this. Net exports' contribution to growth turned negative in the second half of 2022, following a loss in export momentum and a pick-up in imports, which worsened further in early 2023. Inventories continued to wind down and very weak construction investment pulled down total investment growth last year. A notable expansion of technology-intensive and export-oriented sectors lifted industrial production to record high levels in 2022. The 6 February earthquakes caused a tragic loss of life and significant destruction of capital assets. High frequency indicators captured the first negative economic effects of the earthquakes already in February, with steep monthly falls in industrial production and retails sales, and declining economic confidence. However, economic activity rebounded quickly in the following months and consumer confidence increased sharply to levels not seen in 5 years, before steeply falling back in the aftermath of the elections. Due to Türkiye's relatively strong performance during the COVID-19 crisis, income convergence with the EU resumed, with per capita GDP in purchasing power standards rising to 69% of the EU average in 2022 from 59% in 2019, and above its 2015 high of 68%.

Graph 9.1: **Türkiye - Real GDP growth and contributions**



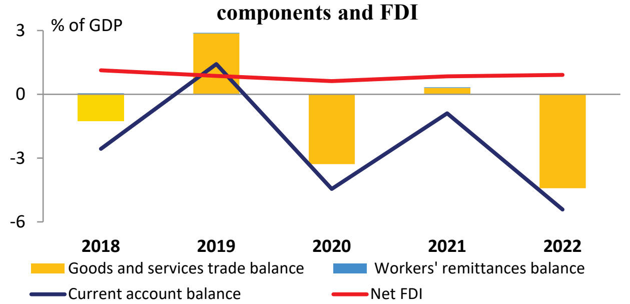
Source: WiiW

Table 9.1: **Türkiye - Key economic figures**	**2014-19** average	**2020**	**2021**	**2022**
GDP per capita (% of EU-27 in PPS)[1)]	65	61	63	69
Real GDP growth	4.3	1.8	11.4	5.6
Economic activity rate of the population aged 15+ (%), total	52.1	49.3	51.4	53.1
female	*32.8*	*30.9*	*32.8*	*35.1*
male	*72.0*	*68.2*	*70.3*	*71.4*
Unemployment rate of the population aged 15+ (%), total	11.1	13.2	12.0	10.4
female	*13.8*	*15.0*	*14.7*	*13.4*
male	*9.9*	*12.3*	*10.7*	*8.9*
Employment of the population aged 15+ (annual growth %)	2.3	-4.8	7.9	6.7
Nominal wages (annual growth %)	16.5	18.0	19.3	73.2
Consumer price index (annual growth %)	11.2	12.3	19.6	72.3
Exchange rate against EUR	4.2	8.0	10.4	17.4
Current account balance (% of GDP)	-2.7	-4.5	-0.9	-5.4
Net foreign direct investment, FDI (% of GDP)	1.1	0.6	0.8	0.9
General government balance (% of GDP)	-2.0	-2.9	-2.3	-1.1
General government debt (% of GDP)	29.0	39.7	41.8	31.7

Notes :
1) Eurostat
Source: national sources

External imbalances increased and remained a major vulnerability. The current account deficit swelled to 5.4% of GDP in 2022 and increased further in the first half of 2023 to more than double its average in 2018-2022, as the negative terms-of-trade shock and large imports of non-monetary gold (a traditional safe asset in times of policy uncertainty in Türkiye) drove the trade deficit back into double digits for the first time in a decade. However, excluding gold and energy trade, the current account recorded a 5% surplus. The high external deficits remain a key macroeconomic vulnerability, aggravated by the strong reliance on short-term borrowing, a very high sovereign risk premium and the low level of foreign exchange reserves (with a large share in non-core foreign currencies). The central bank's net foreign assets even turned negative in April as it used its reserves to defend the exchange rate before the elections. Reflecting deteriorating market perception of domestic economic policy, the five-year credit default swap has been high and very volatile. After peaking in the summer of 2022 above 900 bps (basis points), it declined to between 500 bps and 600 bps by the end of the year before spiking again following the presidential and parliamentary elections in the spring of 2023. External debt remained moderately high at around 50% of GDP in early 2023, decreasing from the peak of 60% of GDP that it reached during the COVID-19 crisis. However, the debt stock remains sensitive to the lira's exchange rate fluctuations and its structure worsened as economic agents increased their reliance on short-term funding as a response to rising refinancing costs. Banks' increased exposure to foreign currency swaps with the central bank raises economy-wide foreign currency liquidity concerns. The external debt roll-over ratios have been stable at close to 100% for the banking sector but have rapidly come down under 100% in early 2023 (albeit from high levels) in the non-banking sector. The non-financial sector's foreign exchange deficit remained broadly unchanged at less than 10% of GDP and its short-term position remained positive – important

Graph 9.2: **Türkiye - Current account selected components and FDI**

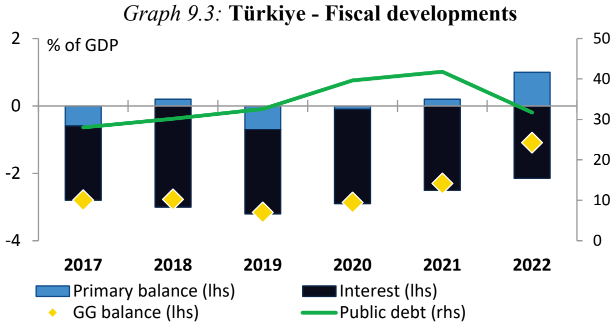


Source: IMF and Central Bank of Türkiye factors attenuating external vulnerability.

Inflation remained high as, before the elections, monetary policy prioritised the maintenance of exceptionally low interest rates sustained by an expanding web of regulatory and macroprudential measures. Inflation peaked at 85.5% in October 2022. It declined steeply in the following months on the back of sizeable base effects before rebounding again since June, exceeding the 5% target by a very large margin. Before the elections, inflation targeting and the free-floating exchange rate were effectively no longer the guiding framework of monetary policy. The monetary policy transmission mechanism was broken, with limited responsiveness by key market interest rates to the central bank policy rate. Despite very high inflation and tightening global financial conditions, the central bank lowered its key policy rate in the autumn of 2021 and cut it further in several steps by a cumulative 1 050 bps to 8.5% in February 2023 (the last 50 bps cut was delivered after the earthquakes). To sustain the resulting deeply negative real-interest rate and alleviate its policy contradictions, the authorities have introduced an increasingly complex web of regulatory and macroprudential measures to reduce dollarisation, support the lira, lower inflationary pressures, ration and direct credit, and cap interest rates. This set of measures achieved some short-term results but failed to address the fundamental drivers of high inflation; namely deeply negative real interest rates, the absence of an effective policy anchor and the lack of institutional independence of the central bank and key agencies. After depreciating by 40% against the US dollar in the first three quarters of 2022, the lira remained broadly stable before resuming its depreciation trend in early March 2023, which intensified (along with exchange rate volatility) after the May elections. Starting in June and under the guidance of a new central bank governor, the central bank increased the key policy rate to 25.0% in August and signalled a gradual further tightening of monetary conditions and simplification of the existing micro- and macroprudential framework.

The authorities' commitment to fiscal discipline wavered and the fiscal stance turned pro-cyclical in early 2023, necessitating the adoption of a revised budget in July. The budget continued to outperform expectations, ending 2022 with a central government budget deficit of 0.9% of GDP – significantly below the revised budget target of 3.4% and the previous year's deficit of 2.8% of GDP. The general government deficit fell to 1.1% of GDP, which was also far below the expected 3.2% of GDP. The initial 2023 central government budget targeted a deficit of TRY 659.4 billion (3.5% of GDP) but was based on a rather optimistic macroeconomic assumption of 5% real GDP growth and 24.9% average consumer price inflation. Total revenue was planned to increase by 36.0% and expenditure by 52.0% in comparison with the 2022 budgetary outcome. The budget introduced some new measures but failed to fully exit the 'crisis mode' of ad hoc decisions. On the revenue side, the 2% accommodation tax adopted in 2021 started to be applied at the beginning of 2023. The corporate income tax rate has been lowered as planned to 20%. Government expenditure increased strongly in early 2023 due to the elections and the earthquakes. The government budget continued underwriting costly and poorly targeted measures to support the lira and cushion the impact of high energy prices, although lower-than-expected international gas prices and financial repression measures that forced domestic banks to increase their holdings of government bonds led to some savings. Some spending measures with a large budgetary impact (including public wage and pension hikes, and the removal of the age requirement for early retirement) were finalised after budget adoption and were not fully reflected in the original budget. The fiscal stance was tightened after the elections. A revised budget was adopted in July, including multiple and sizeable tax increases (VAT, corporate income tax, special consumption tax, motor vehicle tax, etc.) and additional expenditure to cover earthquake reconstruction needs and pre-election spending measures.

