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Progress towards Meeting the Economic Criteria for EU Accession

The EU Commission's 2021 Assessments

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European Commission
Directorate-General for Economic and Financial Affairs

Progress towards Meeting the Economic Criteria for EU Accession

The EU Commission's 2021 Assessments

EUROPEAN ECONOMY Institutional Paper 161

ABBREVIATIONS

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
GG	General Government
ICJ	International Court of Justice
IDF	Investment Development Fund
IFIs	International Financial Institutions
ILO	International Labour Organization
IMF	International Monetary Fund
INSTAT	Institute of statistics Albania
LFPR	Labour Force Participation Rate
LFS	Labour Force Survey
MoF	Ministry of Finance
Monstat	Statistical Office of Montenegro
NPLs	Non-performing loans
OECD	Organisation for Economic Co-operation and Development
PESR	Public enterprise for state roads of North Macedonia

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
TRY	Turkish Lira
VAT	Value-added tax
UK	United Kingdom
UNSCR 1244	United Nations Security Council Resolution 1244
VET	Vocational education and training.
WBIF	Western Balkans Investment Framework
WiiW	the Vienna Institute for International Economic Studies
WTO	World Trade Organization
y-o-y	year on year

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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 seven enlargement countries Albania, Bosnia and Herzegovina, North Macedonia, Kosovo[(*)], Montenegro, Serbia and Turkey. The annual country reports assess progress achieved in each of the countries in advancing the necessary political and economic reforms as well as the legal transformation in line with the EU accession criteria. The European Commission adopted the country reports on 19 October 2021 as part of its 2021 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 2021 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 enlargement 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] http://europa.eu/rapid/press-release_IP-19-2752_en.htm

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 has made **some progress** and is **moderately prepared** for developing a functioning market economy. Hit by the double shock from the earthquake of November 2019 and the COVID-19 pandemic, GDP contracted in 2020, although by less than initially expected. Pandemic-related domestic lockdown and international travel restrictions caused large losses to tourism and manufacturing, but economic conditions started to improve in the second half of the year. Within the limited fiscal and monetary policy space, the government and the central bank took swift and appropriate actions to support business, households and the health sector. This cushioned the impact on the labour market and preserved macroeconomic and financial sector stability. It also pushed up the public-debt and deficit ratios and increased the country's vulnerability to external shocks. Dealing with the double shock stretched the capacity of the administration, but it largely ensured business continuity and continued work on most ongoing reforms. As last year's recommendations to improve the functioning of the market economy were partly addressed, in the coming year Albania should in particular:

→ foresee in the medium-term fiscal plan a gradual reduction of the public debt ratio starting in 2022 and the return to a positive primary balance as of 2023, and begin implementing the medium-term revenue strategy;

→ implement the reform of public investment management procedures;

→ develop a comprehensive strategy to tackle all aspects of informality and establish a regular monitoring of informality and of the strategy's implementation.

Economic governance

Albania's public debt and deficit increased sharply due to the COVID-19 pandemic in 2020 and are set to remain at elevated levels in 2021. In response to the double shock from the November 2019 earthquake and the pandemic, the 2020 budget was amended four times and resulted in a large increase of debt and deficit. In 2020, the government declared a state of emergency and applied the escape clause of the organic budget law[2], to allow for an increase of the debt-to-GDP ratio and the deficit. In July 2021, the government amended the 2021 budget for the 3rd time by normative act to increase mainly capital expenditure and the deficit, extended the application of the escape clause to 2021 without extension of the state of emergency and postponed the new primary balance rule to 2024.

To cover the increased external and budgetary financing needs, including the swift but moderate pandemic-related support to business and households, the government requested and received financial support from the IMF (EUR 174 million from the Rapid Financing Instrument) and from the EU. The EU disbursed the first EUR 90

[2] The organic budget law requires under normal circumstances an annual reduction of the debt to GDP ratio until it reaches 45%.

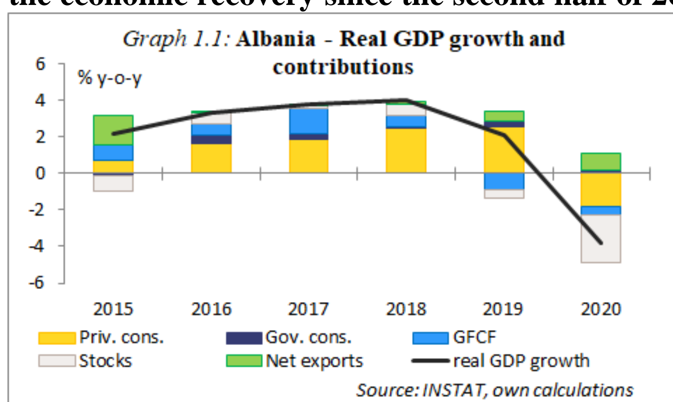
million instalment of the EUR 180 million of macro-financial assistance on 31 March 2021 (the second instalment can be requested upon fulfilment of policy conditions before November 2021). In addition, Albania issued a EUR 650 million Eurobond in June 2020 and is preparing the placement of another EUR 500 million Eurobond in 2021. Albania has partially implemented the policy guidance jointly agreed at the May 2020 Economic and Financial Dialogue between the EU and the Western Balkans and Turkey.

Macroeconomic stability

The economy contracted by 3.8% in 2020 in the wake of the COVID-19 crisis, less than initially projected. Economic growth averaged 3.1% in 2015-2019, driven by exports - in particular tourism, and by private consumption, propelled by employment growth in the thriving services sector, but also in manufacturing. In 2020, the pandemic hit these growth drivers and private consumption fell by 2.3%. Exports and imports dropped significantly by 25.6% and 20% respectively, mainly because international travel restrictions caused large losses in tourism. Nevertheless, the economy proved more resilient than initially expected because of the growth of agriculture, post-earthquake reconstruction and increased role of regional tourism, as well as timely support to business and households. A moderate recovery which began in the second half of 2020, strengthened in 2021 to 5.5% GDP growth in the first quarter, supported by high hydro-electricity production, construction and a recovery of manufacturing. Short-term indicators signal that a rebound of tourism-related services in response to strong demand from regional and domestic tourists reinforced the recovery in the second quarter.

Fiscal and monetary policy support limited the social and economic impact of the COVID-19 pandemic, and post-earthquake reconstruction expenditure has helped the economic recovery since the second half of 2020. The government and the central bank took swift actions, including financial and liquidity support equivalent to 2.65% of GDP, to support business, households and the health sector, which cushioned the impact of COVID-19 on the labour market and preserved macroeconomic and financial sector stability. The Bank of Albania (BoA) lowered its record-low policy rate from 1% to 0.5% in March 2020, and provided liquidity to the economy. A moderate recovery took hold in the second half of 2020, supported by increasing public expenditure on reconstruction and recovering exports. Per-capita GDP (at purchasing power parity) increased from 29% of the EU average in 2016 to 31% in 2019. This still represents a very slow rate of convergence.

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



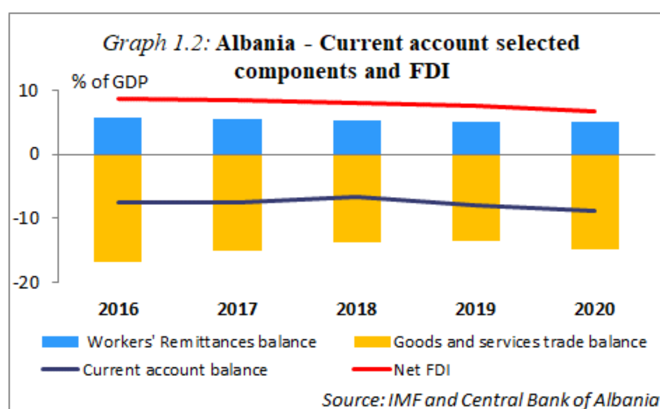
Source: INSTAT, own calculations

Table 1.1: **Albania - Key economic figures**	**2012-17** average	**2018**	**2019**	**2020**
GDP per capita (% of EU-27 in PPS)[1]	30	30	31	31
Real GDP growth	2.3	4.0	2.1	-3.8
Economic activity rate of the population aged 15-64 (%), total	63.9	68.3	69.6	69.1
female	*54.8*	*59.7*	*61.7*	*61.2*
male	*73.2*	*76.9*	*77.6*	*77.1*
Unemployment rate of the population aged 15-64 (%), total	15.9	12.8	12.0	12.2
female	*14.4*	*12.3*	*11.8*	*12.4*
male	*17.0*	*13.2*	*12.2*	*12.1*
Employment of the population aged 15-64 (annual growth %)	2.5	2.1	2.4	-1.9
Nominal wages (annual growth %)[2]	2.5*	3.1	3.8	2.7
Consumer price index (annual growth %)	1.8	2.0	1.4	1.6
Exchange rate against EUR	138.45	127.57	123.01	123.77
Current account balance (% of GDP)	-9.0	-6.8	-8.0	-8.8
Net foreign direct investment, FDI (% of GDP)	8.3	8.0	7.5	6.9
General government balance (% of GDP)	-3.6	-1.6	-1.9	-6.9
General government debt (% of GDP)	68.9	67.7	65.8	76.1

Notes:
1) Eurostat
2) average gross monthly wages, average of 2015-2017
Source: national sources

The drop of services exports and remittances widened the already high current-account deficit significantly in 2020, which was partly financed by portfolio investment inflows. In 2015-2019, rising service exports and remittances helped the current-account deficit to narrow from an average 10.9% of GDP in the five-year period 2010-2015 to an average of 7.6% in the 2015-2019 period. Following the drop in services exports (i.e. tourism), falling income of short-term workers abroad and lower remittances from non-residents, it widened to 8.9% of GDP in 2020 and 9.5% of GDP in the first quarter of 2021. Foreign direct investment (FDI) inflows already started to decrease from their peak above 8% of GDP in the 2013-2018 period to 7.5% of GDP in 2019 due to the completion of a few large energy projects, before they fell to 6.9% of GDP in 2020. In the last five years, FDI fully financed the current account deficit, but in 2020, debt-creating capital inflows (incl. the EUR 650 million sovereign Eurobond issued in June 2020) contributed to its financing.

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



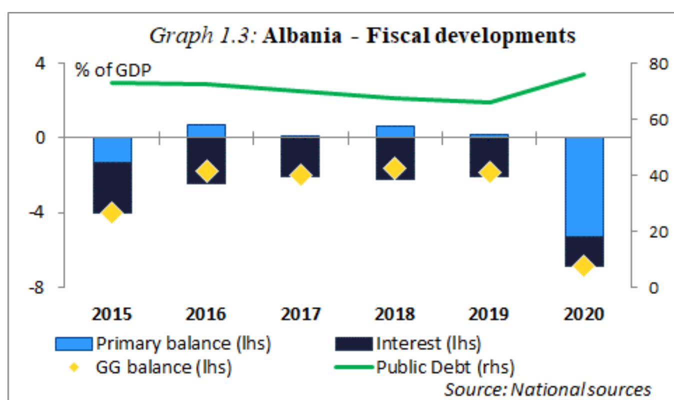
Source: IMF and Central Bank of Albania

External debt increased, but foreign exchange reserves provided a sufficient safeguard and the exchange rate remained stable. External debt, mostly consisting of long-term government debt climbed from 60% to 65.8% of GDP in 2020, and is set to increase again as the government is preparing a new EUR 500 million placement in 2021 and announced annual placements of Eurobonds in future. Foreign exchange reserves decreased slightly to EUR 3.9 billion in June 2021, equivalent to 7.5 months of imports, and continued to provide an adequate safeguard against adverse shocks. Despite a short-lived depreciation at the beginning of the COVID-19 pandemic, which triggered a temporary intervention by the central bank, the exchange rate of the Albanian lek lost only about 0.6% of its value against the euro in 2020, but returned in the second quarter of 2021 to its pre-2020 trend of continuous appreciation since 2016.

Inflation rose slightly, but remained far below target and the central bank kept its very accommodative policy stance, unchanged since March 2020. Annual inflation averaged 1.7% over the last five years but rose slightly from 1.4% in 2019 to 1.6% in 2020, mainly due to rising food prices, but declined again in the first half of 2021 to 1.4%. The monetary and exchange rate policy framework has not changed. The BoA, which operates under an inflation-targeting regime (currently 3%) coupled with a floating exchange rate, kept its very relaxed policy stance unchanged since March 2020 in view of the continuing economic impact of the pandemic and the large gap to the inflation target.

High revenue loss and extraordinary expenditure led to rising fiscal deficit and public debt ratios in 2020, erasing the gains of several years of fiscal consolidation efforts. In 2020, high capital expenditure on post-earthquake reconstruction and on other infrastructure projects (+35.9% year-on-year) in addition to the pandemic-related support measures, pushed the expenditure ratio from the average 29% of GDP between 2015 and 2019 to 33.2% of GDP. Tax revenue[3] performed well from 2016 to 2018, but its growth had already stalled in 2019, before it dropped by 6.5% year-on-year in 2020, which led the tax revenue ratio to drop to 24.6% of GDP, down from an average of 25.4% of GDP in 2016-2019. The fiscal deficit remained below 2% of GDP in 2016-19, supported by increasing revenue and decreasing interest expenditure. The public debt ratio decreased moderately but continuously, from 72.7% in 2015 to 65.8% at the end of 2019.

Graph 1.3: **Albania - Fiscal developments**



Source: National sources

Plans for fiscal consolidation and the recommended broadening of the tax base have been postponed. In 2020, the fiscal deficit climbed to 6.8% of GDP and, coupled with public guarantees of 3.1% of GDP, pushed the debt-ratio to 76.1% of GDP. The declining trend in public external debt also reversed as it rose to 36.1% of GDP in 2020

[3] Including social insurance contributions

from 30.4% in 2019. In the first half of 2021, the rebounding tax revenue by 20% helped to decelerate debt and deficit growth, despite expenditure growth of 10% compared with the first half of 2020. The 2021-2023 medium-term fiscal framework, which was first submitted in October 2020, originally foresaw a significant debt and deficit reduction starting in 2022, underpinned by a new fiscal rule requiring the primary balance to be zero or positive with effect from 2023. However, due to the budget amendment of July 2021, which increased the deficit target for the year and postponed the application of the primary balance rule to 2024, the medium-term fiscal consolidation plan may have become obsolete, though it was not updated. The long foreseen medium-term revenue strategy was postponed and the raising of the VAT registration threshold as of 2021 narrows the tax base instead of broadening it.

Fiscal risks persist, but their monitoring improved, whereas reforms of public investment management stalled. Since 2019, a fiscal risk statement has accompanied the budget proposal. Its scope was gradually expanded to also cover public private partnerships (PPPs). However, despite continuing training and assistance to improve public investment management, long-agreed institutional reforms like the unification of the selection and approval process of public investment projects were not implemented. As a result, some areas of public investment, including reconstruction funds, are not subject to the usual evaluation criteria and procurement rules. The necessary increase of staffing in the Ministry of Finance and Economy in order to implement these important tasks is still pending and overall the efficiency of the strongly increasing public investment expenditure shows little improvement.

Considering the limited fiscal and monetary policy space, the macroeconomic policy mix in response to the double shock has been appropriate. The expenditure increase was timely and prudent, but the high level of debt severely limits the fiscal space to deal with shocks in the near future. The BoA's further relaxation of the already loose monetary policy stance in March 2020 was appropriate in view of the weak economic activity and the persistently below-target inflation rate. Its provision of liquidity and its temporary money market intervention supported financial and external stability. The macro-fiscal policy mix in response to the pandemic and the post-earthquake reconstruction needs has been generally appropriate and supportive to economic stability.

Functioning of product markets

Business environment

The increasing digitalisation of public services helps to lower the administrative burden on businesses as well as corruption and informality. Albania has continued to facilitate business registration procedures and licensing through the e-government portal. Online tax payments reduced opportunities for corruption e.g. by having less face-to-face meetings with tax officials. The Bank of Albania waived fees for home banking transactions and the government paid the crisis assistance funds preferably on bank accounts in order to reduce movement and contacts during the pandemic. Both led to an increase of online financial services and financial inclusion, which usually help to reduce informality. The implementation of electronic invoicing ("Fiscalisation") in

2021 reinforces this development. Nevertheless, the informal economy remains large – it is estimated to account for about one third of GDP[4].

Progress on improving legal certainty for businesses has been mixed, while concerns about the effective implementation of legislation and strategies persist. The adoption of the new Unified Law on Investment, which has been postponed from 2020 to 2021, meant that the expected improvement of legal security of investors has been delayed. The implementing legislation for the Bankruptcy Law was completed in 2020, and the National Bankruptcy Agency is fully operational. The implementation of the previous business investment development strategy (BIDS), which ran until 2020, progressed only slowly and most business surveys indicate that reforms have slowed down in the past 2-3 years. The Ministry of Finance and Economy is developing a new BIDS for 2021-2025, which is to provide the basis for the government's support to SMEs and investment. Businesses highlighted problems[5] in finding skilled staff and still considered corruption and informality (despite the latter's perceived decline) to be widespread. Other major concerns raised by the business community include a failure to implement legislation effectively, *ad hoc* regulatory and taxation changes, and the controversial use of public procurement procedures. The increased pace of VAT refunds by the tax administration help the liquidity position of small businesses, but the payment of large VAT refunds in instalments, without interest, undermines the credibility of the revenue administration.

State influence on product markets

To address the impact of COVID-19, the government provided about 2.6% of GDP to support businesses, households and the healthcare sector in 2020. This included minimum wages disbursed to 38 993 small businesses and self-employed, affected by the 3-month lockdown, lump-sum grants to 172 890 retrenched workers of small businesses in sectors affected by continuing mobility restrictions (e.g. tourism) and double benefits to 60 788 recipient households of economic assistance or unemployed registered prior to the lockdown measures. The government encouraged informally employed people to register in order to receive support by active labour market policies.The government also provided liquidity to businesses in the form of sovereign guarantees under which the equivalent of 1% of GDP was contracted by March 2021 through 850 loans via the 12 banks in Albania. The government also granted postponement or relief of profit and corporate income tax payments for affected business in 2020. The Ministry of Finance and Economy published the eligibility conditions for the support and the progress of disbursement. Applications were processed via established institutional channels and non-affected business and high-income individuals were excluded from the support.

The state's footprint in the economy and reported state aid levels are relatively low but incomplete reporting makes it difficult to evaluate effects on competition. According to newly established sector accounts, the public sector's share of gross value

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[4] IMF 2019, WP 19/278, "*Explaining the Shadow Economy in Europe: Size, Causes and Policy Options"* estimates on shadow economy in 2016 in Albania between 28% and 30% depending on the model.

[5] *Albania – enterprise survey 2019*; www.enterprisesurvey.org

added of the economy was about 11% in 2017. Public sector employment[6] decreased from 16.3% of total employment in 2014 to 14.3% in 2017 and increased again from then on to a 15.8% in June 2021. In 2019, Albania reported state aid increasing to 0.3% of GDP. This is probably underreported, given the lack of capacity and independence of the State Aid Commission. Most of the support targeted employment promotion, tourism and research in form of tax exemption, tax deferral, tax rate reduction and deduction of social security contribution. The Albanian Investment Corporation, which is owned and funded by the state to develop investment projects of public interest, was established in July 2020.

Privatisation and restructuring

There are about 170 extra-budgetary units and public corporations that lack effective oversight and their reliance on state funding pose fiscal risks. Using ESA 2010 methodology, the Institute of Statistics distinguishes between 154 extra-budgetary units of the central and local government (regulators, universities, football clubs, about 24 goods producers, water supply, sewerage and waste disposal companies) and 16 non-financial public corporations (4 in the energy and mining sector, the post, ports and fruit markets) and 1 public financial corporation. Albania has extended its improved monitoring of fiscal risks from state-owned enterprises in the energy sector to the water and sewerage utilities of local governments. In accordance with the national privatisation plan 2017-2020, 12 assets were privatised for a total value of about EUR 5.7 million in 2020, through public auction procedures, giving the former landowners priority to purchase the assets.

Functioning of the financial market

Financial stability

Liquidity injections and regulatory forbearance supported the stability of the financial sector during the crisis. In view of the impact of the COVID-19 pandemic, the BoA temporarily facilitated the deferral of loan instalments between March and August 2020, and extended the use of relaxed provisioning and loan restructuring rules so far until mid 2021. These rules are also applicable by the small but growing non-bank financial sector of about 32 institutions[7]. The ratio of NPLs to total loans remained stable in 2020 and slightly declined to 7.8% in May 2021, but it remains influenced by the regulatory exemptions. Overall, the banking sector closed 2020 with 15% lower profits than 2019 (return on equity fell to 10.7%), and the banking sector's capital adequacy and liquidity ratios dropped by 1 pp. to 18.1% and 3.5 pps. to 12%, respectively, in the first quarter 2021 compared with 2020. The BoA's stress tests of end 2020 confirmed the banking sector's resilience against macroeconomic and liquidity shocks for 2021/22, but the banks' relatively large exposure to government securities (averaging 25% of their assets) and to loans and deposits in euro (though decreasing to just below 50% of the total), continue to pose risks to the banking sector.

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[6] As share of total employment of the 15-64 year old acc. to LFS (INSTAT)

[7] Including 11 insurance companies, 5 investment funds and 3 pension funds with a share in total financial sector assets of 7.5 % in 2019.

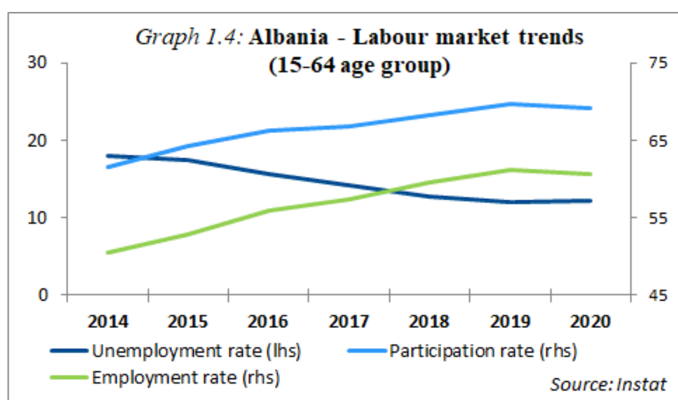
Access to finance

Favourable financing conditions, improving payment systems and growing trust in the banking sector improved access to finance. Lending to the private sector[8] grew 7.7% in both 2019 and 2020, increasing the average credit-to-GDP ratio from 34% in 2019 to a still low 37.8% in 2020, partly on account of the lower GDP denominator. In addition to favourable financing conditions and the relaxed loan provisioning and restructuring rules, the sovereign guarantee schemes, the increasing share of domestically owned banks in total banking system capital[9], and the growing public trust in the financial system have helped the lending performance. Albania has continued to align its legislation with EU Directives on financial instruments, payment systems, and anti-money-laundering (see chapter 4). The new capital market law, adopted in May 2020 (see chapter 9), contributes to the development and integrity of the very small capital market, which does not yet offer alternative financing channels to business.

Functioning of the labour market

After years of continuous improvements in participation, employment and unemployment rates, all labour market indicators deteriorated in 2020, but remained better than 2018 levels. Solid employment growth averaging 3.7% in the 2015-2019 period helped lower the unemployment rate (15-64) from 17.5% to a record-low 12%. Rising labour-force participation (from 64.2% in 2015 to 69.6% in 2019 for the age group 15-64) has driven growth in labour supply, despite a decreasing working-age population due to lower fertility rates and emigration. Since 2018, the decrease of the working age population accelerated reaching almost 1% in 2020 while total population declined by 0.6%. In the wake of the COVID-19 pandemic, the unemployment rate increased only slightly in 2020, by 0.2 pps. year-on-year, partly because of the government's support measures and partly because the 1.9% fall in employment was coupled with lower participation in the labour (15-24) market due to the higher number of discouraged workers. After a strong increase in the first quarter of 2021, the unemployment rate recovered to 12.1% in the second quarter supported by strong growth of public employment. Compared with 2019, employment decreased by 2.8% in agriculture, 5.3% in services, and 0.5% in industry in 2020. The gap between the participation rates of men and women remained in 2020 unchanged from 2019 at 15.9 pps. but slightly increased in the first half of 2021.

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



Source: Instat

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

[9] Domestic banks' share of capital in total banking sector assets increased from 21.6% in 2019 to 31% in February 2021, partly because the share of EU banks in the market further decreased with the departure of the last Greek bank in the country (Alpha bank).

Nominal wage growth in 2020 decelerated by 1 pp. to 2.7%, as wage indices of most sectors dropped (though data might be influenced by informal practices). The nominal wage growth decelerated more strongly from the third quarter of 2020 on, and annual average real wage growth fell to 1.1%, less than half of the 2019 growth rate. The practice of under-stating wages in the contracts has seemingly increased in recent years, according to a survey[10], in which almost half of Albanian respondents either had no written contract or had a lower wage in their official contract than what they actually receive. Informal employment is estimated at 32.2% of non-agricultural employment[11] but the low capacity of the labour inspection directorates only allowed for an inspection of about 7% of companies and only 5% of those were fined in 2019[12].

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

Albania has made **some progress** and has **some level of preparation** in its capacity to cope with competitive pressure and market forces within the EU. Energy and transport infrastructure, the use of digital communication as well as education outcomes have improved, but significant gaps to regional and European levels remain. Albania's competitiveness is hindered by a lack of entrepreneurial and technological know-how, significant levels of informality, unmet investment needs in human and physical capital, and low spending on R&D. The pre-existing significant skills and education gaps have probably widened due to the COVID-19 related lockdowns and distance learning. Regional integration and exports increased but remained below potential. The lack of product and geographical diversification of exports add to Albania's vulnerability to external shocks.

As 2019 recommendations to improve competitiveness and to sustain long-term growth have only been partly implemented, in the coming year Albania should in particular:

→ develop a Youth Guarantee Implementation Plan and institutionalised tools to monitor skills needs in the labour market;

→ establish effective consultation mechanisms with businesses and social partners and enhance business support services to improve access to finance and entrepreneurial know-how;

→ re-orient public expenditure composition towards development of human capital and innovation, and incentivise the link between innovative businesses and academia.

Education and innovation

The number of higher education graduates increased, but progress on vocational training is limited and funding for education and research remained low. The share of university graduates among the 25-29 age group increased hugely over the last decade, to 40.8% in 2019, but labour market transition remains challenging. Albania

[10] SELDI policy brief no. 11, November 2020, Hidden economy in the Western Balkans 2020: Trends and policy options
[11] ILO 2021: *Overview of the informal economy in Albania*, based on 2019 labour force survey data.
[12] OECD competitiveness in Southeast Europe 2021

lacks tools to monitor skills needs of the labour market regularly, thus curricula are not well adapted to business requirements, and skills mismatches persist. Although medium and large enterprises ranked an inadequately educated workforce as the third of their top three business obstacles[13], they are not able to absorb the increasing number of graduates.

The proportion of companies investing in R&D (about 18%) was the second lowest in the region[14] and the 0.03% of GDP public spending on research remained insufficient to strengthen the link between business and academia. At the same time, the share of young people not in employment, education or training (NEET) further increased in 2020, as a result of the crisis induced by COVID-19 (27.9% of the 15-29 year old) 27.9, while the vocational training and remedial education offer for the lower educated young and middle-aged work force remains limited, underfunded and unattractive. A modernisation of the legislative framework to provide vocational education and training (VET) is on its way, but implementation of the reforms is hampered by a lack of staffing at the responsible Ministry of Finance and Economy as well as at the newly established National Agencies for Employment and Skills (NAES) and for VET and Qualifications.

Physical capital and quality of infrastructure

Overall investment levels declined over the last five years but digital infrastructure improved. Overall investment in the economy in terms of real gross fixed capital formation (GFCF) fell from 24.5% of GDP in 2015 to 22.9% of GDP in 2020, because of contracting real growth of GFCF since 2019. This was mainly due to declining private investment from 19.1% of GDP in 2015, to 17% in 2019, and 16% in 2020, and a decreasing level of FDI-inflows**.** Annual public investment, on the other hand, remained broadly stable over the 2015-2019 period, averaging 5.4% of GDP (incl. local government investments), but jumped to est. 7.3% of GDP in 2020, mainly because of post-earthquake reconstruction of housing and public buildings. Despite continuous relatively high levels of public investment, Albania's infrastructure remained below the level of regional peers. On the positive side, water and electricity distribution progressed and digital infrastructure improved, with a growing proportion of households having internet access.

Reforms of the energy sector regulation advanced and first steps were taken towards diversification of the energy mix. Since 2018, Albania has successfully promoted investments into solar power to begin diversifying its energy mix, so far dominated by hydropower, which is dependent on rainfall, a resource that is forecasted to decline, due to climate change. In May 2020, Albania amended the Power Sector Law, which improved compliance with the EU energy legislation and allowed for the effective separation of the electricity distribution system operator from the production operator. Consequently, Albania's ranking in the Energy Transition Index climbed from 52nd in 2020 to 25th is 2021. In February 2021, Albania adopted a new Energy Efficiency law, and has begun drafting the legislation for the energy certification of

[13] World Bank 2019
[14] World Bank / European Investment Bank / OECD, *Enterprise survey – Albania* (2019).

buildings. However, the third National Energy Efficiency Action Plan has expired without being fully implemented and a strategy for increasing industrial energy efficiency is missing.

Sector and enterprise structure

During the pandemic, the shift to services and manufacturing stalled, and agriculture and construction gained relative significance. Although the relative weight of the agricultural sector in the economy declined from almost 19.8% of GDP in 2015 to 18.4% in 2019, it remained larger than in all other countries in the region. In 2020, agriculture gained 1 pp. weight due to its growth and the low performance of almost all other sectors, while construction recovered from its 2019 low to 9.2% of GDP. The increase of the share of services stalled at 48.5% of GDP, due to the contraction of the accommodation, food-related services and retail trade sectors, and manufacturing lost ground slightly from 6.3% in 2019 to 6.2% of GDP in 2020. The business registry[15] reflects this shift in an increasing share of goods producers (due to an increasing registration of agricultural enterprises) and a decreasing share of services producers from 2019 to 2020. The overall number of registered non-agricultural enterprises slightly decreased by 0.4%.

SMEs' contribution to employment and value added increased in 2019. SMEs are 99.8% of all enterprises (1-249 employees), while large enterprises (250+ employees) only account for 0.2%[16]. These shares are the same as the EU average, though the share of medium size enterprises with 50-249 employees is slightly higher in Albania than in the EU. In contrast to the EU, Albanian SMEs account for a much larger share of employment (81.6% vs 66.7%) and value added (72.4% vs 56.5%), in particular the 37% of employment by micro enterprises in Albania (29.9% in EU). Microenterprises are the largest employment contributors and account for the largest share of employees, in particular in the accommodation and food services, and trade sectors, which have been most hit by the COVID-19 pandemic. These sectors' employment importance is not matched by their contribution to investments, which is the lowest of the four groups of enterprises, reflecting their sectoral focus, but also indicating their low productivity and growth potential. However, SMEs' contribution to employment and value added increased in 2019 compared with 2018, while large enterprises only contributed positively to investment. Enterprises continued to increase their use of the internet. The share of businesses using social media for marketing increased by 7 pps. to 89.7%, but computer use for internal business processes remained low.

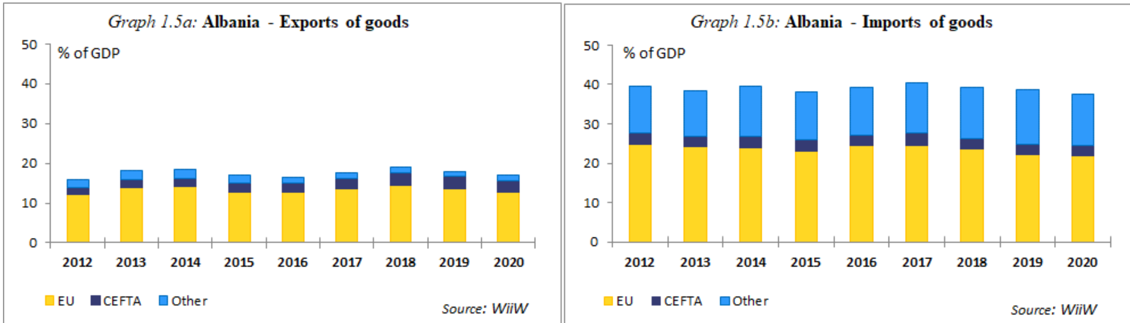
Economic integration with the EU and price competitiveness

The EU remained the main trading partner and source of FDI for Albania but overall trade and FDI fell sharply due to the COVID-19 pandemic. The trend for overall trade has been decreasing slightly since 2017, but the pandemic caused a notable drop from 77.1% of GDP in 2019 to 61.8% of GDP in 2020 (in real terms). The COVID-19 pandemic caused the exports of Albania's goods to the EU to drop by 11.4%

[15] INSTAT, Statistics based on business register 2020.

[16] INSTAT, Structural Survey of Enterprises for 2019, classification of size in line with EU definition, not including agricultural and fishing activities.

in 2020, about 2 pps. more than total exports, while imports of merchandise from the EU dropped by 6.4%, 1 pp less than total imports. The difference, partly due to base effects, means that the EU absorbed a slightly lower share of Albania's goods exports (74.7%, compared to 76.3% one year earlier), while its share in Albania's imports slightly increased to 58%. Italy remained Albania's largest trade EU partner for both imports and exports. The shares of trade with CEFTA countries increased by 0.6 pps. to 17.8% for exports and by 1 pp. to 6.5% for imports, and the share of trade with the rest of the world increased too, both indicating a gradually increasing diversification in trade partners. The largest goods export categories remained commodities and processed goods with low value added such as metals, minerals, footwear and textiles. The export base remains limited and service exports continued to dominate Albania's foreign sales, accounting for 79% of all exports in 2019. Hit by the impact of the pandemic on travel and tourism, they dropped by 34.5% year-on-year in 2020. In 2019 (2020 data not yet available), the EU was the destination of 66% of Albania's service exports and more than half of the total exports to the EU were services. The EU's share in Albania's FDI inflows increased in 2020 to 52.8 %, despite the exit of the UK, and its share in the FDI stocks increased to 54.9%. In terms of annual change, FDI flows from the EU fell much less (-7.5 %) than FDI inflows of the rest of the world (-18.3%) in 2020. The index of the real effective exchange rate (REER) of the Albanian lek continued to appreciate, by 1.8% in 2020 (3.5% in 2019) as well as in the first half of 2021, mainly as a result of the lek's nominal appreciation against the Turkish lira and the euro.



2. MONTENEGRO

2.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Montenegro has made **some progress** and is **moderately prepared** in developing a functioning market economy. The country experienced a sharp recession in 2020 as the COVID-19 pandemic took a heavy toll on its tourism-dependent economy, with large negative spillover effects on private consumption, investment, employment, trade and public finances. To support citizens and the economy, authorities implemented several economic support packages, including wage subsidies, loan moratoria and temporary tax reductions for businesses and citizens. These measures were, to a large extent, well targeted, transparent and of a temporary character, avoiding market distortions while preventing an increase in the number of bankruptcies. In spite of some delays due to the pandemic, the government continued implementing some of the envisaged reforms of the business environment. An orderly government transition in the middle of the crisis preserved the effectiveness of the COVID-19 policy response. The new government managed to mitigate fiscal risks by accumulating sizeable fiscal buffers to cover 2021 financing needs, including for additional COVID-19 support programmes. The financial sector remained stable during the crisis, as a result of its strong pre-crisis position and the support measures implemented by the authorities, but the delayed impact of the crisis on bank balance sheets calls for close monitoring of the financial institutions.

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

→ once the recovery is entrenched, implement a medium-term fiscal consolidation plan foreseeing a meaningful reduction of the budget deficit and the public debt ratio;

→ strengthen fiscal governance by setting up an independent body for fiscal oversight;

→ support the economy by reducing public sector arrears and deadlines for VAT return;

→ further reduce institutional and legal obstacles to swift and effective NPL resolution and ensure sound credit risk management, a transparent display of asset quality and adequate provisioning;

→ develop and implement concrete actions and measures to reduce the informal economy.

Economic governance

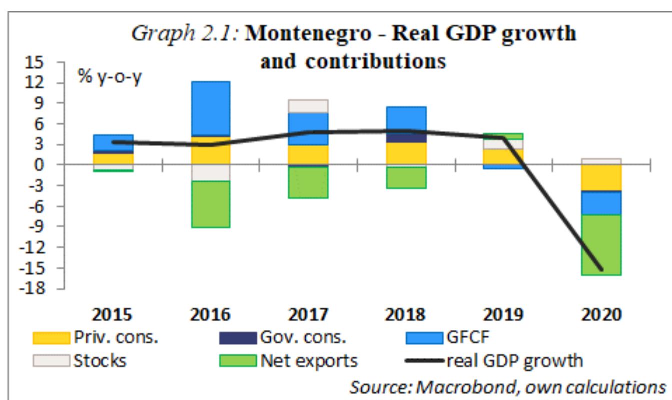
One of the first measures of the new government was to reaffirm its commitment to the EU path. Combating the COVID-19 pandemic while finding a balance between stabilising public finances and supporting economic activity quickly became top priorities. Despite the change of government, there has been a continuity in the policy response to the crisis. The governments implemented five socioeconomic support

packages totalling some 6% of GDP in 2020 and additional 7% of GDP in 2021 (including loan support programmes). Measures combine direct wage subsidies, favourable loan programmes, tax deferrals and other actions targeting the most vulnerable sectors. Montenegro has also received rapid emergency support from various international institutions, including EUR 60 million Macro-Financial Assistance from the EU, whose final instalment was disbursed on 1 June 2021, after Montenegro fulfilled all policy conditions. The new government's Economic and Reform Programme (2021-2023), adopted with a delay in April 2021, projects a rather ambitious fiscal consolidation path relying on a quick recovery of the economy, a fall in public investment spending and a tight control of current expenditure.

Macroeconomic stability

After recording a relatively fast pace of growth in the previous five years, Montenegro suffered one of the deepest recessions in Europe in 2020. The COVID-19 outbreak had an overwhelming impact on Montenegro's tourism-dependent economy as this sector accounts for more than 20% of GDP, while 74% of all jobs are in the service sector. Therefore, the collapse in foreign tourist arrivals in 2020 contributed to a massive contraction of the economy by 15.2%. The negative performance of net export was the key trigger of the recession, but not the only one. Social distancing measures and the closing of retail shops and catering services depressed private consumption too, while weak business confidence and a high degree of uncertainty constrained investments. Rising government expenditures could only partially cushion the deep recession. Overall, rapid growth in the pre-crisis years brought Montenegro's per-capita income in purchasing power standards from 41% of the EU-27 average in 2014 to 50% in 2019, to fall back to 46% in 2020 due to the COVID-19 crisis.

Graph 2.1: **Montenegro - Real GDP growth and contributions**



Source: Macrobond, own calculations

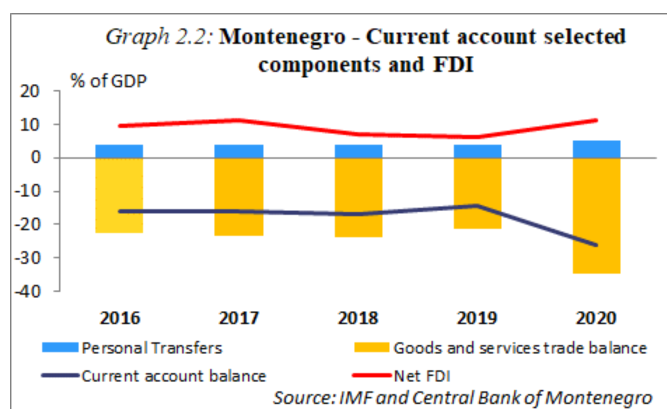
The economy still suffered from the restrictions to contain the epidemiological situation in the first quarter of 2021, with real GDP contracting by 6.4% y-o-y. Strong base effects, the easing of containment measures and some pick-up in tourism activity turned annual growth positive in the second quarter, as retail sales surged by 19.6% y-o-y, exports rose by 53.4% y-o-y, while the rise in domestic demand also fuelled a sharp (28.6% y-o-y) increase in imports.

The collapse in tourism revenue further aggravated Montenegro's chronic external imbalances. The dramatic fall in services exports, in particular tourism, affected Montenegro's traditional surplus on the services account, which shrank to 4% of GDP in 2020, down from 20% of GDP a year earlier. Despite a significant contraction of goods imports, a small surplus of the primary balance and relatively resilient

remittances, this pushed the current account deficit to 26% of GDP, compared to an average of 14.9% of GDP in the previous five years. The current account deficit eased somewhat to 19.5% of GDP in the four quarters to June 2021, driven by a revival of services exports and remittances, also reflecting statistical base effects. However, the recovery in domestic demand also boosted imports, widening the merchandise trade deficit and preventing a more pronounced reduction of the current account deficit.