Graph 9.3: **Türkiye - Fiscal developments**



Source: National sources

The relatively good budget performance in recent years masks an underlying trend of growing fiscal risks. The government debt ratio peaked at 42.3% of GDP in early 2022 but came down to 31.2% of GDP in early 2023, helped by the strong denominator effect from the very high level of inflation. Concerted 'liraisation' efforts increased the share of new domestic borrowing in lira to 90% in 2022. Nonetheless, two thirds of the total debt stock remains denominated in foreign currencies, while the average time to maturity of the debt stock remained unchanged at 5.4 years, as external debt maturity decreased for the fifth year in a row. Some measures, such as the FX-guaranteed lira deposits, had a direct and sizeable impact on the budget and are a significant source of (contingent) budget liabilities, even after they were fully transferred to the central bank in July. Successive crises and shocks triggered the adoption of numerous ad hoc measures with budgetary effects that have strained public finance management. The multiple and sizeable tax exemptions and reductions undermine tax bases and complicate planning, while successive tax amnesties have become the rule rather than the exception, despite official policy declarations. The planned new single consolidated framework for all public-private partnerships has yet to be adopted. Even though fiscal performance has been consistently robust in recent years, there are still no national fiscal rules or independent fiscal institutions to monitor fiscal performance. The medium-term budget framework is subject to frequent changes and is not sufficiently credible and binding.

The macroeconomic policy mix remained largely focused on the pursuit of growth at the expense of rising economic vulnerability. Fiscal policy turned expansionary in early 2023, despite the very high level of inflation and large external imbalances. The maintenance of deeply negative real interest rates by the central bank and the complex web of regulatory and macroprudential measures to sustain them created major vulnerabilities, led to market fragmentation and disrupted price signals. The low level of policy credibility and institutional weaknesses (including the lack of central bank independence) undermine the effectiveness of the policy mix and hinders the post-electoral economic policy normalisation.

Functioning of product markets

Business environment

The institutional and regulatory environment is characterised by weaknesses in transparency, predictability and rule-based implementation. The government's highly interventionist pre-election policy increased uncertainty and volatility on the product and financial markets. Türkiye lacks a mechanism for systematically consulting business organisations and social partners during the preparation of new legislation. Intellectual property right enforcement continues to be very weak. According to the e-Government Benchmark report of the EU for 2022, Türkiye performed above the EU average in enabling regular areas of business operation (such as administrative and tax requirements, human resources and refund of VAT) on digital platforms, except for those that require cross-border transactions. However, Türkiye's performance is lower in online services for new business, which remain relatively cumbersome. Market exit remained costly and time-consuming due to complicated insolvency procedures. Türkiye digitalised some steps in the insolvency procedure, such as liquidation, but it still takes 1 037 days on average to complete a bankruptcy process through the judicial system. Even though alternative dispute resolution mechanisms have been promoted, commercial judicial processes are slow and a large backlog of commercial court cases remains. The number of newly established businesses increased by 27.8% in 2022, while the number of liquidated companies went up by 26.0% and the number of closed ones by 42.8%. The acquisition and management of companies under the trusteeship of the Savings Deposits Insurance Fund (SDIF) are carried out in a non-transparent manner. In June 2023, the trusteeship of the Fund was managing 620 companies based in 35 provinces across Türkiye, with a total asset value of TRY 128.9 billion and 27 213 employees.

The informal sector's share in the economy declined but remains structurally high and well above the OECD and EU averages. In 2022, the share of unregistered employment fell to 26.8% from 34.8% in 2019, while in the non-agricultural sector it was down to 16.8% from 23.3%. The government announced its new action plan for the fight against the informal economy (2023-2025) in December 2022. The plan includes 44 actions to measure the size of the informal economy; raise the level of social awareness and voluntary compliance; improve cooperation and interagency data sharing; adopt legal, administrative and technical measures; and strengthen audit capacity. However, the plan lacks performance indicators to track its implementation progress.

State influence on product markets

The State increased its intervention in the price-setting mechanism of key sectors. More than a quarter of the consumer basket is composed of goods whose prices are set or heavily influenced by public authorities. A 25% upper cap on rent increases was applied until July 2023. A month before the May elections, the Energy Market Regulatory Authority cut electricity tariffs by 15%. Households and places of worship were exempted from natural gas payment for a month and 25 cubic meters have been provided free of charge to citizens starting in June 2023 for the following 11 months. Meanwhile, the regulators have continued carrying out intensive price audits to investigate allegations of unfair pricing and stockpiling, particularly in essential products. The VAT exemption period for new equipment and machinery deliveries to the manufacturing sector for innovation, design and R&D activities was extended until the end of 2024. Following the February 2023 earthquakes, the VAT rate applicable to prefabricated buildings and containers to be delivered to the earthquake zone was reduced from 18% to 1% until 31 December 2023.

State aid transparency and control remains weak. Legislation to implement the State aid law has not been adopted. The newly established Directorate-General for State Aid has not been assigned any enforcement power regarding the State aid law. The lack of implementing legislation and an operational institutional framework mean that this law is not enforceable. Türkiye has not formally set up a comprehensive state aid inventory or adopted an action plan to align all State aid schemes with the EU *acquis*. The current structure of State aid control is neither independent nor operational (see Chapter 8). The committed investment for the 64 supported projects reached TRY 491 billion in May 2023. As is the case for the general incentive scheme, Türkiye has not published data concerning the actual support granted to these projects. Small and medium-sized enterprises (SMEs) benefit from numerous support measures and initiatives in a fragmented way. The SME Development Organisation of Türkiye (KOSGEB) and the Ministry of Industry and Technology conducted evaluations of four more support programmes in the reporting period and published them on KOSGEB's website.

Privatisation and restructuring

The scope of privatisation remained limited. Privatisation receipts increased from USD 413 million in 2021 to USD 504 million in 2022 (less than 0.1% of GDP), with 87.5% related to the sale of real assets. The Turkish Wealth Fund (TWF) holds shares in major companies in the financial (including state-owned banks, Borsa Istanbul and consolidated public insurance companies), telecommunications, petrochemicals, real estate, mining, agriculture and transport sectors. The Law on the Istanbul Financial Centre adopted in June 2022 granted the TWF the right to conduct all business and management operations in the Istanbul Financial Centre area for 20 years, with a managing company established as a joint stock company. The involvement of the TWF through this company means that these operations will be exempted from audit by the Turkish Court of Accounts (*see Chapter 32*). In addition to the numerous immunities granted to the TWF, this law provides a series of new tax exemptions, deductions and incentives. The TWF's total assets increased to TRY 3.2 trillion (44.1% of GDP) at the end of 2021, up from TRY 2.2 trillion (43.6% of GDP) in 2020.

Functioning of the financial market

Financial stability

The banking sector has remained broadly stable but is facing financial stability challenges. The commercial banks' average regulatory capital ratio declined from its peak of 20.4% in early 2022 to 18.7% in July 2023 but stayed significantly above the required minimum. The decline was more pronounced in State-owned banks, whose capitalisation fell to 14.5% in early 2023 – a two-decade low –

despite several recapitalisation rounds in previous years, before rebounding to 16.3% in July. The fall in capitalisation was the result of banks' support for the authorities' economic and development agenda, including in the aftermath of the February 2023 earthquakes. Some of the macroprudential measures to protect capital adequacy have been modified but remain in place (e.g., allowing the use of an outdated FX rate and the suspension of mark-to-market accounting rules). Credit growth, the extremely negative real interest rates and growing collateral valuation brought the non-performing loans ratio down to a new low (falling in July 2023 to 1.6% in the banking sector as a whole and to just 1.0% in the State-owned banks) while loan-loss provisioning increased further. The share of stage 2 loans under close monitoring also declined to below 10%. Bank profitability improved but remained negative in real terms. The average return on assets was 3.7% and return on equity was 49.9% for the banking sector as a whole in 2022, but were only 2.0% and 29.9% respectively in State-owned banks. FX-guaranteed deposits were around a quarter of total deposits in mid-2023, bringing the share of lira-denominated deposits to 57.4% (still below their level a decade ago), while underlying dollarisation increased.