Net FDI inflows remained high in 2020 thanks to a reduction of capital outflows. Overall, net FDI totalled 11.2% of GDP in 2020 compared to 10.1% on average in the previous five years, thus covering 42.9% of the current account deficit. The rest of the deficit was financed through reserves and new debt issuance. However, the increase in net FDI was driven by a substantial drop in FDI outflows in 2020, after the temporary surge in outflows in 2019 due to the buyback of the electric power company's shares from a foreign investor. Net FDI eased to 9.4% of GDP in the four quarters to June 2021. The reimbursement of maturing sovereign debt using government deposits reduced the stock of international foreign exchange reserves from the equivalent of 8.2 months of imports at the end of 2020, to 6.8% in June 2021.

Graph 2.2: **Montenegro - Current account selected components and FDI**



Source: IMF and Central Bank of Montenegro

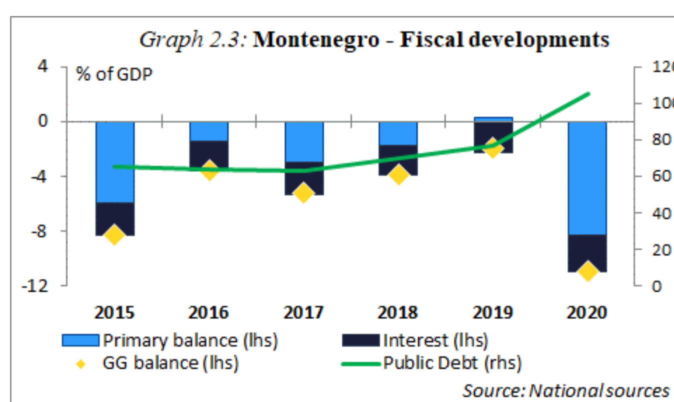
Table 2.1: **Montenegro - Key economic figures**	**2012-17** average	**2018**	**2019**	**2020**
GDP per capita (% of EU-27 in PPS)[1)]	43	48	50	46
Real GDP growth	2.3	5.1	4.1	-15.2
Economic activity rate of the population aged 15-64 (%), total[1)]	61.5	64.7	66.2	61.5
female	*55.1*	*57.2*	*59.1*	*54.7*
male	*67.8*	*72.3*	*73.3*	*68.3*
Unemployment rate of the population aged 15-64 (%), total[1)]	18.4	15.5	15.4	18.3
female	*18.3*	*15.3*	*15.9*	*18.8*
male	*18.4*	*15.6*	*15.0*	*17.8*
Employment of the population aged 15-64 (annual growth %)	2.5	3.2	2.6	-10.1
Nominal wages (annual growth %)	1.0	0.1	0.8	1.3
Consumer price index (annual growth %)	1.6	2.9	0.5	-0.8
Exchange rate against EUR	1.0	1.0	1.0	1.0
Current account balance (% of GDP)	-13.7	-17.0	-15.0	-26.0
Net foreign direct investment, FDI (% of GDP)	12.0	6.9	6.2	11.2
General government balance (% of GDP)	-5.0	-3.9	-2.0	-11.0
General government debt (% of GDP)	60.1	70.1	76.5	105.1

Notes:
1) Eurostat
Source: national sources

The demand shock resulting from the pandemic, along with falling oil prices, resulted in negative inflation for most of 2020. The use of the euro as legal tender means that the Central Bank of Montenegro cannot influence the money supply, which is determined by flows of the balance of payments. Inflation averaged 1.5% in the period 2015-2019. In 2020, food was the main inflationary driver; however, transport (and notably fuel prices) worked in the opposite direction. As a result, prices declined by 0.8% on average in 2020. As the economy showed some signs of recovery and global commodity prices started increasing in early 2021, inflation turned positive. In June 2021, consumer prices grew by 2.8% y-o-y.

The country's fiscal position, which had deteriorated already before the COVID-19 due to large debt-financed infrastructure projects, suffered a further blow from the pandemic-induced crisis. Since the beginning of the construction of the first section of the Bar-Boljare highway in 2015, budget deficits have remained high, averaging 4.6% of GDP annually in 2015-19. The sharp contraction of the economy, combined with government discretionary support measures, produced a large budget deficit of 11% of GDP in 2020. The strongest negative impact (-13.1% y-o-y) came on the revenue side, driven by the loss of the tourism season. Expenditure rose by 4.8% y-o-y due to fiscal support measures in spite of the government's efforts to reallocate spending from the capital budget, which was cut by one third, into healthcare. The Ministry of Finance and Social Welfare approved temporary financing for the first six months of 2021, as the adoption of the state budget was delayed. The recovery of economic activity and the introduction in January 2021 of electronic cash registers boosted tax revenues, contributing to a significant reduction of the budget deficit over the year. In the first seven months of 2021, the central government deficit amounted to 2.6% of the projected GDP, compared to 6.5% in the same period a year before. In June 2021, the central government debt declined to 89% of GDP, including government deposits estimated at 9.4% of GDP.

Graph 2.3: **Montenegro - Fiscal developments**



Source: National sources

The large budget deficit and the contraction of GDP in 2020 led to a substantial increase in the debt ratio. Overall, public debt surged to a record-high 105% of GDP at the end of 2020. To meet increased financing needs, the previous government secured funds from the IMF, the EU, the World Bank and other international financial institutions, totalling some 6% of GDP. In December 2020, the new government borrowed EUR 750 million thorough a Eurobond at favourable terms to build buffers and cover financing needs in 2021. In March 2021, the government repaid a maturing bond of EUR 228 million , still leaving EUR 584 million in the cash reserve (or around 12.7% of estimated GDP).

Montenegro has been confronted with a major crisis under exceptional circumstances. Its small tourism-dependent economy faced a major shock while its already weak public finances constrained the available fiscal space. Yet, the authorities' policy response to the crisis was timely and well targeted, adjusting its coverage as the situation evolved. In spite of an historical change of government in the middle of the crisis, the new administration avoided radical changes and adopted rather prudent economic and fiscal policies.

Functioning of product markets

Business environment

The COVID-19 palliative measures managed to contain the number of bankruptcies so far. The number of bankruptcies totalled 785 cases in 2020, practically the same number as in 2019, reflecting to some extent the efficacy of the policy response to maintain companies alive during the recession. However, the government support that cushioned businesses will eventually have to be withdrawn. Meanwhile, the number of new registered businesses in 2020 declined by 23% over the year, as pandemic-related uncertainties delayed new investment decisions in spite of further facilitation for registering companies. Thus, electronic registration of companies was introduced in December 2020 for single-member limited liability companies.

Further progress was recorded in the reduction of the tax burden. The number of local taxes and fees has been cut. In addition, a registry of fiscal and para-fiscal charges on state and local level was established in March 2021, facilitating business processes and increasing transparency. The new government decided to discontinue the programme of granting Montenegrin citizenship in exchange for investment in the country due to its poor results. Overall, the number of active e-services on the government's electronic portal increased to 575 in 2020, although most of them remain informational, and electronic payments under e-government services remain underdeveloped. The first electronic public procurement system was launched in January 2021. Montenegro's alternative dispute resolution mechanisms relies on the bailiff system for enforcement of debt claims. However, the system for collection of claims needs to be reinforced, as indebtedness of local businesses remain a major challenge. In March 2021, there were more than 19,000 frozen bank accounts (almost one third of registered businesses), totalling claims worth EUR 809 million (or 17.6% of GDP). The issue of informality in Montenegro mainly concerns informal wages and some informal labour, rather than unregistered firms. As a result, a significant proportion of the population is reliant on the informal economy, suffering disproportionally during the economic downturn, as they did not qualify for wage subsidies like in the formal economy. So far, government's fight against informality relies primarily on the control measures, a more efficient work of the inspection services and the deployment, in 2021, of new systems of electronic fiscal invoices and for electronic management and security printing of excise stamps.

State influence on product markets

State influence on the economy remains rather limited, also in terms of price formation. Moreover, the Agency for Protection of Competition is playing a more active role to eradicate undue State aid. The bankrupt state-owned Montenegro Airlines has been the main beneficiary of state aid for several years. In December 2019, the government adopted a law granting Montenegro Airlines EUR 155 million (around 3% of GDP) over the next six years. However, the Agency for Protection of Competition ruled against this decision in September 2020. In April 2021, a pre-bankruptcy procedure was introduced at the request of the revenue and customs administration, putting an end to a long trajectory of state support to the national airline. The Agency also investigates public aid granted to the two national maritime companies. Since the outbreak of the COVID-19 pandemic, the government adopted a series of measures providing support to businesses and employees to mitigate the negative economic impact of the pandemic. In order to enhance the transparency of public support granted and prevent undue state aid, the government set up in November 2020 a public register of COVID-19 related measures.

Privatisation and restructuring

The privatisation process has been practically concluded but the new government is engaged in the review of past deals. A few companies, mainly in transport, tourism and utilities remain left in public ownership. The privatisation council has established a commission to audit past privatisation contracts. Meanwhile, the new government has replaced the management at several state-owned companies. In August 2021, the government set up a company (named Montenegro Works) to advise and supervise the financial situation of all state-owned enterprises (SOEs) and support the implementation of reforms aimed at improving their management. After halting operations of the indebted Montenegro Airlines in December 2020, the government registered a new national airline, purchasing two planes and launching the recruitment procedure for technical staff from the former national airline. The new company started its first flight on 10 June 2021. Meanwhile, efforts to attract private investors through concessions have lost momentum. Following the finalisation of the prequalification tender for a 30-year concession of the two international airports (Podgorica and Tivat), the concession process has been kept on hold as the new government is yet to decide whether the tender will be cancelled or continued.

Functioning of the financial market

Financial stability

Montenegro's banking system entered the crisis in a strong position with solid capital and liquidity buffers. In 2019, before the onset of the COVID-19 pandemic, the system-wide ratios for regulatory capital was 19.8%, return on equity 9.0%, return on assets 1.2% and non-performing loans (NPLs) 4.7%. This situation, coupled with regulatory measures, allowed the banking sector to absorb the crisis impact so far. The Central Bank of Montenegro adopted nine packages of temporary measures, including

several loan moratoria, reduction in reserve requirement rates and a ban on dividends. The capital adequacy ratio of the banking system remained high, at 18.5% at end-2020 and 19.2% in June 2021, albeit profitability declined markedly in 2020. Meanwhile, temporary crisis support measures, including credit restructuring, helped containing NPLs, which rose only slightly, to 5.45% at the end of 2020 and to 5.70% in June 2021. On 8 September 2021, the central bank presented the preliminary results of an asset quality review of all commercial banks evaluating the soundness and quality of financial balance sheets. Overall, the COVID-19 crisis further tested the resilience of the financial sector. So far, key financial sector indicators have been stable. However, as the temporary crisis support measures expire, the number of impaired loans is set to rise due to the unprecedented recession, warranting enhanced supervision and policy preparation by the authorities.

Access to finance

Credit growth decelerated in 2020 but picked up again in early 2021. Banks tightened their criteria for approving new loans as the economic crisis worsened in 2020. Consequently, credit growth decelerated to 3.2% y-o-y in 2020, down from 4.5% a year before, to rebound by 6.8% y-o-y in June 2021. Moreover, the crisis reduced banks' deposit stock by 3% y-o-y in 2020, before it strongly rebounded by 11.4% y-o-y in June 2021. The number of banks declined from 15 to 12 as two small banks were closed in 2019 and another two banks merged in December 2020. As a result, the share of foreign ownership in bank's capital totalled 85%, with a further 13% owned by domestic investors and 2% by the government. Overall, credit risks remain high, resulting in expensive interest rates. This presents a major obstacle for businesses, in particular small ones. To alleviate the situation, the state-run Investment and Development Fund established several credit lines with the support of EU funds, to provide loans at subsidised interest rates.

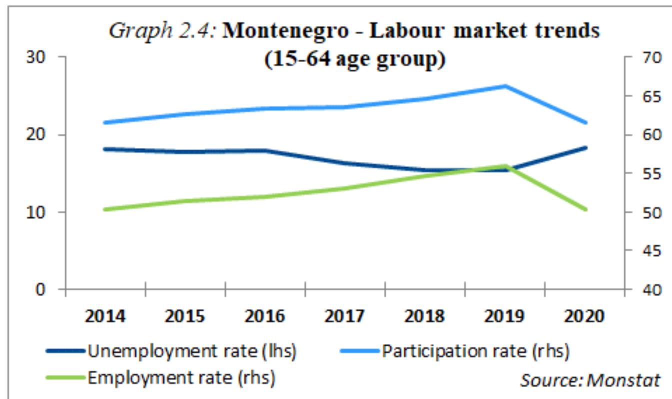
The size of the non-bank financial sector remains marginal. The stock market's role in the local economy is very small in terms of market turnover (i.e. 0.75% of GDP in 2020), while the assets of insurers and micro-financial institutions represent around 1.5% of GDP each.

Functioning of the labour market

The COVID-19 pandemic erased five years of labour market improvement. Conditions deteriorated quickly despite measures adopted by the government to help companies retain jobs. In 2020, the unemployment rate (population aged 15-64) increased by 3 pps. to 18.4%, a level not seen since 2014. Furthermore, the labour force shrank by 7% y-o-y, as 20,000 workers dropped out, discouraged by the severity of the crisis and the lack of opportunities in a confined economy. The COVID-19 crisis only added to an already poor situation. Active labour market policies appear insufficient to increase markedly employment opportunities for jobseekers. As a result, long-term unemployment remains high and chronic, concerning 74.7% of all unemployed in 2020. Skills mismatches remain another significant challenge, in particular for persons with

vocational education training or higher education. Montenegro's tax wedge remains relatively high, especially for low-wage workers, contributing to labour informality. Moreover, the structure of the social benefits system discourage women from re-entering the labour market, as the financial return required to work (i.e. reservation wage) tends to increase with the number of children. This is also reflected in their much higher inactivity and lower employment rates compared to men. Thus, in 2020, the female inactivity rate was 45.3% compared to 31.7% for men, while their unemployment rate was only 1 pp. higher than men's (17.8%).

Graph 2.4: **Montenegro - Labour market trends (15-64 age group)**



Source: Monstat

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

Montenegro has made **some progress** and is **moderately prepared** to cope with competitive pressure and market forces within the EU. The COVID-19 pandemic demonstrated that a lack of diversification makes Montenegro's tourism-dependent economy highly vulnerable to shocks. Some efforts have been made to improve innovation capacities and introduce EU standards at local companies thanks to public grants, but these remain modest compared to the scale of the challenge. The quality of the educational system and curricula preferences appear inadequate to raise human capital and to address skill mismatches. Modern telecommunication and energy infrastructure is being deployed rapidly, but there is a substantial deficit in transport infrastructure, hindering the integration with regional and EU markets. In addition, the low sophistication of domestic products, the small size of local companies and low level of participation in external markets represent major obstacles for increasing competitiveness and diversifying the economy.

As some of the 2020 recommendations have not been fully implemented, in the coming year Montenegro should in particular:

→ improve dual VET and tertiary education programmes in close cooperation with business associations;

→ develop transport infrastructure without endangering fiscal sustainability;

→ facilitate and promote SMEs exports.

Education and innovation

Investment on research and development (R&D) continues to increase, but the country remains a modest innovator. While the government support for R&D has continued to rise steadily since 2017, the modest level of investment limits the ability of enterprises to innovate and develop new products, but also for absorbing new technologies from abroad. The new science and technology park (STP) in Podgorica is still under construction, while the STP Tehnopolis in Nikšić is more advanced, with continuous technological upgrade and skills development. The country continued to participate in EU research programmes. The adoption in July 2020 of the laws on innovation activities and incentives for research and innovation development introduced fiscal incentives for developing the digital economy and the functioning of the national innovation system. Meanwhile, important secondary regulation to define the eligibility of the R&D tax incentives is being developed.

Montenegro's education system is facing numerous challenges. Schoolchildren lag behind international peers according to numerous ratings. The COVID-19 pandemic delayed remedial actions for improving the quality of education based on results from the 2018 PISA tests. Skills mismatch remains a persistent challenge for VET and higher education. Tertiary educational attainment remains lower than the EU average, and there is an oversupply of business and humanities graduates, contrasting with a shortage of medical, technology, and mathematics graduates. The result is a chronic occupational mismatch in relation to labour market opportunities. A more intense participation of business associations in the development of dual VET programmes could help reduce this gap. Overall, the COVID-19 pandemic contributed to a rapid development of the digitalisation of the education system but not of its quality.

Physical capital and quality of infrastructure

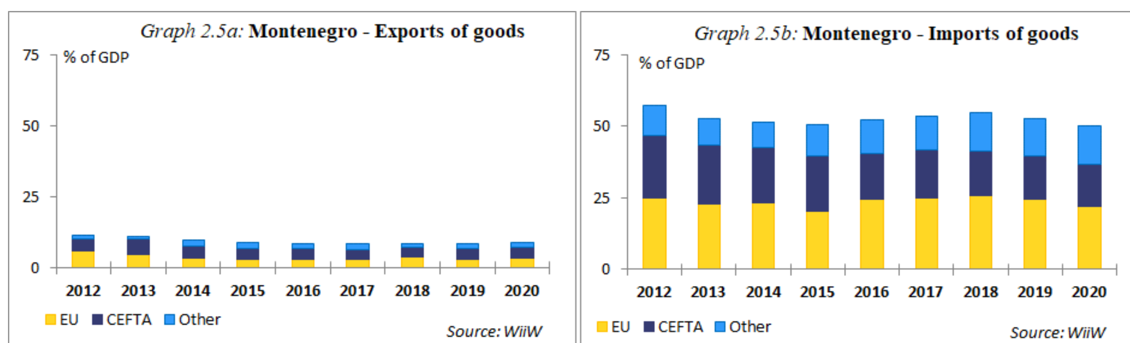
The COVID-19 pandemic and the very late adoption of the 2021 budget delayed investment in infrastructure and equipment. In 2020, construction activity contracted by 5.6%, and gross fixed capital formation by much deeper 12.3%. After a two-year delay, completion of the first section of the Bar-Boljare highway is planned in 2021. Construction of the next section depends on the outcome of feasibility studies and the setup of a viable financing scheme. Railway upgrading continues slowly, with the repair of some bridges and track sections in 2020. Fast and reliable broadband networks are crucial for the digitalisation of the economy. Overall, around 93% of households have access to at least 2 Mbit/s connection, 80% have access to 30 Mbit/s, and only 30% use ultrafast (100 Mbit/s) service. Although 98.6% of local enterprises use computers, only half of their employees have internet access. In May 2021, one local telecom company started 5G network testing in real conditions. Several projects of electricity transmission and interconnection with neighbouring countries are underway. The reconstruction of the Pljevlja thermal power plant to comply with modern environmental standards was delayed. The Energy Community launched a procedure against Montenegro after the thermal plant exceeded the agreed number of operating hours. Meanwhile, renewable sources of electricity production are being diversified with several wind, solar and hydropower projects underway. Offshore oil and gas exploration drilling started in March 2021.

Sectoral and enterprise structure

The structure of the economy remains broadly unchanged despite the crisis. The share of employment in services remained practically unchanged during the pandemic, accounting for 74.1% of total employment in 2020. By subsectors, some marginal decline (by 1 pp.) could be observed in retail trade, accommodation and food services, the parts more affected by the crisis. Other sectors, such as information and communication, expanded their activity during the pandemic; however, this increase was barely reflected in new jobs. The largest growth in 2020 was related to professional, scientific and technical activities, reaching 6% of total employment in 2020, compared to a modest 2% historical average. The development of tourism, energy and transport infrastructure in recent years has been reflected in a continuous growth in construction, from 6.6% in 2015 to 9.9% of total employment in 2019, falling to 8.4% in 2020 as many works were delayed due to the pandemic. Agriculture and industry account for 7.5% and 18.4% of jobs respectively in 2020, with little change over time. The small size of local companies limits output performance. Practically, 99% of companies are small or medium sized, of which 92% are micro enterprises. Furthermore, only 7% of local firms are involved in exports.