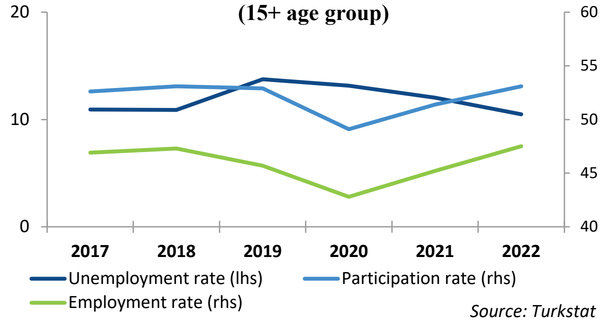
Access to finance

The financial sector operates in an overregulated environment. Far-reaching macroprudential and regulatory measures have disrupted the functioning of the financial markets. Reducing interest rates and keeping them down necessitated additional actions to mitigate the fundamental contradictions of such a policy in a high-inflation environment. A series of incentives and restrictions have been introduced since late 2021, covering: FX-protected lira-denominated deposits; maintenance of a certain share of lira-denominated deposits; reserve and security requirements; collateral in swap and interbank money markets; tax exemptions; FX-surrender requirements for exporters; capital adequacy ratios; risk weighting; and commercial loans. These measures rationed and directed credit, and replaced price signals with quantitative targets or directly socialised risk. As part of the economic policy changes initiated after the elections, the authorities have undertaken some limited steps to gradually simplify the macroprudential framework. After declining in 2022, total lending rebounded in early 2023 (mainly driven by SME, consumer, and credit card loans) but was, at 52.1% of GDP in June, still far below its five-year moving average. Lending to non-financial companies remained largely subdued – except for SME loans, which were supported by regulatory measures. The very high level of inflation led to banking-sector assets falling sharply from 127% of GDP in 2021 to 96% in 2022, while the share of foreign-owned banks in total banking sector assets declined from 25.9 % to 24.9%.

Functioning of the labour market

The labour market strengthened but structural challenges remain significant. Job creation was very strong in 2022 but slowed down in early 2023. In the second quarter of 2023, the seasonally adjusted labour force participation and employment rates reached 53.4% and 48.2% respectively. The labour force moved into more productive activities. There were notable job gains in industry and construction, and particularly large job creation in services, while agriculture continued shedding labour. The shift in employment out of agriculture also caused a decline in the share of workers without social security registration to around a quarter of all employment in early 2023. The seasonally adjusted unemployment rate declined to single digits for the first time in 5 years. However, time-related underemployment and the potential labour force increased from an already high level, indicating labour market slack that is still structurally significant (as evidenced by the 23.5% labour under-utilisation). Women's participation in the labour market continued to increase, although the gap with male participation remained very high (above 35 pps). Türkiye maintained its strong focus on supporting entrepreneurial learning and women's

Graph 9.4: **Türkiye - Labour market trends (15+ age group)**



Source: Turkstat

entrepreneurship. However, job creation lagged and the gap between the male and female employment and unemployment rates widened further. In the second quarter of 2023, the share of young people (15-24 years) not in employment, education or training (NEET) stood at 20.8%, falling across most educational levels. Regional labour market disparities declined and reached one of the lowest levels in years, with the unemployment rate across different regions ranging from 6.2% to 19.2% in 2022. Following two large increases in 2022, the net minimum wage was raised again by 54.6% in early 2023 and by 34.0% in July – pro-cyclical rises that fostered inflation and further disrupted the functioning of the labour market.

9.2. THE CAPACITY TO COPE WITH COMPETITIVE PRESSURE AND MARKET FORCES WITHIN THE UNION

Türkiye has a **good level of preparation** and made **limited progress** in achieving the capacity to cope with competitive pressure and market forces within the EU. Despite improved vocational training, the mismatch between the education system and labour market needs remains a concern. Expenditure on research and development has continued to increase, albeit at a very slow pace, and is still below the government's target. Investment was relatively subdued in 2022. There was progress in the diversification of energy supplies and the share of energy generated from renewable sources increased significantly. However, the local content requirement in the renewable energy generation sector is a discriminatory practice and a cause for concern. Trade openness increased further, but integration with the EU continued falling, although remaining high. Deviations from Türkiye's obligations under the EU-Turkey Customs Union continue to hinder bilateral trade.

The Commission's recommendations from 2022 were not fully implemented and remain valid. In order to improve competitiveness and support long-term growth, Türkiye should in particular:

→ continue increasing enrolment in education (especially pre-education), support the school-to-work transition and the activation of young people who are not in education, employment or training (NEET) NEET and incentivise female labour market participation;

→ take further steps to diversify energy supplies and increase the share of renewables in the energy mix;

→ improve SMEs' access to long-term finance.

Education and innovation

Efforts to improve human capital continued, but skills mismatch remains a key concern. Total expenditure on education was 4.8% of GDP in 2021, representing a real year-on-year decrease of 27.1%. Government spending was 3.4% of GDP in 2021, decreasing further by 0.6 pps from 2020. In the 2021-2022 school year, net enrolment rates decreased for primary education (the first 4 years) but increased for lower secondary education (the second 4 years), upper secondary (the final 4 years) and (marginally) for tertiary education. There has been a significant progress in pre-school attendance (see Chapter 26). However, Türkiye continues to score poorly in educational attainment in the Gender Gap Index calculated by the World Economic Forum, ranking 129th of 146 countries in 2023. The share of students in vocational and technical secondary education has reversed its previous downward trend and increased by 0.6 pps to 28.0% in 2022. The share of pupils in religious education fell below 10% in upper secondary education for the first time in 8 years. It also decreased, albeit marginally to 13.4%, in lower secondary education. Türkiye has the largest skills gap for workers with tertiary education among the OECD countries. There is a persistent mismatch between the skills acquired in the education system and the requirements of the labour market, including those relevant for the digital transformation and green transition.

Investment in R&D increased further, albeit at a slow pace and lagging the EU's performance. R&D expenditure increased gradually from 0.8% of GDP in 2013 to 1.4% in 2021, but the gap with the EU average of 2.3% remains large. The government has intensified its support for business research and innovation, including through tax incentives. The private sector continues to be the main driver of R&D, with a 61.3% share of R&D expenditure. There is still significant room to enhance cooperation between research institutions and economic operators. In the Global Innovation Index 2022, Türkiye's overall score has improved so that it now ranks 37th out of 132 countries, thus entering the top 40 for the first time ever. However, according to the EU innovation scoreboard, Türkiye's innovation score declined from 49.2% in 2021 to 47.7% in 2022 and the performance gap with the EU has widened further. The number of domestic patent applications increased by 6.8% in 2022 by comparison with 2021, but Türkiye's total international patent applications declined significantly by 25.0% in the same period.

<u>**Physical capital and quality of infrastructure**</u>

Investment activity was relatively subdued in 2022. In 2022, total investment accounted for 29.2% of GDP, up by 1.0 pps from its 2021 level. Construction's share of total investment fell to a historic low level in 2022, but rebounded in the first half of 2023, with the government's social housing project and its reconstruction efforts in the aftermath of the February earthquakes. Machinery and equipment's share of investment followed the opposite pattern, falling from its 2022 peak to 44.6% in the second quarter of 2023. Total net foreign direct investment (FDI) were 0.9% of GDP in 2022, close to its 5-year average. Geopolitical uncertainties, the build-up of macroeconomic imbalances and an unpredictable business and regulatory environment remain the main obstacles to attracting foreign investment.

Diversification of energy supplies has improved and the use of renewables substantially increased. Türkiye has high ambitions to become a regional energy hub and is investing heavily in the exploration of new gas fields in the Mediterranean and the Black Sea, as well as in building new LNG terminals. However, dependence on oil and gas imports (particularly natural gas imports from Russia) remains high and energy demand is steadily growing despite energy efficiency measures. The establishment of a national emissions trading system (ETS) aligned with the EU ETS and with a sufficient level of ambition (notably in the overall cap on allowances) remains a necessary precondition for the economy's cost-effective decarbonisation. Türkiye raised the share of renewable energy in the country's installed power capacity to 54% in 2022. Private investment continued driving growth in renewable installations and the preferential feed-in-tariff was extended until 2030. In addition, the National Energy Plan (2023-2035) released in January 2023 aims at further increasing the shares of renewable energy sources and of nuclear energy in installed capacity and in primary energy consumption by 2035. The plan was prepared in line with Türkiye's 2053 Net Zero Emission Target, which implies a further increase of up to 50% of renewable energy sources in primary energy consumption, as well as a sharp decrease in the share of fossil resources from 83.3% in 2020 to 20.8% by 2053.

Competition and pricing mechanism issues persist in the energy sector. There was limited progress in liberalising energy markets, as the unbundling of the State-owned gas company BOTAŞ was once again suspended. As a result, BOTAŞ remained vertically integrated (comprising gas trade, pipeline and LNG infrastructure) and retained its dominant market position – thus hindering transparent, cost-reflective and non-discriminatory pricing. The local content requirement practices in the renewable energy generation sector are discriminatory and a cause for concern because they impair EU companies' competitiveness in the Turkish energy market. Türkiye continues to be an important gas-transit country, ensuring the smooth operation of the Trans-Anatolian Pipeline (TANAP) which, as part of the Southern Gas Corridor (SGC), transmits natural gas from Azerbaijan to Europe by connecting to the Trans Adriatic Pipeline (TAP) *(see Chapter 15)*.

The COVID-19 pandemic accelerated the economy's digital transformation. The telecommunication sector is subject to specific taxation and various fees that were increased as part of the budget consolidation efforts in July. Although the ICT sector's share in GDP remains low at 2.3% in 2022, the number of broadband internet subscribers reached 90.6 million in 2022, up from 88.2 million in 2021. The total number of mobile broadband users was 71.7 million at the end of 2022, representing a population penetration rate of 84% that remains significantly below the OECD average of 124.5%. Türkiye nevertheless has the lowest average download speed of fixed broadband connection in the OECD. The share of citizens using e-government rose from 58.9% in 2021 to 68.7% in 2022. Türkiye ranks 16 out of 35 countries with an overall score of 72% in e-Government maturity, which is above the EU average (68%). Digitalisation efforts in business continued, with the share of enterprises involved in e-sales increasing to 19.3% in 2021, up by 6.8 pps from 2020 level (see Chapter 10).

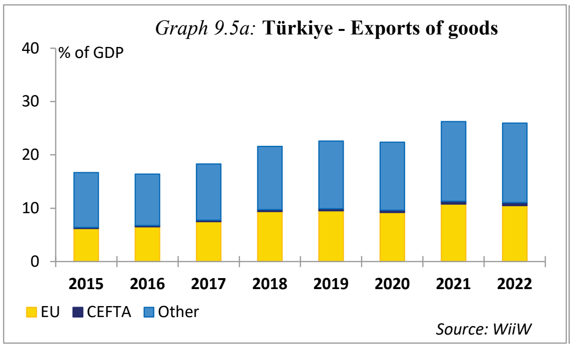
Sectoral and enterprise structure

The economy is dominated by the service sector, but its share declined. Service sector employment remained largely unchanged in the last 5 years, accounting for 56.6% of total employment in 2022. Service activities surged in 2022, led particularly by accommodation and food, transportation, and financial and insurance services. However, their share in GDP declined to a multi-year low of 56.6%, largely due to the expansion of industry. Industry accounted for 21.7% of employment in 2022, up by 0.3 pps from its 2021 level. It increased its share of GDP from the low 20s pre-COVID-19 to above 26% of GDP in 2021 and 2022. The construction sector slowed down, with its share in GDP decreasing slightly from 5.1% in 2021 to 4.9% in 2022. Similarly, the sector's share in total employment declined to 6.0%, down by 0.1 pps from its 2021 level. By contrast, the agriculture sector's share in GDP increased from 5.5% in 2021 to 6.5% in 2022. However, its share in total employment dropped further to 15.7% in 2022 (down by 1.5 pps from its 2021 level).

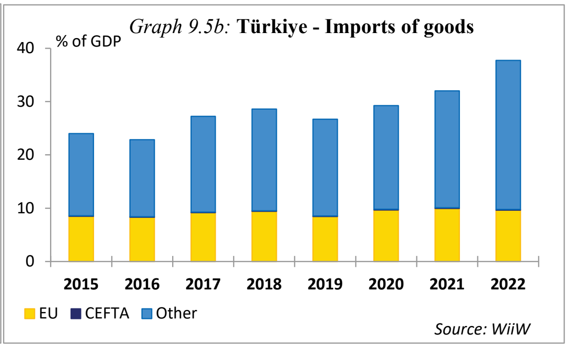
Small and medium-sized enterprises are the backbone of the economy but face multiple challenges. SMEs employ around three quarters of all workers and generate more than half of the economy's value added. Around 56% of SMEs in the manufacturing sector operate in low technology sectors. Türkiye has continued to implement various economic support schemes targeting SMEs. Targeted credit support improved SMEs access to finance and their share in total loans increased to around 28% in the first half of 2023, up from 24% in the previous 5 years. However, long-term finance remains a key problem for SMEs and they are financed mostly through short-term loans or equity. KOSGEB provides support to companies on R&D, innovation, product development, internationalisation, entrepreneurship and investment in high technology and strategic products. The Scientific and Technological Research Council of Türkiye also implements SME support schemes.

Economic integration with the EU and price competitiveness

Economic integration with the EU declined further but remains high. Türkiye is the EU's seventh largest trading partner, representing 3.3% of the EU's total trade in goods with the world in 2022, while the EU is Türkiye's largest trading partner by far. The EU's share of Turkish exports declined to 40.5% in 2022 – on a downward trend since 2018 – while the share of Turkish imports originating in the EU decreased strongly from 31.5% in 2021 to 25.6% in 2022 – well below its long-term average and largely due to strong price effects and increased energy imports from non-EU countries (notably Russia). The EU's share of FDI inflows into Türkiye increased markedly from 40% in 2021 to 79% in 2022. The EU's share in the overall stock of FDI rebounded to 68% in 2022 but was still below its long-term average of around 70%. Trade openness continued to increase steeply in 2022, reaching 81% of GDP (up from levels around 50% before 2017) as both exports and imports reached new highs.



Graph 9.5a: **Türkiye - Exports of goods**



Graph 9.5b: **Türkiye - Imports of goods**

In 2022, Türkiye removed some of the additional duties imposed on products of non-EU origin and in free circulation within the EU-Turkey Customs Union. However, many additional duties remain in force, in breach of the rules of the EU-Turkey Customs Union. Non-tariff barriers, such as import surveillance and excessive customs checks, continue to hinder trade flows.

10. UKRAINE

10.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Due to the impacts of Russia's ongoing full-scale invasion as well as the pre-existing structural economic challenges, the Ukrainian economy is **between an early stage and some level of preparation** towards establishing a functioning market economy. Since the full-scale invasion by Russia, the conduct of monetary policy, overall economic governance and the institutional and regulatory environment have faced exceptional difficulties. Despite the extraordinary challenges, the Ukrainian authorities have responded swiftly and appropriately, while showing remarkable resilience and adaptability to preserve macroeconomic and financial stability, although the authorities will need to continue their efforts to return economic and monetary policy settings to those conducive to the smooth long-term functioning of a market economy.

Ukraine's macroeconomic performance was somewhat muted before the full-scale invasion. Low levels of investment, a declining working age population, reliance on low value-added sectors all contributed to subdued economic growth (of around 3% per year in the four years before the pandemic) and a persistent gap with the standards of living in the EU. In 2022, as a result of the war, the economy contracted by 29.1%.