Economic integration with the EU and price competitiveness

The COVID-19 pandemic slowed the otherwise strong trade integration with the EU. During 2020, Montenegro’s foreign trade contracted by 18.1% compared to the previous year, while bilateral trade with the EU saw a similar contraction of around 16% y-o-y. The EU remains Montenegro`s main foreign partner, accounting for 44% of its total trade (i.e. 38.5% of total exports and 45.1% of total imports of goods). This compares to 31.2% of total trade with CEFTA countries. The EU also remains the main source of FDI inflows for Montenegro, even if its share decreased markedly to 27.0% of total FDI inflows in 2020, as compared to 42.1% in 2019. The low level of processing of local products and the modest size of businesses hinder export competitiveness. Montenegro’s largest exports concern low value-added products in bulk, namely aluminium, bauxite and electric current. These three items alone made up 42% of total merchandise exports in 2020.



The COVID-19 crisis had a negative impact on Montenegro`s trade openness ratio. The collapse of the 2020 summer tourist season sunk services exports to 4% of GDP, compared to 20% of GDP a year earlier. Moreover, merchandise trade also fell sharply, with exports and imports of goods declining by 12.2% and 19.0% y-o-y, respectively. As a result, the total exchange of goods and services plunged from 108.5% of GDP in 2019 to 86.3% in 2020. To succeed in EU or regional markets, and considering the rigidity of its monetary regime, Montenegro would need to improve substantially the competitiveness of its products, services and companies.

3. NORTH MACEDONIA

3.1. 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. Severely hit by the pandemic, the economy slipped into a recession in 2020. A gradual recovery set in as of spring 2021. The government implemented a strong fiscal response to mitigate the crisis impact on households and firms. The fiscal deficit rose to 8.2% of GDP in 2020 while the public debt level rose sharply to 60.2% of GDP, as additional financing needs had to be covered. Capital expenditure was cut in a budget revision to create space for crisis-related transfer payments, yet it was still heavily under-executed. The authorities took some additional measures to improve fiscal transparency, although a fully operational state aid registry is yet to be developed. There has been little progress made in improving revenue mobilisation and collection, as well as public investment management, including through a stronger framework for public-private partnerships. The new organic budget law, which is expected to significantly improve fiscal governance, is yet to be adopted by Parliament, and its implementation is delayed. Bolstered by regulatory easing, the financial sector remained strong and lending to the private sector constant. The business environment continued to be impeded by the large size of the informal economy.

As the recommendations of the 2020 Report were partly implemented and in order to improve the functioning of the market economy, North Macedonia should in particular:

→ Continue supporting the economy through well-targeted fiscal measures until the economic recovery is on firm grounds, while anticipating a gradual return to the pre-crisis primary deficit in the medium-term; improve revenue collection and broaden the tax base in line with the Tax System Reform Strategy, including by streamlining tax exemptions;

→ Adopt the Organic Budget Law with adequate provision for fiscal rules in line with Commission comments and take the necessary legislative steps for the establishment of the Fiscal Council;

→ Further reduce institutional and legal obstacles to swift and effective non-performing loans (NPL) resolution, including by facilitating out-of-court settlement and modernising the insolvency regime.

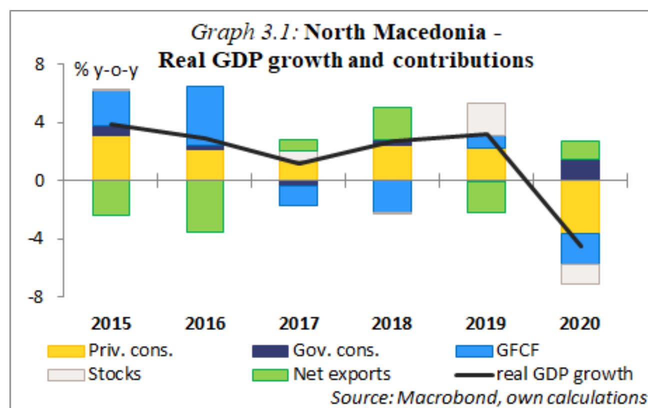
Economic governance

The government addressed the challenges from the COVID-19 pandemic, while at the same time making some progress on important fiscal and structural reforms. Between March 2020 and April 2021, the government successively adopted five sets of

measures to mitigate the economic and social impact stemming from the COVID-19 pandemic. These included subsidies to wages and to employer contributions, tax deferrals, as well as interest-free loans. The central bank, too, reacted swiftly to support the economy, by implementing four successive cuts in the key policy rate, and regulatory easing measures to provide borrower relief and bolster bank lending. The government improved fiscal transparency, notably by enhancing the reporting on the finances of public enterprises and municipalities. However, the most important measure to improve fiscal governance, the new Organic Budget Law, which contains provisions for fiscal rules and a fiscal council, was adopted by the government in December 2020, but has not yet been adopted by Parliament. Moreover, its implementation depends heavily on the introduction of the new Integrated Financial Management Information System (IFMIS), which is delayed. Other important reforms are also lagging behind, in particular measures to combat the informal economy, and the establishment of a fully functional state aid registry. To address the increased financing needs in 2020, the government was granted assistance under the International Monetary Funds's Rapid Financing Instrument (IMF RFI), and loans from the World Bank. It also benefitted from macro-financial assistance from the EU, which was completed in June 2021 after the government had fulfilled all conditions for disbursement of the second tranche. The policy guidance jointly agreed at the May 2020 Economic and Financial Dialogue between the EU and the Western Balkans and Turkey has been partially implemented.

Macroeconomic stability

North Macedonia's economic upswing came to a sudden halt in 2020, as the COVID-19 pandemic hit domestic and foreign demand. North Macedonia's economy had been on a path of accelerating growth in the two years prior to the crisis, when the pandemic hit the country in March 2020. Domestic economic activity plunged in the wake of containment measures, and external trade suffered from lockdowns and recessions in trading-partner economies, and through the temporary breakdown of automotive supply chains. Due to falling imports, net exports contributed positively to GDP growth, as did government consumption, mitigating the impact of lower private consumption and investment. Household disposable income suffered from a stark drop in remittances from abroad. Investment, which had picked up in the second half of 2019 after two sluggish years, plummeted in the second quarter of 2020, yet recovered over the summer. After a steep drop in output between April and June 2020, the annual decline gradually eased in the second half of the year, as containment measures were lifted and foreign demand strengthened. Overall, annual real GDP dropped by 4.5% in 2020. Convergence with



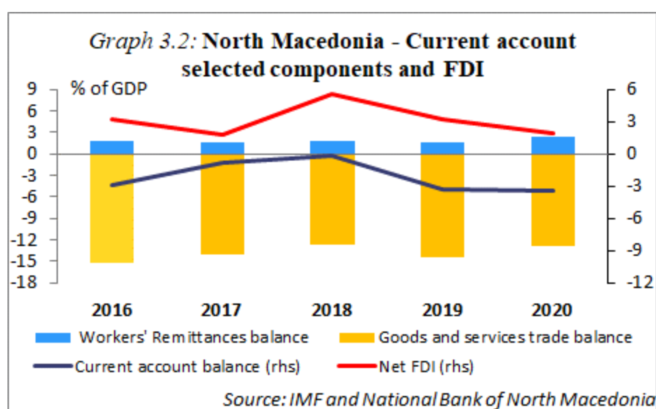
Graph 3.1: **North Macedonia - Real GDP growth and contributions**

Source: Macrobond, own calculations

EU income levels remains sluggish. Real GDP per capita has increased only marginally in the past five years, from 36% of the EU-28 average in 2015 to 38% in 2020.

External imbalances increased during the pandemic. After averaging at 1.5% of GDP between 2014 and 2018, the current account deficit increased in 2019, and further in 2020, to 3.5%, as private transfers dropped markedly below their average of the past five years, and in spite of an improving merchandise trade balance. The shortfall was not covered by net FDI inflows, which, against stark outflows of intercompany debt, amounted to only 1.9% of GDP, much below their average of 3% in the preceding five years. After having decreased each year between 2016 and 2019, the external debt ratio rose in 2020 to 80.2% (+7.3 pps. year-over-year), mainly as a result of foreign financing for crisis-induced needs. However, the structure of the debt implies moderate risks. About 70% of the total consists in long-term debt, and the share of intercompany debt and trade credits, which constitute less volatile components of foreign debt, remained high. With substantial foreign capital inflows, including through two Eurobonds issued in 2020 and 2021, the government bolstered its foreign exchange reserves (+30% year-over-year at end-March 2021), representing five months of prospective imports.

Graph 3.2: **North Macedonia - Current account selected components and FDI**



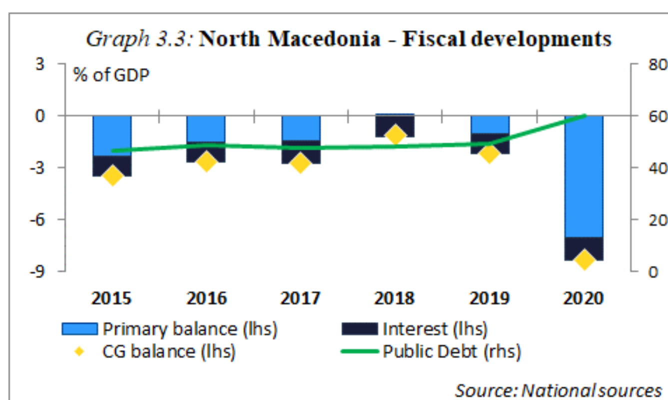
Source: IMF and National Bank of North Macedonia

Table 3.1: **North Macedonia - Key economic figures**	**2012-17** average	**2018**	**2019**	**2020**
GDP per capita (% of EU-27 in PPS)[1)]	36	37	38	38
Real GDP growth	2.3	2.7	3.2	-4.5
Economic activity rate of the population aged 15-64 (%), total[1)]	64.8	65.4	66.3	65.5
female	*51.8*	*52.2*	*54.8*	*54.0*
male	*77.5*	*78.3*	*77.3*	*76.7*
Unemployment rate of the population aged 15-64 (%), total[1)]	26.9	21.0	17.4	16.6
female	*26.4*	*20.1*	*18.6*	*16.1*
male	*27.2*	*21.5*	*16.6*	*16.9*
Employment of the population aged 15-64 (annual growth %)	2.3	2.5	5.1	-0.3
Nominal wages (annual growth %)	1.6	5.8	5.1	8.3
Consumer price index (annual growth %)	1.1	1.5	0.8	1.2
Exchange rate against EUR	61.59	61.51	61.51	61.67
Current account balance (% of GDP)	-1.9	-0.1	-3.3	-3.5
Net foreign direct investment, FDI (% of GDP)	2.4	5.6	3.2	1.9
General government balance (% of GDP)	-3.5	-1.1	-2.2	-8.2
General government debt (% of GDP)	37.2	40.6	40.7	51.2

Notes:
1) Eurostat
Source: national sources

Monetary policy supports the ongoing economic recovery, while heeding rising inflationary pressures. Inflation was subdued until picking up in the second half of 2020, driven by rising prices for food, fuels, including higher excises on oil products, and a statutory price rise for electricity in August. In the first half of 2021, additional domestic price pressures arose from services, in particular the transport sector. On average, the consumer price index (CPI) rose by 1.2% in 2020, compared to 0.8% in 2019, and further to 2.7% in the first eight months of 2021. The currency is in a stable, de facto pegged exchange rate regime with the euro. The central bank lowered the key policy rate in March 2020, followed by three further cuts of 25 bps each, to reach the historic low of 1.25% in March 2021. Overall, the monetary policy stance is in line with current economic fundamentals, including still moderate inflation dynamics, and the need to support the economic recovery amidst lingering domestic and external risks due to the COVID-19 crisis.

Graph 3.3: **North Macedonia - Fiscal developments**



Source: National sources

Public finances deteriorated in 2020, as automatic stabilisers kicked in and the government implemented discretionary support measures. Between 2014 and 2019, the general government fiscal deficit was declining each year, in terms of GDP, albeit

largely on the back of under-execution of budgeted capital expenditure. In 2020, the deficit rose to 8.2% of GDP, as revenue declined by 6.9% year-over-year, while current expenditure increased by 13.9%. The government adopted a range of crisis-support measures in 2020 and early 2021, comprised of fiscal measures as well as liquidity support, and including i.a. wage subsidies, tax deferrals, and interest-free loans. Fiscal support from these packages amounted to some 3% of GDP in 2020, with further implementation of measures in the first half of 2021. Tax revenue has recovered since the last quarter of 2020, as containment measures were gradually lifted and companies paid deferred income tax liabilities. Capital spending, at 82% of the revised budget, was, again, severely under-implemented.[17] The government had to resort to a budget reallocation and to two supplementary budgets to accommodate the support measures. The composition of public spending was hence tilted towards transfer payments. Overall, shortcomings in revenue collection and a large number of tax exemptions eroding the tax base have contributed to a decline in public revenue ratios in recent years, adding to fiscal risks from a rising pension deficit, large indebtedness of public enterprises, and still significant budget arrears.

Debt levels surged, as the government needed to meet crisis related financing requirements and roll over maturing debt. General government debt rose by 10.5 pps. year-over-year to 51.2% of GDP, accounting almost exclusively for the rise in the public debt ratio to 60.2%. Foreign borrowing made up a large part of the debt increase, including two Eurobonds of EUR 700 million each, issued by the government in May 2020 and in March 2021.

The government further enhanced fiscal transparency. In 2020, the Ministry of Finance started publishing consolidated data of municipalities' budget execution on its website. This is an important step towards addressing weaknesses in local governments' management of public finances. Moreover, the government requires all public and state-owned enterprises at state level to publish quarterly income and expense statements with a three-to-four months lag, hence allowing for improved management of fiscal risks arising from the finances of these enterprises, many of which run sizeable deficits and have accumulated large debt stocks. Still, there is a need for more detailed income and expense statement as well as balance sheets for state owned enterprises. Current data presentation does not allow for a meaningful public finance and fiscal risks analysis. In addition, the government set up a dedicated website for information on the implementation of COVID-19 related support measures, including the main beneficiaries.

The governance of public finances was further strengthened, but concerns remain regarding the implementation of the new Organic Budget Law. In December, the government adopted a draft Organic Budget Law, which includes provisions for fiscal rules, a fiscal council, and a proper medium-term budget framework. However, the law

[17] However, this does not account for capital expenditure carried out by off-budget entities, the most significant one being the PESR, which is implementing a sizable investment programme of over EUR 1 billion. Central and local government habitually accounts for about one third of total public sector investment.

still needs to be adopted by Parliament and accompanied by implementing legislation, which could lead to protracted implementation. The draft provides for escape clauses proposed for the fiscal rule which are too wide and would allow for an accelerated rise in public debt. Enforcement of the new law is unclear in view of the phasing approach for its enactment. The work on the development of the secondary legislation is still in its initial phase. Moreover, its implementation depends heavily on the introduction of the new integrated IT system (IFMIS), which is yet to be adopted as well.

There is a need to adopt robust fiscal rules and ensure commitment to such rules. Namely, the medium-term fiscal strategy adopted recently that targeted a return to the planned fiscal rule, was discredited a week later with the adoption of the 2021 budget revision which delayed fiscal consolidation plans until 2025. With a view to improving revenue mobilisation, the government conducted a review of foregone revenues from tax deductions in direct income taxation and preferential VAT rates, in line with the 2020-2023 Tax System Reform Strategy adopted in December 2020. Moreover, the government adopted an Action Plan for improving public investment management, based on the recommendations of the respective 2020 IMF report. However, the government has not yet progressed in its project to include off-budget entities into the general government sector where warranted by international statistical standards.

The government started work on strengthening the framework for public private partnerships (PPP). The Ministry of Economy is preparing draft amendments to the 2012 PPP law, providing for a streamlining of powers regarding administrative guidelines, contract formats, terms and conditions concerning selection, implementation and management of PPP projects. The draft also includes new tools and processes to ensure better management of fiscal risks arising from PPP. However, considerable delays are expected with regard to the development and establishment of the PPP and concessions registers which would facilitate the implementation of the laws.

Once the economic recovery firms up, a shift in the policy stance would be appropriate. While the fiscal and monetary stance is still appropriate in light of current financial and economic conditions, the country will need to gradually phase out and reorient crisis-related fiscal support as the economic recovery gains firmer ground. The government's response to the crisis managed to soften the impact in particular on employment and disposable income. In order to support a sustainable economic recovery and faster growth in an effective manner, the government needs to address major challenges facing the economy, such as wider mobilisation of public revenue; improved management of public investment; investment in human resources; and more transparent allocation of state aid. It also needs to envisage a gradual return to fiscal consolidation and debt stabilisation. Moreover, the continued rise in wages, bolstered by crisis-induced government wage subsidies, remain a challenge for external competitiveness, given the adverse developments in labour productivity over recent years.

Functioning of product markets

Business environment

The government takes first steps towards reducing the number of para-fiscal fees. With a view to streamlining the large array of parafiscal charges imposed on businesses, the government published, on a designated web page, a list containing 377 parafiscal charges at central and local level including their value. The implementation of other key measures, is however, protracted, such as 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 time of procedures, is still under preparation. Furthermore, increasing the efficiency and transparency of public administration, reducing the time and costs of commercial disputes and promoting alternative dispute resolution mechanisms would address some of the factors limiting the competitiveness of domestic companies.

Challenges posed by the large informal economy are not addressed in a decisive manner. The informal economy continues to pose an important obstacle to business operations for regulated firms. According to IMF estimates, it could account for as much as 37.6% of GDP. 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. Other practices common to the informal economy include not issuing tax receipts or invoices, or underreporting turnover. Freelance work and personal services provided at home or via the internet, the prevalence of which is growing, often go unregistered. Implementation of the government's 2018-2020 Action Plan to combat the informal economy remains sluggish. A new Action Plan has yet to be developed and adopted.

State influence on the product market

The government provided large-scale support in the pandemic and improved transparency on these payments. The government has consistently ensured public dissemination of information related to the adoption of the COVID-19 support measures. A designated webpage is active and contains information on the condition and criteria for the allocation of the support. All financial transactions related to the payment of the COVID-19 support, including the amounts of aid and names of beneficiaries, are available on-line in real time. The government has also prepared and has made available online a clear overview of the implementation of the COVID-19 support packages according to type of aid. 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 competences of the Commission for the Protection of Competition (CPC) in state aid supervision.

Privatisation and restructuring

The public sector's stake in the economy remains low and unchanged. In 2020, the number of companies in which the government held a stake remained the same as in the three preceding years (16 companies in full state ownership and 40 companies in partial ownership, most of these with a state ownership share of below 1% of issued capital.).

The total value of state ownership in enterprises remained at 10.7% of the GDP. There are currently no plans for further privatisations.

Liberalisation of the electricity and natural gas market has progressed. In early 2020, the electricity market was fully liberalised, in line with the 2019 Law. Retail prices have been deregulated, except for the universal supplier for which the regulator (ERC) sets the price. At end-2020, over 30,000 consumers (per metering points) were purchasing electricity from the active suppliers on the open market, under mutually agreed (unregulated) prices. Over 16,000 retail customers switched suppliers in 2020, more than twice than in the same period one year earlier. In September 2020, the government designated a subsidiary of the national electricity market operator (MEPSO), to act as the nominated operator of the organised electricity market. The electricity transmission and distribution network operators are unbundled in accordance with the EU *acquis*. The natural gas market was liberalised in 2015. At the end of2020, there were six licensed active natural gas suppliers and natural gas traders. Wholesale gas prices are fully deregulated, but the market remains illiquid, without a virtual trading point. The gas transmission system operator is not yet unbundled in line with the Third Energy Package.

Functioning of the financial market

Financial stability

The authorities strengthened the institutional framework for ensuring financial stability but important measures to bolster the financial safety net remain incomplete. In April 2020, the authorities responsible for the supervision and oversight of different segments of the financial market signed a Memorandum of Cooperation establishing a Financial Stability Committee. A draft law which will both allow for the establishment of a permanent committee, and assign the National Bank a unique and leading role in developing and implementing North Macedonia's macro-prudential and financial stability policies is currently being prepared. However, following regulatory normalisation, the NPL ratio is expected to rise. The new insolvency law could help expedite the resolution of NPLs, but it has not yet been adopted. In this regard, there is also a need to strengthen the framework for deposit insurance.

Diversification of the financial sector remains slow. Banks continue to dominate the country's financial sector, accounting for some 82% of sector assets at the end of 2020. Banking sector concentration remains moderate and was almost unchanged compared with previous years, with some 57% of assets held by the three biggest banks. Ten out of the sector's fourteen banks are predominantly in foreign ownership. The share of foreign in total equity has been consistently high in the past five years, at about 75%.