Despite the war, the Ukrainian authorities ensured predictability, transparency and stability-orientation in policy-making. In light of the wartime conditions, the National Bank of Ukraine (NBU) took decisive and appropriate actions to maintain financial stability and bolster confidence in the domestic currency, particularly by suspending the inflation-targeting framework, fixing and devaluing the exchange rate, and raising its main refinancing rate. In addition, the banking sector remained fully operational and stable with ample liquidity, also thanks to previous reforms and supervisory forbearance measures. Although the full impact of the war on the quality of assets in the financial sector remains to be seen, the ratio of non-performing loans has been high and appears to have increased more recently.

The state of public finances has deteriorated substantially due to the duration and cost of the war and its impact on economic activity, undoing the considerable fiscal consolidation and corresponding reduction in the debt stock that had been achieved in previous years before the COVID-19 pandemic. Tackling this, notably by introducing measures to increase the revenue base, will be of key importance going forward. Furthermore, the state footprint on the economy, already high before the war, has increased. The significant internal and external population displacements, together with capital destruction, affected the labour market, which was characterised by a relatively low activity rate and somewhat higher unemployment rate compared to the EU, already before the invasion. Despite progress, the functioning of product markets continues to show a number of weaknesses, particularly related to institutions, corruption, contract enforcement, and competitiveness, which are reflected in a large informal economy. At the same time, this assessment also highlights the determination and capability of the authorities to navigate through the exceptional challenges Ukraine is facing.

In order to improve the functioning of the market economy, and taking into account the ongoing war and ensuing reconstruction efforts, Ukraine should in particular:

→ continue to implement prudent policies underpinning macroeconomic stability. Ensure adequate resources to maintain core state functions, while ensuring the sustainability and improving the transparency of public finances. Safeguard the stability of the financial sector, including by addressing the growing presence of non-performing loans;

→ take measures to improve the business environment with a view to prepare for reconstruction efforts, in particular by reducing regulatory and administrative burden, addressing issues related to corruption and the rule of law and enhancing the anti-monopoly framework. Take steps to enhance the management of State-Owned Enterprises in line with OECD recommendations, while intensifying privatisations;

→ develop and implement a strategy to attract and reintegrate displaced persons in the Ukrainian labour market and those whose participation has been disrupted by the war as well as to address structural labour market issues and, take steps to tackle informal employment, and increase labour market participation.

Economic governance

The government has shown a strong commitment to implement much-needed reforms to encourage growth and financial stability. The authorities of Ukraine have demonstrated a strong commitment to pursue stability-oriented macroeconomic policies since the Maidan Revolution of Dignity in 2014. As part of the reform requirements outlined in successive IMF programmes, important actions were taken to reinforce the stability of the banking sector, including measures to enhance banking supervision and resolution mechanisms, as well as reforms to improve the independence of the National Bank of Ukraine. Ukraine has also taken steps to bolster the transparency of public finances and institutions, in particular by publishing budgetary information, improving the public procurement system and introducing asset reporting requirements for public officials. Additional reforms are needed to further guarantee the transparency of public finances, as well as prevent interference from vested interests, fight corruption, strengthen the rule of law, and improve the business environment.

The policy and regulatory response to the exceptional war situation was overall appropriate, although it has had an impact on the application of market principles and government involvement in the economy. Throughout Russia's full-scale invasion, the Ukrainian authorities demonstrated commendable resilience and adaptability in implementing policies to maintain macroeconomic and financial stability. Nevertheless, the current context has inevitably led to some centralisation of power and a reduction in the independence of institutions responsible for economic policy. The central bank appropriately suspended the inflation-targeting framework, moved to a fixed exchange rate regime and introduced supervisory and regulatory forbearance measures (all of which helped safeguard financial stability and bolstered confidence in the domestic currency)34. In addition, the NBU directly financed about one third of the government's funding needs in 2022, although this practice ceased in early 2023, reducing risks for price and external stability. The government also introduced price controls on essential goods and communal services, and many taxes were temporarily reduced. Support schemes to households and businesses have been expanded and deregulation efforts have continued, which helped improve the business environment. Overall, the government has shown a remarkable degree of continuity, including through the design of a seven-pillar national recovery and development plan, presented in May 2022 and followed-up by a government priority action plan for the current year approved in March 2023. The continuous and evolving engagement with the IMF, as well as with the Commission under the Macro-Financial Assistance Plus instrument (MFA+), have also been an important anchor for further reform efforts.

Macroeconomic stability

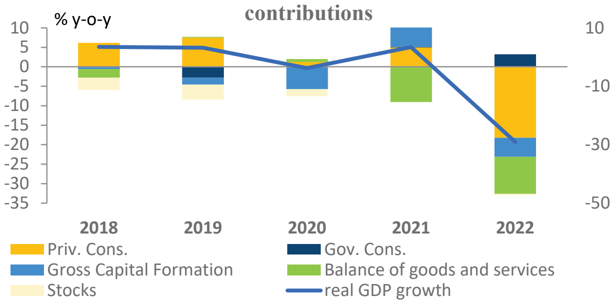
Before Russia's full-scale invasion, Ukraine's macroeconomic performance was rather weak, owing to low levels of foreign and domestic investment, a declining population, and a reliance on low value-added sectors. In 2021, total investment in Ukraine accounted for 13.8% of GDP (EU average of 22.1%). Foreign direct investment (FDI) has remained weak at an average of 2.8% of GDP over 2017-2021. A decline in population, fuelled by low birth rates and substantial emigration, has not only reduced Ukraine's total population but also decreased the share of the working-age population from 70% in 2011

[34] However, conscious of the long-term impacts of a fixed exchange regime on the economy and on the effectiveness of monetary policy, the NBU adopted in June 2023 a strategy to ease FX controls and move towards a more flexible exchange rate once conditions allow. On 3 October 2023, the NBU shifted to a managed float system for the hryvnia, marking the first step in liberalising the exchange rate.

to 67% in 2021. This has hindered economic growth and added to fiscal pressures by increasing the dependency ratio. In addition, Ukraine's economy is reliant on low value-added sectors – especially agriculture and mining – which makes the economy vulnerable to fluctuations in global commodity prices and weighs on its living standards. As a result, Ukraine has made limited gains in income convergence with the EU average over the past decade, with GDP per capita standing at 29.3% of the EU average in 2021 in terms of purchasing-power parity (PPP). Income inequality remains low compared to the EU and has been stable over the past decade, with the GINI coefficient reaching 25.6 % in 2020, compared to an average of below 30% in the EU.

Ukraine's economy has been profoundly impacted by Russia's war of aggression. After a milder-than-expected COVID-19 recession and an incomplete rebound in 2021, real GDP growth collapsed in 2022 (-29.1%, somewhat more resilient than initially expected). Population displacement, supply-chain disruptions, inflationary pressures, and territorial losses due to the war took a toll on economic activity in 2022, especially on consumption and investment, which fell by 27% and 34%, respectively. Net exports also declined considerably as supply bottlenecks weighed on exports and the spending of Ukrainian refugees abroad boosted import growth. Despite growing by 18% in real terms due to war-related spending, the contribution of public consumption to GDP growth remained small. In 2023, the economy has started to recover somewhat despite continued Russian attacks. This is thanks to the resilience of critical energy infrastructure, some positive signs of a partial return of refugees, and the ability of businesses and households to adapt to the war economy.

Graph 10.1: **Ukraine - Real GDP growth and contributions**



Source: SSSU, own calculations

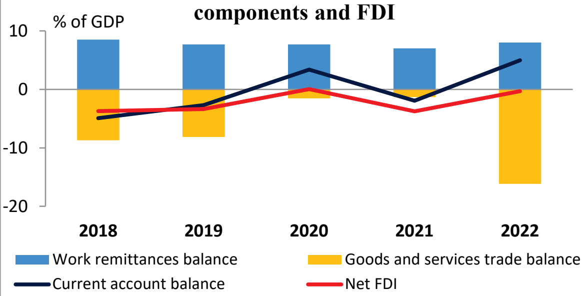
Table 10.1: **Ukraine - Key economic figures**	2014-19 average	2020	2021	2022
GDP per capita (% of EU-27 in PPS)	29	30	29	n.a.
Real GDP growth	-0.8	-4.0	3.4	-29.1
Economic activity rate of the population aged 15-70 (%), total	62.5	62.1	61.8	n.a.
female	*56.4*	*56.3*	*56.1*	*n.a.*
male	*69.2*	*68.5*	*68.1*	*n.a.*
Unemployment rate of the population aged 15-64 (%), total	9.0	9.5	9.9	n.a.
female	*7.7*	*9.1*	*10.2*	*n.a.*
male	*10.2*	*9.9*	*9.6*	*n.a.*
Employment of the population aged 15-64 (annual growth %)	-3.3	-4.0	-1.9	n.a.
Nominal wages (annual growth %)	21.7	10.4	20.9	5.9
Consumer price index (annual growth %)	18.0	2.7	9.4	20.2
Exchange rate against EUR	26.6	30.8	32.3	40.2
Current account balance (% of GDP)	-1.8	3.4	-1.9	5.0
Net foreign direct investment, FDI (% of GDP)	2.6	0.2	3.8	0.3
General government balance (% of GDP)	-2.3	-5.3	-3.4	-16.3
General government debt (% of GDP)	68.7	60.9	48.9	78.5

Source: national sources

The current account turned into a surplus following Russia's invasion. In the 5 years prior to the pandemic, Ukraine's registered current account deficits of 2-3% of GDP mainly due to a sizeable negative trade balance. This was offset in part by traditionally strong remittances inflows to Ukraine. The pandemic caused the current account to swing into a small surplus due to a compression of import volumes following the sharp contraction in economic activity over the course of 2020. Russia's war of aggression against Ukraine led to an unprecedented trade deficit of 16.2% of GDP in 2022, which was mainly driven by a strong contraction in the exports of goods (-35.2%) due to production disruptions as well as transport and supply-chain difficulties. Still, the current account posted a record surplus of 5% of GDP, thanks to a strong surplus of both the primary and the secondary income balance, driven by exceptionally high foreign official grants and remittances inflows, which stood at 5.4% and 15.7% of GDP, respectively.

Foreign investment has fallen markedly following the outbreak of the war. After a notable recovery in 2021, foreign investment inflows have collapsed since the outbreak of the war (-92% in 2022). Portfolio investment in Ukraine registered an outflow of 1.3% of GDP in 2022, while other investments in the country reached 8.5% of GDP, driven primarily by the additional government borrowing. The financial account registered an aggregate outflow of USD 11.1 billion (6.9% of GDP) in 2022. The gap to the current and capital account inflow of USD 8.2 billion was financed through the draw-down of the official international reserves by USD 2.9 billion.

Graph 10.2: **Ukraine - Current account selected components and FDI**



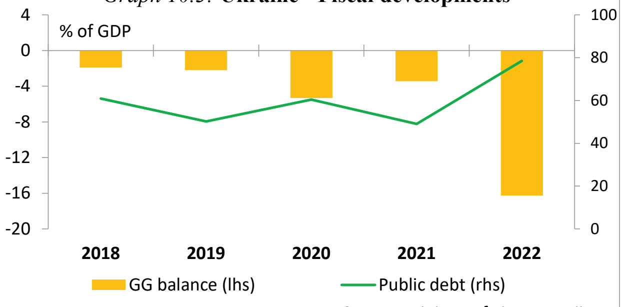
Source: IMF and Central Bank of Ukraine

The National Bank of Ukraine (NBU) has ensured financial stability and strengthened confidence in the domestic currency. Prior to the war, Ukraine implemented welcome reforms to enhance the autonomy and governance principles of the NBU, which successfully helped reduce inflation from 12.6% in January 2017 to 3.2% in January 2020. Following the Russian full-scale invasion, the NBU introduced swift actions to ensure financial stability and strengthen the confidence in the domestic currency. These included suspending the inflation-targeting framework, fixing and devaluing the exchange rate, and raising its main refinancing rate. While official reserves suffered a depletion in the first months of the war, international financial support helped restore them to their highest historical level in July 2023. The positive trends in terms of improved expectations and confidence in the national currency allowed the NBU to refrain from a further increase in its policy rate beyond 25% (which was on the contrary cut by 300 basis points in July 2023 and 200 basis points to 20% in September 2023) or from further devaluing the hryvnia (beyond the 25% in July 2022). The NBU took additional confidence-enhancing measures in late 2022 and early 2023, as a result of which the spread between the market and official exchange rates narrowed down to a rather marginal 4%. The central bank is fully committed to return to an inflation-targeting framework in a flexible exchange rate regime as soon as circumstances permit it, as highlighted in the recently adopted FX strategy, as well as in the decision of the NBU on 3 October 2023 to move to a managed exchange rate regime.

Inflation declined strongly in 2023 after reaching a 6 year high in 2022. After some moderation in 2020, inflation increased steadily throughout 2021, mainly due to increasing global commodity prices – particularly for energy and food – as well as supply bottlenecks both in Ukraine and abroad. The war exacerbated inflationary pressures, causing further disruptions in supply chains, a decrease in the supply of some goods, and higher production costs. Coupled with considerable monetary financing by the central bank during the war, these factors led to a strong and steady rise in inflation over 2022, reaching 26.6% in December 2022. Inflation has nevertheless eased visibly since, reaching 8.6% in August 2023, due to increased supply of food and fuels, a rapid partial recovery of the energy system from Russia's attacks, which reduced energy prices, as well as skilful policymaking by the NBU. Indeed, conscious of the adverse effects of monetary financing, including on macro-financial stability, the NBU has discontinued this practice since the beginning of 2023 and the government has relied on taxation, foreign assistance, and financing mobilised from the domestic market. This helped reduce inflation expectations and ease pressures on core inflation.

Public finances deteriorated markedly, reversing the gains from fiscal consolidation prior to the war. The state of public finances has deteriorated markedly due to the duration and cost of the war, making Ukraine lose access to international debt markets and rely on foreign assistance and domestic markets to finance its funding needs. Thanks largely to massive official foreign grants, the 2022 general government deficit was contained to 16.3% of GDP. Driven by spending on defence and public order, overall public expenditure increased by 65% in 2022. While tax revenues contracted by almost 8% in 2022, total public revenues increased by 32%, primarily thanks to the massive foreign grants. The war has led to a reverse in gains from the considerable fiscal consolidation that had been achieved since 2017, during which public debt had decreased from around 81% of GDP in 2016 to 49% of GDP in 2021. Driven by the sizeable borrowing but also reflecting the decline in nominal GDP, total public debt reached 78.5% of GDP at end-2022. The substantial deterioration in public finances highlights the need to execute the budget within the available resource envelop in the short-term, complemented by important efforts to increase the revenue base over the medium term. In addition, in the area of public financial management, building on significant improvements in the years before the war, further priority reform areas include ensuring the availability of fiscal data, restoring the medium-term budgetary framework, improving public investment management, and reinforcing the mandate and functionality of the supreme audit institution. Improving the monitoring and management of fiscal risks, including those related to state-owned enterprises, public guarantees and age-related expenditure, is also an important reform priority.

Graph 10.3: **Ukraine - Fiscal developments**



Source: Ministry of Finance, wiiw

Functioning of the product markets

Business environment

Weaknesses in the business environment led to low levels of investment. Ukraine's competitiveness is weak, primarily owing to weak institutions, the prevalence of market dominance and an ineffective anti-monopoly policy. Nevertheless, some progress in deregulating its economy has been made, where the cancellation of almost one fifth of the regulatory acts under review in the period 2016-2020 was a significant step to streamline regulation. Despite a moderate regulatory burden and no significant legal barriers to market entry, corruption, ongoing geopolitical tensions and inefficient contract enforcement discourages private investment and cross-border business relations, including FDI.