Bolstered by regulatory easing, the banking sector remained stable. The banking sector remained well capitalised and liquid, reflecting banks' robust pre-crisis position and support from the central bank's financial sector measures. The capital adequacy ratio was above its level of five years earlier at end-2020 (+1.2 pps. at 16.7% of risk-weighted assets) and well exceeding the regulatory minimum. Liquid assets account for one third of total assets and cover more than half of short-term liabilities. The quality of the loan portfolio has been improving gradually since the end of 2013, with the ratio of

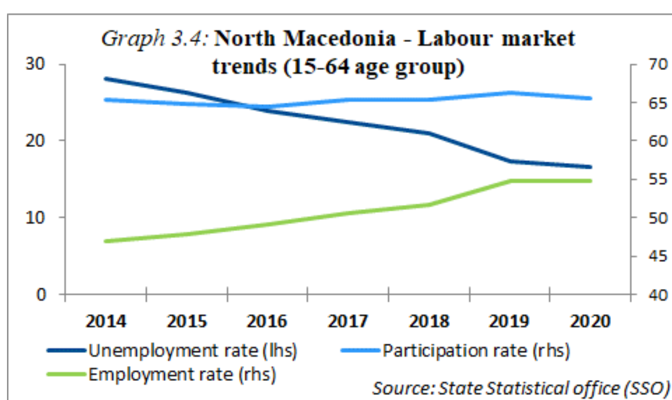
NPLs falling to a record low of 3.4% at the end of 2020, compared to 4.8% at end-2019. The reduction of non-performing loans continues to be influenced by the mandatory write-off of fully provisioned NPLs[18], and also reflects regulatory measures from March 2020, which enabled banks to approve a temporary moratorium on loan repayments, providing greater flexibility and incentives for bank lendingThe central bank's denarisation strategy is contributing to lowering the share of foreign-currency denominated loans and deposits in banks' portfolios, and hence reducing currency risk. At the end of 2020, 44.9% of loans had an FX-component, compared to 46.4% five years earlier.

Access to finance

Bank lending remained robust, but financial diversification and intermediation are not progressing. In 2020, credit to the non-government sector expanded at 6.4% year-over-year, compared to 7.2% one year earlier. It slowed down to an average of 4.8% year-over-year in the first four months of 2021, as supportive regulatory measures were phased out. As in the preceding years, the bulk of credit growth came from household loans, with corporate credit growth decelerating compared to 2019. Central bank action as well as liquidity support from the government, inter alia through European Investment Bank-provided credit lines to the Development Bank of North Macedonia, have eased access to finance for companies during the pandemic. In March 2020, the central bank lowered reserve requirements for loans to the most affected sectors, and in May 2020, it expanded the range of securities accepted from banks as collateral in liquidity-increasing operations.

Functioning of the labour market

Government support measures have mitigated the negative effect of the pandemic on the labour market. Job losses remained contained in 2020, although rising each quarter. The labour force (15-64) dropped markedly (-2.3% year-over-year, end of first quarter 2021), and the activity rate declined by 1.2 pps. in this period, to 65.3%. As discouraged workers left the labour market, the unemployment rate actually decreased, from 17.4% in 2019 to 16.6% in 2020. However, structural deficiencies of the labour market persist, restraining potential growth. Among the most important ones are low participation rates, especially for women. After narrowing by some 7 pps. between 2014 and 2019, the gender gap widened again slightly in 2020, in annual comparison, to 22.7 pps., as male



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

Source: State Statistical office (SSO)

[18] From July 2019, the National Bank introduced an obligation for mandatory write-off of non-performing exposures that have been fully provisioned for more than one year. Until July 2019 (from 1.1.2016 to 30.6.2019), this period was two years.

labour market participation dropped by less during the pandemic than female participation. Youth unemployment remains high, at 35.7%, about the same as one year earlier, although a significant reduction (about 10 pps.) has been achieved since 2018, more recently supported by the government's Youth Guarantee scheme. Women and young people are particularly exposed to unemployment and inactivity, as are people with disabilities and the low skilled. Around 80% of unemployed are long-term unemployed, largely reflecting the skills mismatch. The share of informal workers in total employees remained high, at some 14% in 2019, according to government data, even though declining persistently since 2015. The average tax wedge is regressive in North Macedonia at the bottom of the income distribution: the average contribution rate therefore takes a much higher share of the total income of low-wage earners.

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

North Macedonia has made **some progress** in addressing last year's recommendations and is **moderately prepared** to cope with competitive pressure and market forces within the Union. Integration with the EU in trade and investment remained entrenched also during the pandemic. The level and structure of trade and manufacturing output were affected by lockdowns and supply chain disruptions, domestically and in trade partner countries. The structure of the industry is continuously improving. The deterioration in labour productivity and price competitiveness in 2020 reflects to a large degree the economic impact of the pandemic and the government's job-retention measures. Vocational Educational Training (VET) curricula has improved. Still, skills shortages, reflecting shortcomings in education curricula, capital investment gaps, and limited integration of domestic firms in global supply chains are restricting potential growth. Digitisation of the economy is progressing.

As some of the 2020 recommendations have not been fully implemented, North Macedonia should in particular:

→ Speed up the reform of the education system and increase financing for the VET system and higher education;

→ Improve access of low-skilled unemployed and vulnerable persons to active labour market measures;

→ Adopt and implement energy efficiency legislation.

Education and innovation

Reform of the education system is sluggish and the large skills mismatch persists. While North Macedonia has progressed very well in terms of the number of people with higher educational attainment, curricula are not well suited to equip graduates with necessary skills to match labour demand. State financial support for education is insufficient and coordination between the education sector and businesses is weak. In 2020, public spending on education and training amounted to 3.3% of GDP, compared to an average of 3.7% of GDP in the past five years. The government took some steps

towards improving vocational education (VET), such as adopting several qualifications under the National Qualifications Framework, and introducing a reformed four-year VET programme across all schools, including a strengthened collaboration with private companies.

Innovation activity remains low. At 0.4% of GDP, the economy's expenditure on research and innovation has not increased over recent years, and remains significantly below the EU average. The country remains a modest innovator, according to the EU innovation scoreboard. Even though government funding for innovation has increased in 2020, through the bigger role of the Fund for Innovation and Technological Development (FITD), private firms are reserved about adopting new technologies. The FITD invests in small and medium sized enterprises (SMEs) to improve the innovative capabilities of companies, as well as to support adoption of new technologies contributing to private sector competitiveness. Three public calls were issued during the reporting period. The impact of this funding should be further assessed. Several additional constraints limit innovation activity: insufficient institutional co-ordination, funding limitations, and inadequate support systems for researchers and innovators.

Physical capital and quality of infrastructure

Investment spending remains low in light of major needs to increase physical capital. Gross capital formation, as a share of GDP, dropped in 2020 to 29.6% from 34.5% one year earlier. The share of gross fixed capital formation (GFCF) in GDP has declined gradually in the last years, and amounted to 21% in 2019, compared to 24% in 2015. Over half of GFCF is typically accounted for by investment in construction. Public sector investment makes up about one quarter of the total amount of GFCF, mainly on account of road construction through the Public Enterprise for State Roads. Meanwhile, the need to modernise the country's capital stock, in particular the transport and energy networks, is increasing.

Regional transport connectivity progresses slowly. The quality of transport infrastructure and trade logistics remains low, notably due to delays at border customs. When it comes to Trans-European networks, Road Corridor VIII needs substantial upgrading to highway level. In June 2021, the second deadline to complete the construction of the Kicevo-Ohrid motorway was missed. Delays in construction works also held up completion of major parts of Road Corridor X. The construction of the rail Corridor VIII towards Bulgaria is facing significant delays. The upgrading of cross-border rail connections and the facilitation of crossings on Rail Corridor X runs behind schedule. The Joint Railway Border Station with Serbia at Tabanovce is still in its planning stage. Maintenance and service of regional and local roads and rail systems need to be improved.

The digitisation of the economy is advancing further, but remains low compared with the EU. The percentage of households with internet access at home increased by 10 pps. between 2015 and 2020, to 79%. A fixed broadband connection to the Internet is used by 88% of household users, and by 92% of enterprises with ten 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 available e-government services; and develop digital skills.

Efforts towards energy diversification needs to be improved. The economy is characterised by high-energy intensity with low efficiency in energy production and consumption. Production is highly dependent on coal and imports. The government pursues annual targets for raising the share of renewables in energy consumption. The distribution of natural gas, as an intermediate step in the decarbonisatoin process, is advancing, with efforts made to increase the transmission network. During 2020, the network length was approximately 200 km, with a distribution network of 70 km. The total distributed quantity was around 350 million m^3. The connection to regional gas pipelines progresses slowly. Works on the gas interconnection with Greece has not yet started. This project would support diversification of natural gas sources and facilitate access to transit pipelines.

Measures to improve energy efficiency are stalled. The government recently passed the Law on energy efficiency, transposing Energy Efficiency and the Energy Performance Directives, and setting a best practice for the region, according to the Energy Community Secretariat. However, implementation is hampered by limited human and technical capacity. Financing to promote energy efficiency is limited, and plans to set up an Energy Efficiency Fund should be prioritised. There is a particular need to improve energy efficiency in buildings.

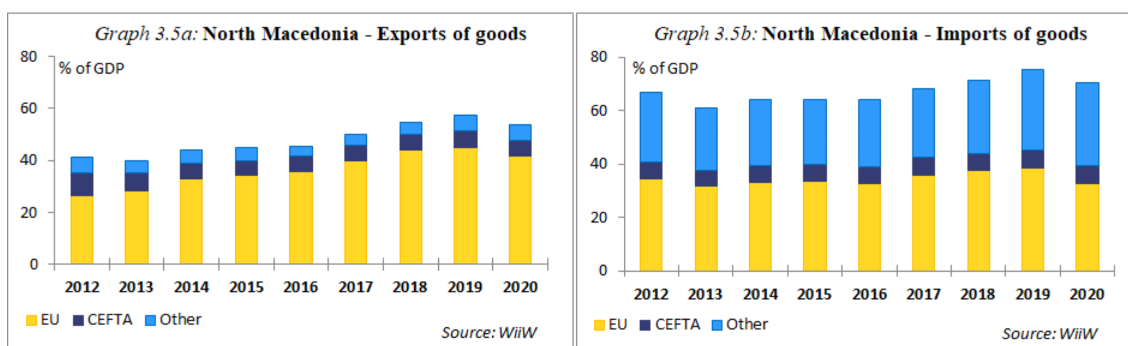
Sectoral and enterprise structures

Manufacturing takes up an increasingly more important share in the economy's output. The sectoral and business structure of the economy has posted gradual, though slow transformation in the past five years. The services sector dominates the output structure, at some 64% of total value added. The share of manufacturing has progressively gained ground, and stood at 15.3% of value added in 2020. This comes largely as a result of increased foreign direct investment. The share of agriculture dropped below 10% in 2020. Over half of employment was accounted for by service industries in 2020, which is only slightly more than five years earlier, followed by industry (33%, compared with 31% in 2015) and agriculture (12%, down from 17% in 2015). Over 99% of all companies are SMEs, providing over 77% of value added in the economy and an almost equal amount of employment. Supported by government programmes for business creation and innovation, the number of firms, in particular micro enterprises rose significantly in 2019, according to official data (+23% year-over-year).

Economic integration with the EU and price competitiveness

Trade openness remained relatively high. The economy posts a high degree of trade openness, at 124% of GDP in 2020. This is slightly lower than in the preceding year, as trade volumes declined by significantly more than GDP. Mainly reflecting the geographical trade structure, but also the impact of the pandemic on supply chains, the decline in exports to the EU in 2020 was less pronounced than for exports to the CEFTA region, while the reverse holds for imports. In 2020, exports to the EU

accounted for 77.5% of total exports, which is only slightly less than in 2019, and partly accounted for by the decline in automotive supply exports, for which EU economies are the most important destination markets. The EU's share of imports, at 46.3% of total, was also lower than in the preceding year (-4.6 pps.). The share of exports to CEFTA countries (11% of total exports) was lower by 0.4 pps., while the share of imports from CEFTA countries increased by 0.4 pps. to 9.6% of the total in this period. EU countries remain the most important investors in North Macedonia, but the EU's share in the total stock of direct investment has declined between 2014 and 2019, by 9.4 pps. to 72.2% (EU-28).



The economy's structural transformation remains driven by foreign investors active in higher value-added production. An important share of foreign investment in the country is allocated to higher value-added manufactured goods (machinery and equipment, chemical products). Accordingly, their production rose at the expense of basic goods (iron, steel and clothing). Since 2018, domestic companies active in these sectors have contributed an increasing share to total exports. However, integration of domestically owned companies in global production networks still remains scarce, mainly due to the type of products manufactured by foreign investors, and their position in the structure of global value chains (i.e. upstream or downstream), but also on account of productivity shortcomings of local firms. In 2020, the cost competitiveness of the economy deteriorated somewhat further. Labour productivity dropped further, on account of government-supported employment in a year of heavy output decline. Gross wages, propped up by government anti-crisis subsidies, continued to rise, even though decelerating compared with preceding years. The real effective exchange rate (CPI-based) has remained broadly stable in the past five years.

4. SERBIA

4.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Serbia has made **some progress** and is **moderately prepared/at a good level of preparation** in developing a functioning market economy. The Serbian economy recorded only a mild contraction in 2020, followed by a strong rebound in the first half of 2021. The impact of the COVID-19 crisis was mitigated by a strong pre-crisis momentum, sizeable and timely fiscal and monetary support measures, the sectoral structure of the economy and a relatively low average stringency of containment measures. External imbalances narrowed in the crisis while their financing continued to be fully covered by Foreign Direct Investment (FDI) inflows. The fiscal space created prior to the crisis allowed Serbia to provide substantial fiscal support for crisis mitigation in 2020 and 2021 and to substantially increase capital spending. Banking sector stability was preserved and lending growth robust, supported by monetary easing, loan moratoria and liquidity-enhancing measures. The labour market has recorded a further decrease in unemployment in 2020, reflecting in particular lower participation rates during the crisis, followed by some increase in the first half of 2021 in line with rising participation rates during recovery.

There has been some progress with tax administration reforms and the privatisation of state-owned banks. However, other major structural reforms of public administration and state-owned enterprises (SOEs) continued to advance slowly, prolonging long-standing inefficiencies. There has been no progress in strengthening the fiscal rules to anchor fiscal policy. 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 corruption and judicial inefficiency, and in the enforcement of fair competition. Last years' recommendations have been partially implemented.

In order to improve the functioning of the market economy, Serbia should in particular:

→ provide well-targeted and temporary pandemic-related fiscal support to vulnerable households and businesses; provided the economic recovery is well entrenched, plan a gradual return to a deficit close to balance in the 2022 budget and medium-term fiscal framework;

→ strengthen fiscal rules by making them more credible and binding and capable of anchoring fiscal policy;

→ to reduce the grey economy, increase VAT collection and improve the tax control process, implement the new model of electronic fiscalisation and the transition to electronic invoicing;

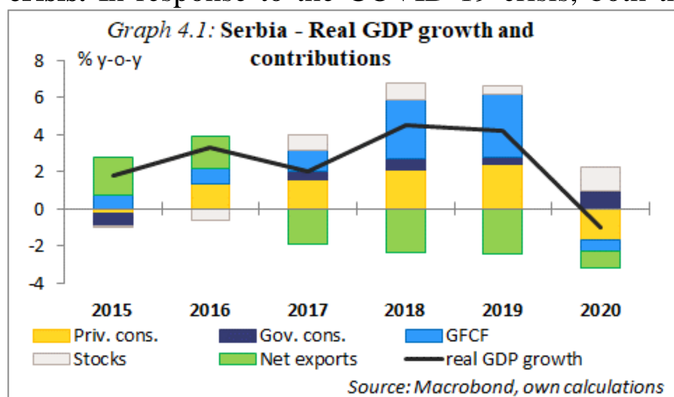
→ contain overall spending on wages as a percentage of GDP by adopting an adequate wage indexation mechanism and taking steps towards an appropriately designed public sector wage system reform;

→ increase the transparency on state-owned enterprises' fiscal impact and implement the new SOE ownership and management strategy to improve the governance of SOEs and reduce related fiscal risk.

Economic governance

The authorities have remained committed to macroeconomic stability and economic reforms, even though some structural reforms have stalled during the crisis. In response to the COVID-19 crisis, both the government and the central bank took a series of sizable and timely fiscal and monetary measures to mitigate the economic effects of the pandemic. Fiscal measures could however have been more targeted in later stages of the crisis to preserve fiscal space at similar overall mitigation levels. Structural reform implementation slowed down during the crisis. The efficiency and predictability of the institutional environment has yet to be ensured to more sustainably support long-term growth. Weaknesses remain in the fiscal governance framework, the business environment, public administration and tax administration, although some progress has been made in the latter area. There also remain weaknesses in the way the state intervenes and manages its presence in the economy, in particular as regards delayed reforms of state-owned enterprises (SOEs). After the conclusion of the July 2018 – January 2021 non-disbursing policy coordination instrument (PCI) with the International Monetary Fund, Serbia has agreed a new PCI with the IMF that runs from July 2021 to December 2023. The policy guidance jointly agreed at the May 2020 Economic and Financial Dialogue between the EU and the Western Balkans and Turkey has been partially implemented.

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



Source: Macrobond, own calculations

Macroeconomic stability

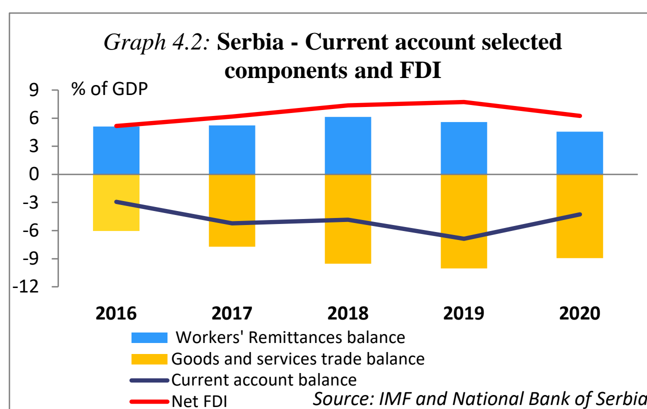
Economic activity has been resilient. Following moderate growth in 2015-2107, annual real GDP expanded by more than 4% in 2018 and 2019 before contracting by 1% in 2020 due to the COVID-19 crisis. The crisis hit private consumption, net exports and private investment in particular, but their decrease was partially offset by increased government consumption and public investment as well as higher inventories.

The recession, which was mild compared to peers in the region, was mitigated by the strong pre-crisis momentum, sizeable and timely fiscal and monetary support measures, the sectoral structure of the economy with a limited role of tourism and a relatively low average stringency of containment measures. Moreover, contraction of goods exports was limited due to expansion of export capacity after strong manufacturing FDI and geographic diversification achieved in earlier years. After three quarters of negative year-on-year growth, GDP expanded by 1.7% y-o-y in the first quarter of 2021, mostly driven by investment and net exports, and by 13.7% y-o-y in the second quarter, mostly driven by private consumption and investment, pointing to a strong rebound in 2021. After remaining broadly unchanged for most of the last decade, the income gap with the EU, as measured by per capita GDP in purchasing power terms, has slightly narrowed

in recent years and stood at 43% of the EU average in 2020 (compared to 41% in 2019, 40% in 2018 and 39% in 2009).

The current account deficit decreased, while its financing remained healthy. After widening substantially from 2016 to 2019 from around 3% to close to 7% of GDP, driven by growing merchandise trade deficits, the current account deficit narrowed substantially to 4.3% of GDP in 2020. This was mainly the result of a lower primary income deficit (essentially due to lower reinvested earnings) and a lower goods trade deficit (as exports of goods contracted less than imports). These balance-improving factors were partially offset by lower secondary income, mainly corresponding to lower worker remittances in the crisis context. The current account deficit continued to be more than fully covered by net inflows of foreign direct investment that stood at 6.2% of GDP in 2020, also supported by the sale of *Komercijalna Banka*. The current account deficit narrowed further in the first half of 2021, decreasing by 65.3% year-on-year to 1.8% of the GDP of the first half of the year, largely due to higher service exports and higher workers' remittances. After a gradual decline from 73.4% in 2015 to 61.5% in 2019, external debt to GDP increased to 66.3% in 2020 and 68.9% in Q1-2021, reflecting in particular the financing of COVID-19 crisis mitigation measures. Official foreign exchange reserves have remained at more than twice the level of short-term external debt and covered 6 months of imports of goods and services in 2020 and Q1-2021, providing an adequate safeguard against adverse shocks.