To allow companies to operate during the war, the authorities have lifted certain regulatory requirements for the period of application of the martial law and continued to progress with a number of broader reforms. Against the backdrop of a highly uncertain outlook, business activity was supported by further steps towards deregulation and reducing administrative burden. As of August 2022, it is possible to set up a limited liability company in an automatic way on the basis of a model charter, without the need to go through a state registration authority. Similarly, digital tools have been deployed successfully to facilitate the functioning of the court system. The Rada also adopted a law that introduces a simplified bankruptcy procedure that avoids summoning the parties, while simplifying the insolvency officers' work and providing for the creation of an automated information system.

The informal sector still constitutes a substantial share of Ukraine's economy, estimated at 30-40% of Ukraine's GDP**.** This significantly impacts tax revenues, exacerbates poor working conditions by hindering access to social protection, distorts competition and hampers the effectiveness of policy measures. Several factors contribute to the persistence of this phenomenon: despite deregulation, there is still a complex and inefficient regulatory framework; weak law enforcement; and a general lack of trust in governmental institutions. Furthermore, corruption creates a volatile business environment, providing a strong incentive for businesses to operate informally.

State influence on product markets

The war has exacerbated the state's footprint in the economy. The Ukrainian state already had a substantial economic footprint in peace times. In 2021, the public sector accounted for 18% of gross value added (down from 21% in 2020) and 32% of gross fixed capital formation (down from 35% in 2020). Ukraine's more than 3 256 state-owned enterprises (SOEs) at central level accounted for one-tenth of output and 18% of employment before the war, with an average return on equity at 0.3% in 2019 far below that of the private sector (8%). Furthermore, SOEs have held a dominant role in many markets, stifling competition and making it difficult for new firms to enter. In 2022, for which detailed national accounts are not available yet, the relative share of the sector of public administration and defence jumped up to 24% of GDP (from 7.2% in 2021), while the share of government consumption more than doubled to 38.2% of GDP. The importance of many public companies, e.g. the railways, the energy provider and the post office, strengthened as a result of their crucial role in the emergency response to the full-scale invasion.

Privatisation and restructuring

Privatisation and corporate governance of state-owned enterprises are a significant challenge for economic policy. Prior to the war, Ukraine had been quite successful in privatising small property and production assets, notably through the electronic auctions platform ProZorro. In July 2022, the Rada adopted a law to simplify the procedure for small privatisations, which have resumed since then. Investors showed interest in two ports, several distilleries and other small real estate pieces. On 30 May 2023, a law was adopted that inter alia unblocks large-scale privatisations, which have been suspended since the beginning of the war, and where progress had previously been limited. The law also amends the structure of the State Property Fund of Ukraine (SPFU). The law also makes significant changes vis-à-vis sanctioned property, which will be transferred to the SPFU for management and/or privatisation, sale or lease. As far as SOEs are concerned, while progress on the corporate governance reform was recorded before the war, it is not yet in line with OECD standards to ensure de-politicised, professional and transparent management.

Functioning of the financial market

Financial stability

Although the already high non-performing loans ratio has increased during the war, financial stability has been preserved thanks to swift policy action by the National Bank of Ukraine. Following the 2014-2016 banking crisis, the National Bank of Ukraine strengthened proper oversight of the banking sector, which was characterised by a high level of non-performing loans. Nevertheless, after two rounds of asset quality reviews, bank closures, and recapitalisations, non-performing loans started to decrease, declining from 58% in 2017 to a still very high 30% in 2021. In response to the full-scale invasion, the National Bank of Ukraine took steps to safeguard banks' liquidity and the confidence in the system, which has remained strong as evidenced by the increase in deposits by 35% y-o-y by end-February 2023. The banking sector has remained stable and with ample liquidity, although Non-Performing Loans ratio increased to 38.1% by end-2022 in light of war-related impacts on economic activity and collateral. Despite building additional provisions for about USD 3.5 billion, banks remained profitable in 2022, owing to high liquidity ratios, which yield significant interest income in a high interest rate environment. With a market share of close to 50% over the last five years, the four state-owned banks dominate the banking sector.

Access to finance

Lending to the private sector remains low. Ukraine's financial sector is predominantly bank-based and the total stock of bank lending to the private sector stood at just 20% of GDP in 2022 (28% in 2021), much below the EU average. Banks showed strong resilience to the war situation. This was thanks to initiatives such as Power Banking (guarantee of service despite power outage) and national ATM roaming (no inter-bank withdrawal charges), although both risk appetite and loan demand have decreased against the backdrop of rising interest rates. Banks' aggregate portfolio contracted by 4% in 2022, with corporate loans almost flat while loans to households declined by 13%. To ease borrowers' situation, the government has simplified the conditions for benefitting from debt restructuring and extended access to the programme of 'Affordable Loans 5-7-9%'. Even during the war, surveys do not point out access to finance as an impediment to conducting business. Capital markets and non-bank financial intermediation are in a very early stage of development.

Functioning of the labour market

Ukraine's labour market suffers from labour and skills shortages, structurally high rates of young people not in education, employment or training (NEET), as well as informal employment. Despite witnessing a decline in labour supply, the unemployment rate has fluctuated at around 9% over the past five years. Labour force participation stood at 62% in 2021, with a low and decreasing rate of participation among women. The share of young people (aged 15-24) who were NEET stood at 15.5% in 2021. Despite high formal educational attainment, skill mismatches persist, which impacts productivity. Improvements in active labour market policies could help increase employment and reduce skill gaps by training workers with the skills that employers need. Informal employment was estimated at 20% of all employed in 2021.

The war has had a profound impact on the labour market and exacerbated pre-existing structural challenges. The massive outflow of people to other countries, an estimated 5 million internally displaced persons, and substantial job destruction in the wake of the invasion have reshaped the labour market landscape. At the macroeconomic level, the most important change was not the increase in the unemployment rate, but the dramatic fall in the labour force. Around 6.2 million people left the country, of which around 2.1 million were of working age. In addition, it has been estimated that around two thirds of refugees at working age have an advanced education. Coupled with the physical and mental impacts of the war on workers, this could exacerbate earlier trends of decreasing labour supply caused by a declining population at working age. Additionally, the surge in internally displaced persons has intensified skill mismatches and labour shortages in regions experiencing a pronounced workforce exodus and higher unemployment rates while fostering informal employment in recipient regions. Despite nominal wages remaining roughly constant, the hike in inflation has led to a collapse in real incomes for households.

10.2. THE CAPACITY TO COPE WITH COMPETITIVE PRESSURE AND MARKET FORCES WITHIN THE UNION

Due to the impacts of Russia's ongoing full-scale invasion as well as the pre-existing structural economic challenges,, Ukraine is at an **early stage of preparation** in terms of its capacity to cope with the competitive pressure and market forces within the EU. The war has severely damaged the country's capital infrastructure and caused a massive human exodus that has deeply affected the economy. Investment as a share of GDP was already very low before the war and infrastructure remained underdeveloped, especially trade-related infrastructure. Investment in research and innovation has been low, and educational outcomes have not met the needs of the labour market.

The structure of the Ukrainian economy changed little in the five years before the start of the Russian war of aggression and remained concentrated in sectors with low added value. Even before the war, the stock of FDI was well below the EU average, reflecting persistent weaknesses in the business environment and high perceived corruption. While trade integration with the EU has been advancing recently, including thanks to the implementation of the Deep and Comprehensive Free Trade Area, it remains low, while the openness of the Ukrainian economy overall had been decreasing before the invasion.

At the same time, the international response in support of Ukraine has been massive over the last year. Future reconstruction could also help support modernization and allow Ukraine to specialise in higher value-added chains and strengthened competitiveness.

To improve competitiveness and support long-term growth, Ukraine should in particular:

→ continue and, when the situation allows for it, accelerate repairs and rehabilitation of infrastructure, in particular the restoration of energy transmission and generation capacity, including from renewable energy sources, as well as utilities, transport infrastructure, schools and health facilities;

→ take measures to facilitate investment, including for reconstruction, in particular by improving public procurement processes, reducing barriers to project implementation, reforming planning processes and strengthening the administrative capacity needed for investment management;

→ take steps to improve the quality of education and training, including for Ukrainians returning from abroad, to ensure outcomes align with the needs of the labour market, including the skills required for reconstruction. Ensure that the education system is also equipped to re-integrate Ukrainians returning from abroad.