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



Source: IMF and National Bank of Serbia

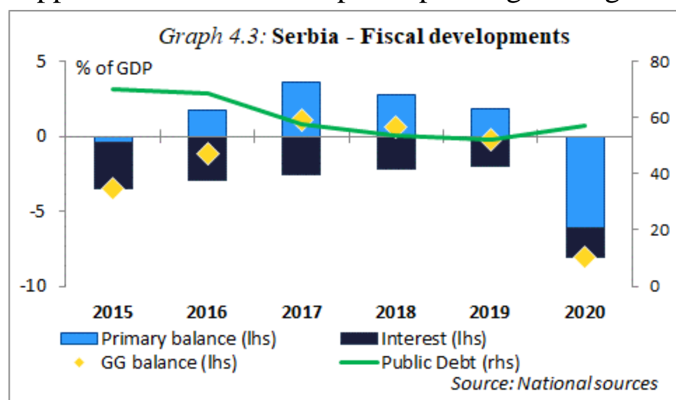
Table 4.1: **Serbia - Key economic figures**	**2012-17** average	**2018**	**2019**	**2020**
GDP per capita (% of EU-27 in PPS)[1)]	40	40	41	43
Real GDP growth	1.3	4.5	4.2	-1.0
Economic activity rate of the population aged 15-64 (%), total[1)]	64.9[2)]	67.8	68.1	67.7
female	*57.2*[2)]	*60.6*	*61.3*	*60.8*
male	*72.5*[2)]	*75.1*	*75.0*	*74.6*
Unemployment rate of the population aged 15-64 (%), total[1)]	19.3	13.3	10.9	9.5
female	*20.3*	*14.2*	*11.5*	*9.9*
male	*18.5*	*12.5*	*10.4*	*9.2*
Employment of the population aged 15-64 (annual growth %)	3.6	1.4	2.4	-0.2
Nominal wages (annual growth %)	3.9	4.3	10.5	9.5
Consumer price index (annual growth %)	3.8	2.0	1.8	1.6
Exchange rate against EUR	118.1	118.3	117.9	117.6
Current account balance (% of GDP)	-5.6	-4.8	-6.9	-4.3
Net foreign direct investment, FDI (% of GDP)	4.3	7.4	7.7	6.2
General government balance (% of GDP)	-3.6	0.6	-0.2	-8.1
General government debt (% of GDP)	62.6	53.7	52.1	57.3

Notes:
1) Eurostat
2) 2014-2017
Source: national sources

Price pressures remained largely subdued and inflation expectations contained. Following seven years of low and rather stable inflation, consumer price inflation averaged 1.6% in 2020, hovering mostly close to the lower end of the central bank's target tolerance band of 3% ± 1.5 pps. After remaining subdued in the first quarter of 2021, inflation picked up in the second quarter of 2021 to 3.6% in May driven by energy and food prices before decelerating to 3.3% in June. To mitigate the crisis, the central bank lowered the key policy rate in four steps from March to December 2020 by overall 125 bps. to 1.0%. This was accompanied by a series of liquidity-supporting measures to provide dinar and foreign exchange liquidity to the market, including purchases on the secondary market of government securities and corporate bonds issued by SOEs. To stabilise the exchange rate, particularly in view of some crisis-induced depreciation pressures from February to October 2020, the central bank continued to apply its policy of frequent interventions on both sides of the foreign exchange market, selling a net EUR 1450 million in 2020.

The fiscal space created in previous years allowed for substantial fiscal crisis mitigation in 2020 and 2021. After surpluses in 2017 and 2018 and a fiscal outturn close to balance in 2019, the COVID-19 crisis increased sharply the general government deficit to 8.1% of GDP in 2020, mostly as a result of implementing discretionary fiscal support measures. These included the deferral of income tax payments and social security contributions, direct wage subsidies, limited direct support to the hospitality sector, direct lump-sum payments to certain groups and to all adult citizens. In addition to the measures with direct budgetary impact, the fiscal support packages also included

the setting up of a guarantee scheme for loans worth 4.4% of GDP in 2020, bringing the total planned size of the package of fiscal and liquidity-support measures to 12.5% of GDP in 2020. The original 2021 budget, which targeted a strong reduction of the deficit to 3% of GDP, was amended in April 2021. The revision foresees a higher than initally planned deficit of 6.9% of GDP in 2021, mostly due to renewed and additional crisis support and increased capital spending. The general government deficit decreased by 87.5% year-on-year to 0.6% of estimated annual GDP in the first half of 2021, driven by a 27% increase in revenue while expenditure overall remained broadly stable. Notwithstanding the crisis context, capital spending has further increased from 4.9% of GDP in 2019 to a record level of 5.4% of GDP in 2020 and is budgeted to reach around 7% of GDP in 2021, also impacted by a further increase in defence spending. Overall, the track record of prudent fiscal policy has played a major role in increasing investor and consumer confidence in the economy, supporting economic growth and significantly reducing government debt before the crisis, thereby creating the fiscal space for sizeable crisis mitigation in 2020 and 2021. Government debt had fallen from a peak of over 70% of GDP in 2015 to 53% of GDP in 2019 (closer to the ceiling of 45% of GDP laid down in the fiscal rules of the budget system law) before increasing to 58% of GDP in 2020 as a result of the high crisis-induced deficit.



Graph 4.3: **Serbia - Fiscal developments**

Public sector reforms have progressed unevenly, prolonging long-standing inefficiencies and fiscal governance challenges. Revenue collection has surpassed expectations in the two years preceding the crisis and has performed relatively well throughout the crisis, supported also by improvements in the tax administration, in particular the strenghtening of the Large Taxpayer Office and the concentration of core activities in fewer sites. A new tax administration transformation programme 2021-2025 was adopted by the government on 20 May 2021. Progress in addressing weaknesses in budget planning and implementation has been slow. Large public wage increases exceeding nominal GDP growth in three consecutive years before the crisis were contrary to government commitments and have led to an increase of the share of expenditure for employees from 9% of GDP in 2017 to 10.5% in 2020. A new system to control general government employment based on medium-term workforce planning remains outstanding. The wage system reform has been postponed by another year while the fiscal space for future implementation of such a reform appears more limited after recent high wage increases. Ad-hoc extraordinary increases for some categories of the public sector (such as the security forces) also tend to complicate the potential implementation of such a reform in the future.

While budget adoption broadly followed legislative procedures, the reform of fiscal rules is still pending. While approval of the 2021 budget was delayed due to the lengthy government formation and the crisis context, the budget was adopted broadly in

line with the normal legislative procedure, including a series of parliamentary debates on the draft budget. The Fiscal Council was also consulted in the process. The system of fiscal rules remains weak as it is not sufficiently binding and relevant for policy-making. In particular, the annual ceiling for the overall general government fiscal deficit does not appear to be sufficiently transparent and operational. The accountability framework also calls for reinforcement as it currently does not offer adequate sanctions in cases of non-compliance nor effective enforcement mechanisms. Work on strengthening the fiscal rules has been postponed by another year. The new fiscal rules are now expected to be finalised by end-June 2022 to be applied to the 2023 budget law according to the new PCI programme agreed with the IMF.

The macroeconomic policy mix has remained appropriate. It helped sustain macroeconomic stability and supported the resilience of economic activity. The prudent fiscal policy and cautiously supportive monetary policy before the crisis ensured the policy space for sizable fiscal and monetary support to mitigate the impact of the COVID-19 crisis while maintaining macroeconomic stability. The acceleration of economic reforms and their full implementation remain key to ensure a sustainable recovery and further strengthen the economy's potential in view of sustainable real convergence with the EU.

Functioning of product markets

Business environment

The business environment has been slowly improving despite a general slowdown in the reform momentum. Over the last few years, Serbia has improved its standing in various international business rankings mostly due to regulatory improvements, for example in issuing construction permits, registering property, making it easier to pay tax, and better protecting minority investments. In 2020, 39 000 new legal business entities were registered of which about 9 000 companies: while the number of registrations for companies was almost unchanged (+0.2%) compared with 2019, the registrations of solo entrepreneurs fell by 25% due to the crisis. About 30 000 legal entities (of which 8 000 companies) were deleted from the register, around 40% less than in 2019. This was mostly due to the base effect from the very high number of compulsory liquidations in 2019 (concerning companies failing to fulfil their financial reporting obligations within a certain timeframe) but, supported by the crisis-mitigating measures, non-compulsory exits also declined by around 13% in 2020. In June 2020, the Government adopted a 2020-2021 action plan for simplification of administrative procedures through the "E-paper" programme aimed at the optimisation of 890 administrative procedures and establishment of a single public register of administrative procedures. The law on foreign exchange transactions is widely considered by the business community to be too restrictive in its design and unpredictable in its application but there are no indications that it might be revised any time soon.

The institutional and regulatory environment is still challenging. While the number of urgent parliamentary procedures decreased, business-related laws and by-laws/decrees are still adopted with very tight consultation deadlines, leaving insufficient time for business to contribute to policy preparation and notably to prepare for changes

affecting their operations. The ongoing setup of a centralised website for consultation procedures could make the consultation process more accessible. Despite a solid legal framework on public procurement and state aid control, implementation of these policies remains weak. The law on state aid control, which entered into force on 1 January 2020, grants legal independence to the Commission for the State Aid Control. However, its operational independence remains to be demonstrated and a credible track record in implementation of the state aid law to be established. Delays in adopting secondary legislation continue to hamper the implementation of adopted laws. In general, contract enforcement is weak, and the courts that enforce property rights remain overburdened. Moreover, the business environment remains hampered by red tape, political interference and limited public administration efficiency. Serbia ranked 94th out of 180 countries in the 2020 corruption perception index compiled by Transparency International, compared to 87th in 2018 and 91st in 2019. Fair competition is negatively affected by the large informal economy.

Some measures were taken to fight the informal economy. The authorities have established a working group chaired by the labour inspectorate to combat informal employment. Another tool is a single information system for inspections (eInspector), which aims to ensure better coordination among various inspections, standardisation of their work, and better availability of data. 36 inspection services started using the tool in July 2019 and then this was extended to several more inspections comprising 44 in total. A contact centre where citizens can directly report on irregularities linking central level inspections with local self-governments started working in March 2020. A special working group for coordination of inspection activities related to the COVID-19 pandemic was established in October 2020. Further improvements in anti-money laundering/combating the financing of terrorism are ongoing.

State influence on product markets

State ownership has continued to gradually decline, but state presence remains large amid persistent governance weaknesses. In April 2021, the Government adopted the 2021-2027 strategy on state ownership and management of SOEs which aims at more sustainable and efficient management of SOEs. Currently, however, governance of these enterprises remains under strong political influence. This includes the irregular appointment of acting managers for extended periods instead of using the standard nomination process. The financial performance of SOEs may imply the build-up of fiscal risks, e.g. in the case of strongly rising debt levels profiting from implicit state guarantees, such as for *Telekom Srbija,* that also benefitted from secondary market acquisition by the central bank of a substantial share of its 2020 bond issuance. Overall, SOEs still account for almost a fifth of value added and formal employment in Serbia. The share of administered prices remained broadly unchanged, at around 20% of the consumer basket. The new law on state aid control entered into force on 1 January 2020. The law has secured the legal independence of the Commission for State Aid Control, with a separate budget and autonomous spending that allows it to considerably increase its administrative capacities and improve operations. Although the overall GDP share of reported state aid has decreased, the track record of enforcing state aid rules is still uneven, while transparency is also lacking.

Privatisation and restructuring

Privatisation of SOEs advanced. Since 2015, when the privatisation law was adopted, more than 310 SOEs, mostly with no or only a small number of employees, have been put into bankruptcy procedure, increasing the total number of SOEs under bankruptcy procedure to 2 000. A smaller number of companies have been privatised, and non-EU investors acquired some of the largest firms in mining, metallurgy, and agriculture. The status of the remaining 78 SOEs employing some 28 000 workers has yet to be addressed through either bankruptcy or privatisation. Six companies with an overall 6 000 employees are planned to be privatised in 2021. The implementation of the strategy for banks with state ownership continued. The privatisation of *Komercijalna Banka* (the third largest bank by assets and the largest remaining state-owned bank) was completed by a transfer of EUR 395 million to the Serbian budget in December 2020**.** The state remains in control of key entities in the insurance sector.

Restructuring of key utility companies is ongoing but is advancing slowly. In May 2021, the government adopted an Action Plan for the unbundling in the gas sector including of state owned public utility *Srbijagas*. The state is now the owner of the transmission system operator, after *Srbijagas* transferred its shares in "*Transportgas Srbija*" to the Republic of Serbia. In January 2021, a new legally independent company in charge of the electricity distribution network and supply *Elektrodistribucija Srbije* was licensed, after having been separated from the state owned EPS company. Both separations in the gas and electricity sector should be confirmed by the Energy Community Secretariat to certify that the whole new organisational structure is in line with the requirements of the Third Energy Package including non-discriminatory third-party access to the gas transmission system. The decarbonisation of the energy sector remains the biggest challenge for the government. A national energy and climate plan is currently being drafted to address this challenge. The pricing policy for the regulated electricity market does not provide adequate cost coverage for investments in the network and the security of supply, also as concerns investments needed for Serbia's energy and climate reforms.

Functioning of the financial market

Financial stability

Financial stability was maintained in 2020. Supported by crisis-mitigation measures, macro-prudential indicators remained sound. The aggregate capital adequacy (regulatory capital to risk-weighted assets) was at 22.4% at the end of 2020, well above the minimum set by the central bank. Liquidity remained high at 37.3% (share of liquid assets to total assets) and 50.9% (share of liquid assets to total short-term liabilities) respectively at the end of 2020, also supported by the central bank's liquidity-enhancing measures. As a result of increased loans loss provisions, the profitability of the banking system worsened with a decline in return on assets (1.1% at the end of 2020 vs 1.8% at the end of 2019) and in return on equity (6.5% at the end of 2020, compared to 9.8% at the end of 2019). The NPL ratio increased to 3.9% at the end of the first quarter of 2021, partly due to the expiration of the second loan moratorium, before decreasing to 3.7% at the end of the second quarter. The authorities have continued to address legacy

NPLs in the portfolio of the Deposit Insurance Agency. Two portfolios of NPLs worth a total EUR 2 billion at face value have been successfully sold notwithstanding persisting obstacles in NPL resolution. The central bank and the government continued to implement their dinarisation strategy addressing the high degree of euroisation in the banking system. Despite uncertainties related to the crisis, the share of dinar-denominated loans and deposits of both households and firms increased in 2020.

Access to finance

Access to finance was supported by crisis-mitigation measures. Foreign-owned banks continued to dominate the financial system, holding around six sevenths of banking system assets following the sale of *Komercijalna Banka* to *Nova Ljubljanska Banka* at the end of 2020. The continuing consolidation of the banking system via mergers and acquisitions has further reduced the number of banks from 26 at the end of 2020 to 24 at the end of June 2021. Favourable financing conditions, resulting inter alia from the central bank's rate cuts and further crisis-mitigation measures and the government-backed guarantee schemes, have supported growth in lending. Credit expanded by 9% for corporates and 11% for households in 2020, which was however largely related to moratorium-related maturity extensions as the volume of newly approved loans decreased at double-digit rates (by around 13% and 20% respectively). 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.

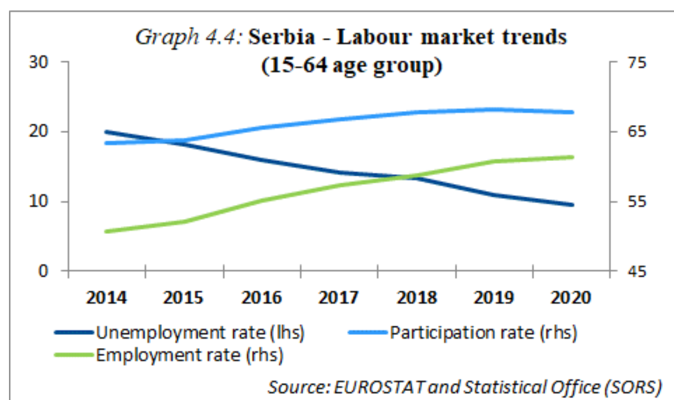
Fucntioning of the labour market

While the labour market has seen considerable improvements in recent years and the impact of the COVID-19 pandemic is expected to be transitory, structural problems, demographic and migration challenges remain. Strong economic growth in the years before the pandemic was reflected in continuously improving labour market indicators until 2020. Thus, prior to the crisis, activity and employment rates increased steadily, while the unemployment rate (15-64) fell to 10.9% in 2019. As an increased number of discouraged workers left the labour force, the rate of unemployment decreased further to 9.5% in 2020, despite a simultaneous decrease in employment. Long-term (4.9%) as well as female (9.9%) and youth unemployment (26.6%) also continued their downward trend in 2020. Reflecting the higher number of discouraged workers, the corresponding activity rate (15-64) fell to 67.7% in 2020 and the proportion of young people in the 15-24 age group not in employment, education or training rose to 15.9% in 2020. The share of informal employment, two-thirds of which was in agriculture, fell to 16.4% of total employment in 2020. As the economic recovery got underway, jobseekers returned to the labour market, which pushed up both employment and unemployment rates (to 61.8% and 11.4% respectively in Q2-2021, also impacted by the changed LFS methodology as of 2021). However, in structural terms, the labour force may have 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 and inadequate activation of young people as well as large regional disparities have continued to be major labour market issues. In February 2020, the government adopted the 2021-2027 strategy on economic migration aiming to foster circular migration by retaining workers and by encouraging professionals from the diaspora to return to the country. The government packages aimed at mitigating the impact of the COVID-19 crisis – with incentives given only to companies that would not reduce their workforce by more than 10% of staff – have contributed to preserve formal employment and to thereby limit the increase in the number of unemployed during the crisis.

Real wages have increased. Despite the COVID-19 crisis real wages went up by 7.7% in 2020, strongly influenced by wage increases already decided before the crisis, in particular in the public sector. The authorities have continued to gradually reduce the overall tax wedge by increasing the non-taxable part of salaries from RSD 16 300 to RSD 18 300 as of January 2021. 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 of wages, the government increased the minimum hourly wage by 6.6% in 2021. Around one in six registered employees receives the minimum wage.

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



Source: EUROSTAT and Statistical Office (SORS)

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

Serbia has made **some progress** and is **moderately prepared** to cope with competitive pressure and market forces within the EU. The structure of the economy improved further and economic integration with the EU remained high. However, despite some progress, the quality and relevance of education and training does not fully meet labour market needs. Public investment has continued to increase with the aim to address serious infrastructure gaps after years of underinvestment. Although the cost of borrowing for small and medium-sized enterprises (SMEs) has declined, they still face a number of challenges, including a volatile business environment and unfair competition. Last years' recommendations have been partially implemented. In order to improve competitiveness and long-term growth, Serbia should in particular:

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

→ ensure a harmonised approach, using feasibility studies, cost-benefit analyses and environmental impact assessments, for prioritising and monitoring all public infrastructure investment regardless of the source of financing, and apply the

principles of competition, equal treatment, non-discrimination and transparency in public procurement and state aid procedures in line with EU standards to all projects including those based on intergovernmental agreements;

→ advance on green energy transition and start with decarbonisation of industry especially in the energy sector; substantially increase investments into renewables and energy efficiency supported by cost-recovering tariffs; implement the action plan on gas unbundling in a timely manner.

Education and innovation

Despite some progress, skills mismatches in Serbia remain high. Public spending on education stood at around 3.3% of GDP in 2019, below the EU average of 4.7%. Pre-primary school enrolment remained around 64% in 2019, while the compulsory six-month pre-school programme is almost universal. Enrolment rates remained high in general in primary and lower secondary education, at some 99.7%, and at around 90% in upper secondary level. The gross enrolment ratio in tertiary education also increased in recent years to around two thirds (67.8%) while higher education attainment in the population aged 30-34 increased to 33.5% in 2019. A basic system-wide teacher training to support the implementation of the new curricula and the development of students' key competencies has continued and reached out to some 75% of education professionals. The authorities are gradually updating both the general and vocational pre-university curricula to make them more relevant to labour market needs, consolidating the national qualification framework (NQF) set-up. Although the pace in adoption of new qualification standards has picked up (32 new qualification standards), a majority of vocational education and training (VET) qualifications remain outdated. VET education is not well oriented to labour market needs with low exposure of students to the workplace. While the roll-out of dual VET education has been progressing, it still concerned only 5% of students in the first year of secondary vocational school in the school year 2020/21. Initial efforts to introduce a monitoring and feedback mechanism under the national work-based VET model are made. Serbia improved slightly in the Human Development Index. Serbia is rated third in the region in view of the World Bank Human Capital Index. There is concern that the COVID-19 pandemic may jeopardise the achieved progress in the struggle to maintain health and education services in the period of restrictions introduced to protect public health.