Education and innovation

Ukraine invests a relatively large share of its GDP in education, which is not proportionately reflected in outcomes. The country invests a higher proportion of GDP in education than the EU. This has contributed to high levels of formal educational attainment, with 54% of the working-age population in 2020 enrolled in or having completed tertiary education, nearly double the EU average. A large part of this share is accounted for by vocational education and training rather than traditional academic degrees. Ukraine ranked 39th out of 77 countries in the latest round of PISA reading assessments in 2018, which is low compared with its investment in education.

Despite relatively high rates of investment and formal educational attainment, there is still a mismatch between the skills of the workforce and those demanded by employers. Nearly 38% of firms in Ukraine identified an inadequately educated workforce as a major constraint, which is much higher than the EU average. This rate increases to nearly half of firms with at least 10% foreign ownership. Compared to relatively large investments in vocational training within the education system, spending on active labour market policies to mitigate the skills mismatch remains very low at just 0.03% of GDP in 2017.

The war has prolonged the pandemic-related disruptions to the continuity of education and poses a serious challenge to educational outcomes in the medium term. As of February 2023, an estimated 10% of all educational institutions in the country had been damaged or destroyed, and around 4.6 million children had been forcibly displaced by the war. According to the Ministry of Education and Science, only 32% of primary and secondary-school students are in full-time, face-to-face education as of June 2023.

Investment in research and development remains low. Total expenditure on research and development, which has been declining over the last 10 years, reached 0.29% of GDP in 2021 compared to an EU average of 2.2%. Over half of R&D spending comes from the private sector. According to the European Innovation Scoreboard 2022, Ukraine is regarded as an emerging innovator.

Physical capital and quality of infrastructure

The state of Ukraine's physical infrastructure reflects a persistent lack of investment in the years before the war and will require significant investment in order to support recovery and economic growth. The average ratio of gross fixed capital formation has fluctuated at around 17% of GDP since the Maidan Revolution, which is about half of the investment effort of similar emerging economies. FDI inflows averaged 2.2% of GDP over the five years from 2018, falling to 0.3% of GDP in 2022. The total stock of pre-war FDI remained low at around 31% of GDP. The country ranks very low on the quality of trade-related infrastructure and around a quarter of firms identified transportation as a major constraint in the 2019 World Bank Enterprise Survey. These challenges have been exacerbated by war-related disruptions to export routes including in the Black Sea. Ukraine has a highly developed gas transmission system that is also closely integrated into the European gas network, though a significant part of the country's overall energy generation and transmission infrastructure has been damaged in the war.

In terms of digitalisation, Ukraine has made remarkable progress in recent years, though war-related damage has disrupted connectivity. In 2021, 83% of Ukrainian households had internet access at home, representing an increase of over 20 percentage points in just three years. Internet connectivity was a key driver of pre-war economic growth, in particular for the IT industry. Good digital connectivity has supported the country's resilience during the war.

The destruction of physical capital caused by the war has been immense. According to the Rapid Damage and Needs Assessment, direct damage in the first year of the war is estimated at EUR 150 billion, with the housing (38%), transport (26%) and energy (8%) sectors having suffered the greatest damage. Total reconstruction and recovery needs were estimated in February 2023 at EUR 380 billion. This encompasses steps towards becoming a modern, low-carbon, disaster- and climate-resilient country in view of becoming an EU Member State and takes into account inflation, surge pricing commonly seen during mass construction, higher insurance premiums, etc. The destruction of the Kakhovka Dam in June 2023 caused severe economic and environmental loss. Russia has occupied, damaged or destroyed a large part of Ukraine's installed power capacity, thousands of kilometres of electric, gas and heating networks, transformers, compressor stations, heat-only boilers and other infrastructure facilities. Emergency repairs have continued with international support, which together with exceptional efforts by the transmission system operator Ukrenergo have kept the grid operational. About a quarter of agricultural land could not be used for production before demining has taken place.

Sectoral and enterprise structure

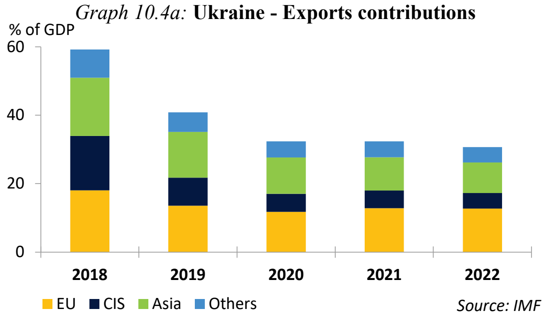
The structure of the Ukrainian economy changed little in the five years before the start of the war and remained concentrated in sectors with low added value. Agriculture accounted for just over 12% of GDP (EU average: 1.6% of GDP) and over a fifth of total employment in 2021. The share of manufacturing in GDP has been declining persistently in recent years from 14.4% in 2016 to 8.6% in 2022 due in part to labour market pressures resulting from high emigration, electricity tariff reform as well as the impact of the war in Donetsk and Luhansk and the COVID-19 pandemic. The ICT sector, where Ukraine had been developing a comparative advantage, kept its relative share in output almost intact at 5.2% of GDP in 2022. Before the war, the trade, agriculture and industry sectors accounted for almost 60% of all employment, suggesting that these sectors were lagging in labour productivity relative to the other parts of the economy.

Nearly all businesses in Ukraine (99.98%) are small and medium-sized enterprises (SMEs), with access to finance remaining an obstacle for firms of all sizes. In 2020, SMEs employed 81% of workers and accounted for 62.6% of GDP and over a quarter of exports. Access to finance remains a key obstacle for businesses of all sizes and was identified by nearly half of firms as a major constraint in 2019, five times the rate in the EU. The interest rate spread for SMEs compared to large firms had been rising before the war, though SMEs account for an increasing share of outstanding loans (61% in 2020) and represent nearly one-third of new lending each year. The government strategy to boost SME development and open access to finance expired in 2020, and an updated strategic policy framework remains to be developed. The government introduced an affordable loan programme to improve access to bank lending for small firms. This has continued and expanded during the war, with an increase in the maximum loan amount and a reduction in interest rates to 0% for the duration of martial law.

Economic integration with the EU and price competitiveness

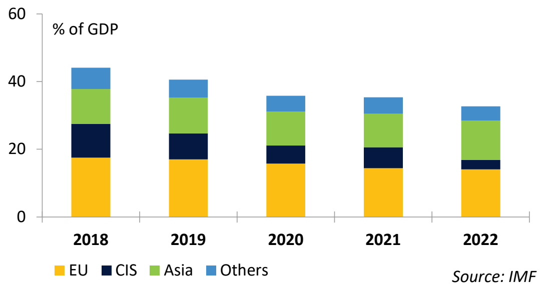
The overall openness of the economy had been shrinking even before the war, with foreign trade relative to GDP contracting from 108% in 2015 to 88% in 2022. Despite this general trend, economic integration with the EU progressed further thanks to the implementation of the Association Agreement and the Deep Comprehensive Free Trade Agreement (DCFTA). Ukrainian companies have been actively using the opportunities of the DCFTA, with 27% more businesses exporting to the EU in 2022 than in 2016. The share of exports to the EU, which consisted mostly of agricultural products, metals and minerals, increased from 28% in 2015 to 36% in 2021. The share of imports from the EU, which comprised primarily machines, chemicals and minerals, also strengthened from 36% in 2015 to 41% in 2021. The EU is the largest source of FDI in Ukraine, accounting for three-quarters of FDI inflows in 2021. Thanks to the temporary suspension of all tariffs, the agreement on road transport and the effective implementation of logistical Solidarity lanes since the start of the war, trade integration with the EU has progressed further, with 39% of Ukrainian exports going to the EU in 2022 and about half of Ukrainian imports coming from the EU.

Graph 10.4a: **Ukraine - Exports contributions**



Source: IMF

Graph 10.4b: **Ukraine - Imports contribution**



Source: IMF

On price competitiveness, unit labour costs remained relatively low and stable in Ukraine between 2014 and 2018, **remaining less than a third of those in neighbouring EU Member States in US dollar terms.**

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