R&D spending remains low at around 0.9% of GDP. Government funding is stable at around 0.4% of GDP, providing close to half of the total R&D financing in 2019. The number of scientific research organisations remained broadly unchanged. 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 are being built in Novi Sad, Čačak and Niš. Serbia adopted an Action Plan for the implementation of its smart specialisation strategy in April 2021.

Physical capital and quality of infrastructure

Investment is increasing, but after years of underinvestment, it needs to effectively address infrastructure gaps. The rise in public investment observed in recent years has been further reinforced while private investment is expected to rebound strongly in 2021 after a crisis-induced decrease in 2020. The economy is attracting significant foreign direct investment, well above the region's average and gradually rising in the last few years prior to the pandemic. Although declining by around a fifth as compared to the record FDI inflow in 2019, substantial amounts of foreign direct investments were recorded even in 2020 (also supported by the sale of *Komercijalna Banka*). However, the share of total investment in the economy still stands only slightly above 20% of GDP, while physical infrastructure needs further upgrading and expansion. A further increase in public investments is planned in 2021, particularly in roads and railways.

The institutional framework supporting new 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 new 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 arrangement allows too many exceptions to the rule, which significantly reduces its effective impact. Moreover, the law on special procedures for linear infrastructure projects (road, rail, waterways, airports, metro, water and wastewater systems) adopted in February 2020 allows linear infrastructure projects of 'special importance for the Republic of Serbia' to be exempted from public procurement rules. Public procurement rules are not always fully complied with and they are not always fully compatible with EU standards. This concerns particularly big infrastructure projects financed via loan agreements with third countries that are directly assigned to companies from these countries, without complying with the requirements of transparency, equal treatment or non-discrimination. The increasing number of exemptions from the application of the public procurement law and a large number of inspected irregularities in public procurement contracts found by the State Audit Institution raise concerns.

The energy sector remains largely inefficient and highly polluting while some regulatory reform steps have been taken. Serbia made some progress towards attracting investments in the energy and mining sector by the regulatory changes adopted in four laws in April 2021 in the field of energy, energy efficiency, renewable energy and mining. The competitiveness is increasingly negatively impacted by an inefficient energy sector based on lignite. The introduction of the new market based auction scheme to support production of energy from renewable sources (as included in the newly adopted legislation) should attract new investments into renewables. Low electricity tariffs do not allow for the necessary investment in infrastructure; tariffs were only increased slightly in January 2021. In May 2021, the government adopted an Action Plan for the restructuring of state-owned enterprise *Srbijagas* and started implementing it. The BalkanStream gas pipeline was finished but the regulatory regime must yet to be brought in line with EU legislation.

Digitalisation remains a top government priority. The 2020-2022 e-government development programme and related action plan adopted in June 2020 have started to be implemented. The government's main objective in this area is to improve the quality of public services by ensuring interoperability, efficient coordination, project management and legal certainty over e-government use and the use of open data. An upgraded e-government national portal was set out in 2020, serving as a one-stop shop for e-government services and as a central point of access for business and citizens alike. The portal is used for a high number of services and played a particular role as an efficient vehicle for vaccination during the COVID-19 pandemic. Some progress has already been made on public access to institutional data thanks to the National Open Data portal (making data available from 22 public institutions so far). The Artificial Intelligence Strategy 2020-2025 has started to be implemented via the related action plan for 2020-2022, including inter alia the foundation of a Research and Development Institute for Artificial Intelligence in Novi Sad. The robust growth of the information and communication sector continued, accounting for a 5% share of value added and a similar share of total exports, with exports for 2020, the year of the COVID-19 crisis, valued at EUR 1.4 billion, which is 4.4% higher than in 2019. Available data confirm improvements in 2020 regarding the use of computers, broadband penetration and e-commerce.

Sectoral and enterprise structure

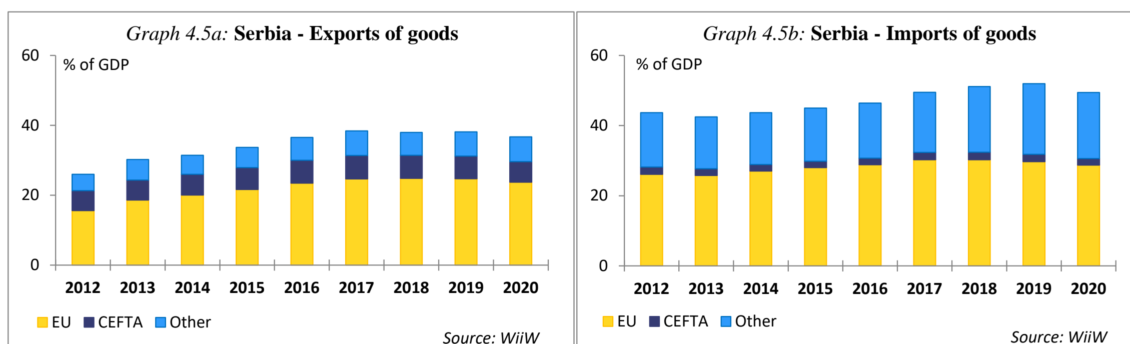
Construction and some services have increased their weight in the economy. Services dominate the economy, providing more than 60% of total value added. Sectors like transportation, retail trade, and information and communication – the last increasingly geared towards exports – benefited from strong growth before the crisis and the steady expansion of foreign sales to increase their economic weight. Reflecting the new investment cycle, the construction sector increased its share in GDP from 3% in 2013 to 5.7% of GDP in 2019, strongly supported by the construction of the Balkanstream gas pipeline. The weight of the agricultural sector has broadly stabilised around 6% since 2017 after a downward trend over the previous few years in line with the growing shares of manufacturing and services. As regards the structure of employment the share of agricultural employment has continued to fall steadily from 20% in 2014 via 17% in 2017 to around 15% in 2020, while there have been increases in the share of employment in the industry and service sectors.

Small and medium-sized enterprises (SMEs) are the backbone of the economy. They provided close to 60% of total employment and turnover in the economy, and around half of the value added in 2019 (SORS annual structural business statistics). 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 68% of total corporate loans in June 2021. Their cost of borrowing has declined recently, but is still above that of large companies. SMEs however still face a number of challenges, including a volatile business environment and lack of non-bank financing. SMEs are facing a lack of a level-playing field: big enterprises and foreign investors often have a direct communication line to the

government and therefore enjoy an advantage over domestic SMEs. Also, the level of subsidies being channelled to foreign investors and large companies, including particularly SOEs, is much higher compared to SMEs. In view of all this, SMEs often complain about unfair competition. Furthermore, SMEs have been particularly affected by the COVID-19 crisis – the 2020 assistance packages were particularly aimed at supporting them through deferral of tax and social contributions payment, but also payment of minimum salaries to their employees, and access to loans for liquidity, while the assistance package in spring 2021 granted all companies equal access to payment of minimum salaries.

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 61.4% of its total trade and two thirds of net foreign direct investment inflows in 2020. Total bilateral trade between the EU and Serbia contracted by 2.4% between 2019 and 2020 to a total of EUR 24.4 billion as a consequence of the COVID-19 crisis. Thanks to a faster increase of Serbia's exports to the EU than imports from the EU over the past several years, trade has become more balanced, with the EU registering a surplus of EUR 2.3 billion in 2020. After the EU, Serbia's main trade partners in 2020 were China (7.2% of total trade), Russia (5.3%) and Bosnia and Herzegovina (4.7%). Trade with the signatories of the Central European Free Trade Agreement represented 15.9% of total exports and 3.8% of total imports in 2020. Introduction of a 100% tariff by Kosovo in late 2018 on imports from Serbia and Bosnia and Herzegovina affected Serbia's goods exports in 2019 and early 2020, with estimated annual losses of around EUR 400 million, representing around 1% of GDP per year. These tariffs were however lifted by Kosovo as of 1 April 2020 while further non-tariff obstacles for imports from Serbia were lifted in June 2020 thus allowing for a partial recovery of deliveries to Kosovo. There are still significant bottlenecks at border crossing points with neighbouring EU countries; these hamper further trade with the EU and transport facilitation with the EU. Trade openness, after a steady increase from 92% of GDP in 2014 to 111.6% in 2019, decreased to 104.5% in 2020 due to the crisis, before rebounding strongly to 112.4% in the first quarter of 2021.



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

Source: WiiW

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

Source: WiiW

Real effective exchange rates have been on an appreciating trend in recent years. The dinar-euro nominal exchange rates remained broadly stable in 2020 as initial depreciation pressures at the beginning of the health crisis were successfully neutralised by the central bank. The CPI based real effective exchange rate has been broadly stable over the longer term, with depreciation by 9% over the period 2014-2016 being followed by appreciation by 9% over the period 2017-2020. Serbia's cost competitiveness improved in the period 2014-2016 with unit labour cost (ULC) based RER depreciating by a cumulative 8% and then deteriorated in the period 2017-2020 RER appreciating by a cumulative 27% (13% in 2020 alone, due the decline in economic activity accompanied by increases in wages in both the private and public sector). The latest IMF external sustainability assessment (done within the Article IV consultations in spring 2021) considered the exchange rate broadly consistent with fundamentals.

5. TURKEY

5.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

The Turkish economy is **well advanced,** but made **no progress** over the reporting period and serious concerns persist over its functioning.

The authorities delivered a sizeable and wide-ranging set of measures to boost domestic demand and soften the economic repercussions of the COVID-19 pandemic. As a result, the economy rebounded quickly from the crisis, reaching pre-crisis levels already in the third quarter of 2020. Amid a strong policy response to the crisis, institutional and policy coordination weaknesses undermined the credibility and effectiveness of authorities' actions and imbalances increased. The macroeconomic policy mix relied too heavily on the credit channel, while direct fiscal support measures were rather limited in view of the magnitude of the social and labour market challenges. The strong monetary expansion last year weakened the lira, increased inflation and dollarisation, and triggered portfolio outflows. The closing of the current account deficit in 2019 turned out to be short-lived and external imbalances remain a major vulnerability. Monetary policy tightened in autumn 2020 but the abrupt dismissal of the central bank governor in March 2021, only four months after his appointment, stirred financial market instability and called into question the authorities' commitment to reducing inflation.

The institutional and regulatory environment weakened further and there are persistent issues with predictability, transparency, and implementation of regulations. Market exit remained costly and slow. The informal sector declined during the crisis but remains large. State intervention in price setting mechanisms persists. The provision of State aid lacks proper implementation rules, enforcement and transparency. Supported by loose monetary policy until the autumn 2020 and favourable regulatory measures, bank lending grew strongly, spurred in particular by state-owned banks. The banking sector remained well capitalised, benefiting from regulatory forbearance and other crisis-mitigation measures. The pandemic had a deeply negative impact on the labour market and poverty. The number of discouraged workers increased significantly and employment levels fell far below their height a few years ago. Female labour market participation and employment remained at particularly low levels. The proportion of young people not in employment, education or training increased.

The Commission's recommendations from 2020 were not fully implemented and remain valid. In order to improve the functioning of the market economy Turkey should in particular:

→ rebalance the policy mix towards a tighter monetary policy stance and use part of the available fiscal space for a targeted increase of budget expenditure to soften the crisis impact on the labour market and alleviate poverty;

→ strengthen the independence of the central bank and improve monetary policy credibility in order to anchor inflation expectations and stabilise the exchange rate;

→ strengthen the business environment, reduce state interference in price setting, and enhance the transparency and control of State aid;

→ step up active labour market policies, in particular for young people and women, as well as the social dialogue.

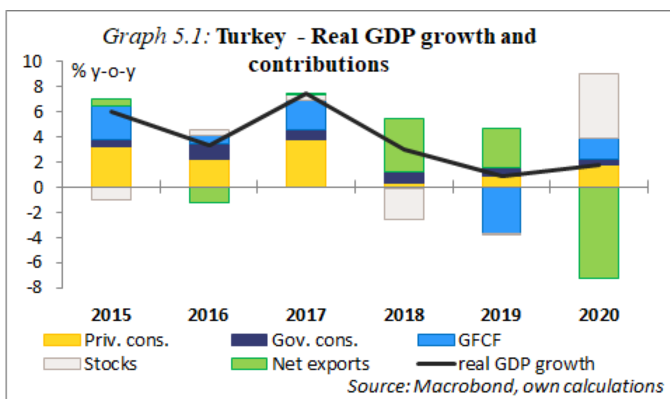
Economic governance

Despite a strong policy response to the crisis, institutional and policy coordination weaknesses undermined the credibility and effectiveness of authorities' actions. Turkey delivered a sizeable and wide-ranging set of measures to boost domestic demand and soften the economic repercussions of the COVID-19 pandemic. This helped the economy to return quickly to growth, being one of the few in the world to avoid a contraction last year. However, the excessive reliance on the credit channel weakened the lira, depleted foreign exchange reserves, and increased inflation, dollarisation, external imbalances and inequalities. Monetary policy has slowly reversed course in the summer of 2020 and tightened more decisively since November under the watch of a new central bank governor. However, the abrupt dismissal of the governor in March 2021, barely four months into office, has called this policy shift and the turn to a simplified and more transparent policy framework into question. Maintaining a sufficiently tight monetary policy stance over a prolonged period remains a challenging task, as demonstrated by a long history of missed targets and rapid policy reversals. The frequent changes at the helm of the central bank are the starkest manifestation of continued institutional weakness in the country's Presidential system. Successive changes of the head of the statistical institute (TURKSTAT) and the fast dismantling of newly created advisory boards on price statistics and labour market undermined TURKSTAT's independence and credibility. The policy guidance jointly agreed at the May 2020 Economic and Financial Dialogue between the EU and the Western Balkans and Turkey was implemented partially, with the rate of implementation improving over previous years.

Macroeconomic stability

The Turkish economy was resilient and rebounded quickly from the crisis, but the recovery was uneven across sectors. Following a short-lived contraction in the second quarter due to containment measures, real GDP reached pre-crisis levels already in the third quarter of 2020. Overall, a large policy stimulus and a strong growth momentum shortly before the pandemic helped the economy expand by 1.8% in 2020. The good performance extended into the first two

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

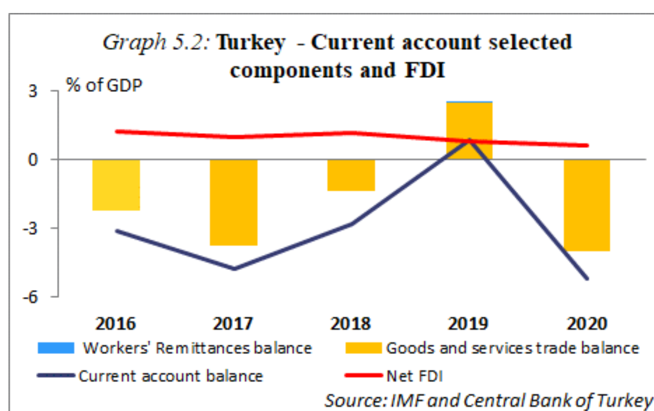


Source: Macrobond, own calculations

quarters of 2021 with growth rates of 7.2% and 21.7% y/y, respectively. After contracting in 2019, domestic demand returned to growth in 2020. Favourable monetary conditions strongly supported robust private consumption and investment. An outsized build-up of stocks, another important contributor to growth, has started to unwind only by the end of 2020. Import growth remained relatively strong, affected by exceptionally high non-monetary gold imports, but retracted since the fourth quarter of 2020 and turned negative in early 2021. After the initial shock from the pandemic, exports of goods rebounded quickly. They gathered pace along with the firming up of global demand and as price competitiveness gains supported a further expansion of Turkey's market share in some non-EU markets. The economic recovery, however, remained uneven because of the high exposure to international tourism and transport – two of the most heavily affected sectors in the pandemic, which still feel its impact. Due to tepid pre-crisis growth, resulting from the unwinding of imbalances after the currency turmoil of 2018, Turkey's real income convergence with the EU reversed – in 2019 its per capita GDP in purchasing power standards was only 59% of the EU average, down from a high of 68% in 2015. However, it rebounded to 64% in 2020 as the Turkish economy performed much better in comparison to a strong decline in the EU.

The closing of the current account deficit in 2019 turned out to be short-lived and external imbalances remain a major vulnerability. With domestic demand returning to growth, higher import of non-monetary gold due to increased financial instability, and a crisis-induced weakening in exports, the current account moved back to a deficit of 5.2% of GDP in 2020. The deficit declined somewhat in the beginning of 2021, driven by the recovery in exports of goods, imports suppression, and lower gold imports. However, it remained relatively high, reflecting the strength of domestic demand, still subdued service exports, and negative terms of trade due to global commodity price increases. The strong monetary expansion in 2020 not only weakened the lira but also triggered financial market instability and portfolio outflows. Official foreign exchange reserves have been the main source of financing of these outflows and of the widening current account deficit. As a result, central bank reserves currency composition worsened and reserves fell by more than 20%, to their lowest level in a decade, while its net foreign assets (excluding borrowed funds) turned negative. Net foreign direct investment has further declined in recent years and remained marginal, despite growing price competitiveness.

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



Source: IMF and Central Bank of Turkey

Table 5.1: **Turkey - Key economic figures**	**2012-17** average	**2018**	**2019**	**2020**
GDP per capita (% of EU-27 in PPS)[1)]	64	63	59	64
Real GDP growth	5.9	3.0	0.9	1.8
Economic activity rate of the population aged 15-64 (%), total[1)]	55.6	58.5	58.4	54.9
female	*34.5*	*38.3*	*38.7*	*35.0*
male	*76.7*	*78.5*	*78.1*	*74.6*
Unemployment rate of the population aged 15-64 (%), total[1)]	10.0	11.1	14.0	13.4
female	*12.3*	*14.0*	*16.7*	*15.1*
male	*9.0*	*9.7*	*12.6*	*12.6*
Employment of the population aged 15-64 (annual growth %)	2.7[2)]	1.8	-2.4	-4.3
Nominal wages (annual growth %)	12.4	18.3	26.2	18.0
Consumer price index (annual growth %)	8.6	16.3	15.2	12.3
Exchange rate against EUR	3.05	5.68	6.35	8.10
Current account balance (% of GDP)	-4.4	-2.8	0.9	-5.2
Net foreign direct investment, FDI (% of GDP)	1.1	1.2	0.8	0.6
General government balance (% of GDP)[1)]	-0.5	-2.8	-3.2	-2.8
General government debt (% of GDP)	29.2	30.2	32.6	39.8[3)]

Notes:
1) Eurostat
2) 2015-2017
3) State government
Source: national sources

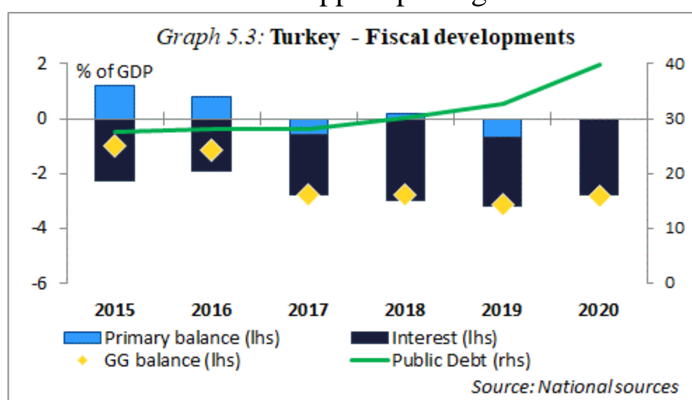
Turkey remains highly exposed to geopolitical risks and changes in global financing conditions. Geopolitical tensions, rising economic imbalances and overall policy uncertainty affected negatively the country risk premium and investor confidence in Turkey. With the exception of the short period between November 2020 and March 2021, marked by clear steps towards monetary policy normalisation, the five-year credit default swaps remained elevated above 350 basis points. The depreciation of the lira drove the external debt ratio further up to 62.7% of GDP at the end of 2020. Turkey's external position, thus, is very vulnerable amidst an uncertain geopolitical environment and in view of a possible tightening of global financing conditions. The continued ability in particular of the banking sector to roll over its short-term external debt and the improvement in the short-term positive net foreign exchange position of the non-financial sector are key factors attenuating this vulnerability.

Inflation increased and price pressures have become entrenched primarily due to the lack of monetary policy credibility. The weakness of the lira, which lost 24% against the U.S. dollar in 2020 and another 14% by mid-June 2021, continued to be a major inflationary factor. In addition, food prices increased markedly by the end of 2020 and have remained elevated since then. Persistently high food price inflation not only hurts disproportionately the poor, but also points to deep-rooted structural problems in the agricultural sector, like long supply chains and underdeveloped logistics and storage. Thus, despite lower energy prices in 2020, inflation stayed in the double-digits, ending 2020 at 14.6%. As energy and other commodity prices increased since the

beginning of 2021, inflation picked up further to 19.3% y/y in August. Producer prices also continued their steep rise, from 5.5% y/y last May to 45.5% in August 2021, pointing to persistent inflationary pressures. The central bank was slow to react to rising inflation last year and started to tighten its policy only in August 2020. It tightened more decisively under a new central bank governor who, between November and March, raised the key policy rate by 875 basis points to 19%. However, his abrupt dismissal triggered financial market instability and called into question the authorities' commitment to reducing inflation. The policy rate has remained unchanged since March, despite increasing inflation and inflationary expectations. The frequent dismissals of central bank governors and recurrent pressure by the authorities on monetary policy decision-makers to lower interest rates severely undermine the bank's independence and its credibility and come at the cost of higher country risk premiums, and exchange rate and financial market instability.

Fiscal policy tightened at the height of the crisis, despite numerous crisis-related measures. The fiscal support package to cushion the crisis impact amounted to slightly more than 2% of GDP, while most of the support (around 10% of GDP) was off budget in the form of new or deferred loans backed by public guarantees. At central government level, the budget deficit was 3.4% of GDP in 2020 – significantly below the revised target of 4.9% of GDP. The general government deficit declined from 3.2% of GDP in 2019 to 2.8% of GDP in 2020, notwithstanding a sharp increase in interest payments and lower revenue from the central bank. The growing domestic demand and targeted tax increases on certain goods, such as motor vehicles, supported revenue. There was a rather modest increase in social spending and transfers to households and limited tax reductions and payment deferrals. However, the good revenue performance and cuts in government consumption and investment expenditure outweighed the impact of these measures on the deficit and allowed the government to reduce the budget deficit and achieve a better than planned result in 2020. While signalling a return to strict spending discipline, which had been a major economic policy asset until 2017, fiscal policy tightened in the midst of the crisis, restraining its support to the economy. The recently revised 2021 deficit took into account the better than planned revenue performance in 2020 (by 2.5% of GDP) and cut the central government deficit target by 0.7 percentage points to an estimated 3.5% of GDP. Although the budget deficit outperformed targets by a wide margin, government debt continued rising. It went up by close to 7 percentage points to 39.8% of GDP in 2020 and continued growing in early 2021 mainly because of the depreciation of the lira. In addition, fiscal risks related to various contingent liabilities increased as well.

Graph 5.3: **Turkey - Fiscal developments**



Source: National sources

The macroeconomic policy mix relied too heavily on the credit channel and a loose monetary policy. Monetary policy overreacted to the crisis and the excessive credit creation spilled over to weaken the lira, worsen financial market volatility, and increase inflation. Direct fiscal support measures, on the other hand, were rather limited in view of the magnitude of the social and labour market challenges. Hence, a rebalancing of the policy mix towards a tighter monetary policy stance and using part of the available fiscal space for a targeted increase of budget expenditure would be needed. Institutional weaknesses, low policy credibility and geopolitical risks seriously undermine the effectiveness of the policy mix.

Functioning of product markets

Business environment

Turkey's institutional and regulatory environment weakened, while government intentions to improve the business climate are at an early stage. Starting a business is still relatively cumbersome, while market exit has also remained costly and time-consuming. Nevertheless, the pandemic intensified both market entry and exits. The number of newly established businesses increased by 20.5% in 2020 as compared to 2019. In parallel, the number of liquidated companies increased by 9.9% and the number of closed ones by 16.4% during the same timeframe. There has been further backsliding in the areas of contract enforcement and insolvency resolution. Even though alternative dispute resolution mechanisms have been promoted, commercial judicial processes are slow and a large backlog of commercial court cases remains. The implementation of the legislation to improve the insolvency system is behind schedule and the process remains inefficient. In order to mitigate the impact of the COVID-19 pandemic on businesses, all pending and new enforcement and bankruptcy procedures were put on hold until 15 June 2020 and concordat proceedings were suspended as well. Turkey lacks a systematic consultation mechanism with business organisations and social partners during the preparation of new legislation.

There has been serious backsliding in recent years with regard to the judicial system. Regulatory enforcement and the constraints on government power worsened the most, while scores on fundamental rights and open government declined from already low levels. The Government adopted a Human Rights Action Plan and an Economic Reform Package in March 2021, envisaging a number of actions, including the development of alternative dispute resolution methods, strengthening specialised courts and reviewing public procurement legislation. Turkey further improved its performance in the area of property rights. However, intellectual property right enforcement remains very weak (*see Chapter 7*). The number of companies managed under the trusteeship of the Savings Deposits Insurance Fund is still high. As of the end of 2020, the management of 796 companies based in 38 provinces across Turkey with a total asset value of TRY 70.3 billion (EUR 7.8 billion) and with a total of 40 061 employees, remained under the trusteeship of the Fund. Neither a schedule for resolving the release of all companies from trusteeship, nor appropriate, effective and timely means of legal redress are in place.

The informal sector remained structurally high, representing a considerable share of economic activity, well above the OECD average. The share of unregistered employment fell below 30% in 2020, mainly due to the decline in informal jobs in sectors seriously affected by the COVID-19 pandemic, such as tourism and construction. The authorities continued to implement the Action Plan and Strategy for the fight against the informal economy (2019-2021). The results of the actions taken so far are, however, difficult to assess. Among others, the Revenue Administration aims to increase the level of voluntary compliance, strengthen audit capacity, review and regulate the legislation, enhance inter-agency data sharing and increase awareness, but no concrete performance indicators against which to measure progress had been set.

State influence on product markets

The state continues intervening in the price-setting mechanism in key sectors. More than a quarter of the consumer basket is composed of goods whose prices are set or heavily influenced by public authorities (price limits, tax rate adjustments). Meanwhile, Turkish regulators have been carrying out intensive price audits across all provinces to investigate unfair pricing and stockpiling practices. In 2020, 495 firms have been found guilty of charging exorbitant prices, mostly on food, protective masks, sanitisers and other basic goods. The total amount of the administrative fines imposed by the Unfair Price Evaluation Board reached TRY 15.5 million. Within the scope of COVID-19 pandemic measures, Turkey reduced the VAT for a comprehensive list of goods and services from 18% to 8% and from 8% to 1% for others until the end of July 2021. VAT for private education services (for 2020-2021 academic years) was also lowered from 8% to 1%. The delivery of the COVID-19 vaccines will also be subject to a reduced VAT rate until 31 December 2021.

State aid transparency and control remained weak. Legislation to implement the State aid law, originally scheduled to be passed a decade ago, has still not been adopted. Turkey 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. Additionally, Turkey has abolished the administrative structure responsible for implementing State aid legislation, while transferring its mandate to the Economic Policies Council. The Directorate-General for Economic Programs and Research, established in 2019 under the Ministry of Treasury and Finance, was assigned the role of coordinating State aid. The current structure of State aid control is considered neither independent nor operational (*see Chapter 8*). The project-based support reached 34 projects with an investment amount of TRY 115.2 billion as of June 2021. Small and medium enterprises (SMEs) benefit from numerous support measures and initiatives, for which there is a lack of systematic monitoring, and evaluations are at an early stage.

Privatisation and restructuring

The pace of privatisation has lost momentum, partly due to the crisis, while the sovereign wealth fund expanded its hold in key sectors of the economy. Privatisation receipts decreased sharply over the last three years, from USD 1.4 billion in 2018 to USD 22 million in 2020. The privatisation of state-owned sugar factories has been ongoing in the reporting period. For 2021, the Privatisation Administration has targeted

the privatisation of electricity generation plants, ports, inspection services for legal metrology and real assets. Government assets owned by the Turkey Wealth Fund (TWF) appear to be ring fenced from privatisation. The TWF holds shares in major companies in the financial, telecommunications, petrochemicals, real estate, mining, agriculture and transport sectors. In 2020, it increased further its presence in the telecommunications and financial sectors. It took over public insurance and individual pension companies with the aim of consolidating them and increasing its share in the non-banking financial industry in Turkey. While remaining the largest shareholder in Borsa Istanbul, it sold 10% of its shares to the Qatar Investment Authority in November 2020. The TWF made some progress towards meeting the Santiago principles on transparency and accountability by publishing its activity reports and consolidated financial statements for the years 2018 and 2019, but there is still room for improving transparency. According to its consolidated financial statements, at the end of 2019, its total assets amounted to TRY 1.5 trillion (34% of GDP). The TWF continues benefiting from certain exemptions from the rules, granted following the outbreak of the COVID-19 pandemic to support companies of strategic importance in distress. These exemptions are mostly related to (publicly held) corporations' transactions, merger and acquisition, unlawful exercise of control, and shareholders' rights.

Functioning of the financial market

Financial stability

The financial sector went through a rapid expansion, but faces adjustment needs in view of the upcoming lifting of forbearance measures. Commercial banks, state-owned banks in particular, were the main vehicle of the policy response to the crisis. Despite rapid credit growth, the banking sector remained broadly stable, partly thanks to the relief provided by forbearance measures. The capital adequacy ratio of the banking sector declined somewhat in early 2021, but at 17.5% in July it was still above the regulatory minimum and historic averages. Pandemic-related incentives, which were extended until September 2021, continued to affect positively bank capital positions. Regulatory measures (extension of the period for delinquent loans to be classified non-performing to 180 days and postponement of loan instalments) and the rapid growth in lending had a strong impact on the non-performing loan (NPL) ratio, which even declined from 5.3% in the beginning of 2020 to 3.7% in July 2021. Stage 2 loans (loans for which the risk of non-payment has increased significantly) have also remained broadly stable at around 11% over this period, although loan restructuring continued to cloud proper assessment. Bank profitability declined somewhat from an already low level because of increased funding and provisioning costs and lower income from fees. Profitability continued to be lower in state-owned banks, largely because of the authorities' heavy reliance on these banks to boost lending. The dollarisation of the system increased from an already high level as the private sector's desire to hedge against exchange rate volatility triggered a further expansion in foreign exchange and gold deposits, with their share rising from around half of all deposits in mid-2020 to 56% in June 2021. Despite an increased country risk premium spilling over to their creditworthiness, commercial banks managed to maintain the rollover ratio of their

external loans consistently above 90% and continued to manage their excess foreign exchange liquidity through the swap markets.

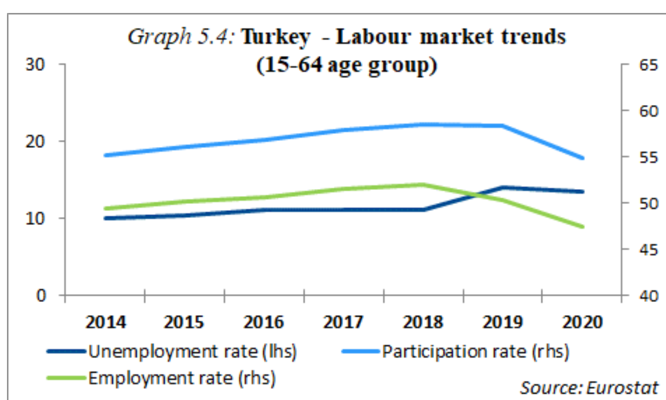
Access to finance

Supported by loose monetary policy and strong regulatory measures, bank lending grew strongly. The authorities took wide-ranging measures to stimulate credit and provide liquidity support to the economy. Consequently, loan growth accelerated rapidly in 2020. Although it slowed down as monetary policy changed course and regulatory changes expired in the autumn of 2020, total credit increased significantly since the beginning of 2020 to 66% of GDP in June 2021. State-owned banks have led the lending spree and expanded their market share. Credit increased strongly both in the corporate and retail segment last year, spurred also by the support offered by the Credit Guarantee Fund, which doubled its allowable loan limits and extended its mandate beyond SMEs to households. While decelerating markedly in early 2021, the growth of household loans still remained robust until mid-2021. Total bank assets increased from 104% of GDP in 2019 to 121% in 2020, while the share of foreign-owned banks in total assets declined slightly from 26.5% to 25.1%. The interest rate spread between USD commercial loans and deposits has declined since the beginning of 2020 and was around its long-term average in the first half of 2021. The spread in lira increased also approached its average but from a low level.

Functioning of the labour market

The pandemic had a major negative impact on employment and poverty. The labour market had not yet fully recovered from the 2018 recession, when the pandemic hit. Repeated lockdowns and reduced economic activity, in particular in a number of labour-intensive sectors, led to a sharp decline in employment, most notably in construction and services. Although the government introduced a job retention scheme, financed by the Unemployment Insurance Fund, and a ban on lay-offs, which benefitted millions of people, employment (15 years and above) fell by close to 3 million or 10% y/y in April 2020. It started to recover in the summer and increased further by June 2021, with a notable rebound of industrial employment. However, employment levels and the employment rate remained below their height a few years ago. The pandemic increased the number of discouraged workers and the labour force participation rate fell to a low of 46.2% in April 2020, before partially recovering to 51.2% in the second quarter of 2021. Male and youth employment bore the brunt of the crisis, while female labour market participation and employment declined as well from already particularly low levels. The rate of youth not in employment, education or training increased further. Undeclared work declined as the pandemic affected relatively more sectors with higher

Graph 5.4: **Turkey - Labour market trends (15-64 age group)**



Source: Eurostat

informality. The unemployment rate was broadly stable at around 13% on average in 2020 but declined by mid-2021. The slack on the labour market, however, was evident by the rise in the composite indicator of labour underutilisation, which takes into account time-related underemployment and potential labour force. While traditionally under 20%, it went up to close to 30% of the labour force in the spring of 2020 and was still elevated in the second quarter of 2021. The job-retention measures that had shielded the labour market in the crisis were lifted in June. Regional labour market disparities are significant, with the unemployment rate ranging from 8.0% to 33.5% in 2020. After nearly two decades of continuous decline, poverty increased sharply in recent years because of the deteriorating labour market situation. The proportion of people with per capita consumption of below $5.5 a day (2011 PPP) went up from 8.5% in 2018 to an estimated 12.2% in 2020. Income inequality worsened as well with the Gini coefficient rising to 0.41 in 2020 – its highest level in a decade.

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

Turkey has made **limited progress** and has a **good level of preparation** in achieving the capacity to cope with the competitive pressure and market forces within the EU. Despite some progress made in improving access to education, the mismatch between the education system and labour market needs persists. Expenditure on research and development continued increasing at a slow pace, but remained well below the government's target. Supported by favourable financing conditions and concessional lending, investment activity rebounded in 2020. Progress was made with regard to the diversification of energy supplies and the development of the renewable energy sector. The extension of local content requirement practices continued to raise concerns. The relative share of the EU in Turkey's foreign trade slightly increased, despite extensive deviations by Turkey from its obligations under the EU-Turkey Customs Union.

The Commission's recommendations from 2020 were not fully implemented and remain valid. In order to improve competitiveness and support long-term growth, Turkey should in particular:

→ continue increasing enrolment in education, improve vocational education and training and better adapt education and training to labour market needs;

→ take steps to open the gas market to competition;

→ remove all protectionist measures not in line with the EU-Turkey Customs Union.

Education and innovation

Turkey has made some progress in terms of improving access to education. Total expenditure on education was TRY 259.2 billion (6.0% of GDP) in 2019, representing a real increase of 2.6% year-on-year. Government spending was around three quarters of it or 4.4% of GDP in 2019, increasing by 0.1 pp. from 2018. In the 2019-2020 school year, enrolment rates continued increasing for preschool, primary (first 4 years), lower secondary (second 4 years), and in upper secondary education (final 4 years). However, the net enrolment rate remained particularly low in the age group 3-5 years and declined

in the tertiary education, while dropout rates remained high in secondary education. (see Chapter 26). The proportion of students in vocational and technical secondary education fell further to 28.6% (from 37.2% five years ago). The share of pupils in religious education remained broadly stable at close to 11% in the upper secondary education, but increased in the lower secondary education to 13.6%, up from 7.3% five years ago. During the COVID-19 pandemic, Turkey has launched distance learning through state-run channels and internet platforms. Gender inequality in the educational system remains high. The scores obtained by Turkish students in the OECD 2018 PISA (Programme for International Student Assessment) test improved, but still remained below the OECD average. Despite some improvements, the unemployment rate among people with higher education was 12.8% in 2020. There is a persistent mismatch between the requirements of the labour market and the skills acquired in the education system. However, as part of its Eleventh Development Plan, Turkey is increasing its efforts to align the education system with the requirements of the labour market, especially by further updating vocational and technical education, developing digital competencies and skills and supporting the participation of young people in the labour market.

The private sector continues to lead research and development efforts. Research and development expenditure increased gradually from 0.8% of GDP in 2013 to around 1.1% in 2019, but still remained well below the government's target of 1.8% by 2023 and also below the EU average of 2.2%. Almost two thirds of this investment came from the private sector. Cooperation between research institutions and the private sector still needs to be further strengthened. While the number of domestic patent applications increased by 0.9% in 2020 as compared to 2019, Turkey's total international patent applications decreased by 10.9% in the same period.

Physical capital and quality of infrastructure

Supported by favourable financing conditions and concessional lending, investment activity rebounded in 2020. High investment, in particular in non-tradable sectors, contributed to the accumulation of macroeconomic imbalances that led to the abrupt depreciation of the lira in 2018. The ensuing correction was short-lived and, driven by significant monetary easing and government-subsidised lending, investment bounced back to 27.4% of GDP in 2020. The share of construction in total investment went down from a plateau of 56% in 2013-2018 to 46% in 2020. The share of investment in machinery and equipment followed the opposite pattern, rebounding strongly from 34% in 2018 to 42% in 2020. Public investment had been broadly stable for years at close to 4% of GDP. However, because of efforts to limit government expenditure and contain the budget deficit, it fell sharply to below 3% in 2019-2020. The government has further advanced preparatory works for the Istanbul Canal project, connecting the Black Sea to the Sea of Marmara, despite strong domestic opposition, environmental and social concerns, and unclear financing and economic returns.

Despite improved diversification of energy supplies, issues remain with competition and pricing mechanisms in the energy sector. The dominant market position of the vertically integrated National Petroleum Corporation BOTAŞ remained unchanged. This affects the viability of the recently established Energy Exchange

Istanbul (EXIST), where a market of derivatives is expected to be launched in 2021. This should provide more depth and liquidity to the energy market. The update to the natural gas market law is long overdue. Good progress was made in the diversification of energy supplies, thanks to the now operational Trans-Anatolian Pipeline (TANAP) transmitting gas to the European section of the Southern Gas Corridor (SGC) and the significantly increased liquefied natural gas imports in 2020. The renewable energy sector of Turkey continued to grow with the support of a generous feed-in-tariff scheme. A new financial support scheme entered into force in June 2021 (after the previous one expired) and facilities commissioned until December 2025 will benefit from it for the next 10 years that follow. It offers overall lower support than before and is denominated in Turkish lira. The state made a commitment to update the mechanism every quarter in order to adjust it for inflation and exchange rate fluctuations. The new scheme continues the financial incentives for the use of domestic equipment (55% at the minimum) in renewable energy installations. The extension of the Local Content Requirement (LCR) practices in Turkey continues to raise concerns. These practices contradict WTO and the EU-Turkey Customs Union rules and affect the EU and other international companies' competitiveness on the Turkish energy market.

Connectivity increased further but remained well below OECD average. The government considers accelerating the digital transformation a key priority to boost productivity and competitiveness of the economy. The number of broadband internet subscribers reached 82.4 million in 2020, up from 76.6 million in 2019. Mobile broadband penetration slightly increased, though it is still below the OECD average. The share of households with access to internet at home grew from 88.3% in 2019 to 90.7% in 2020. Over the same period, internet usage by individuals aged 16-74 also increased from 75.3% to 79.0%. The share of individuals using e-government services reached 51.5% in 2020. The number of 4.5G subscribers increased to 77.3 million in the first quarter of 2021, of which 53.8 million were active users.

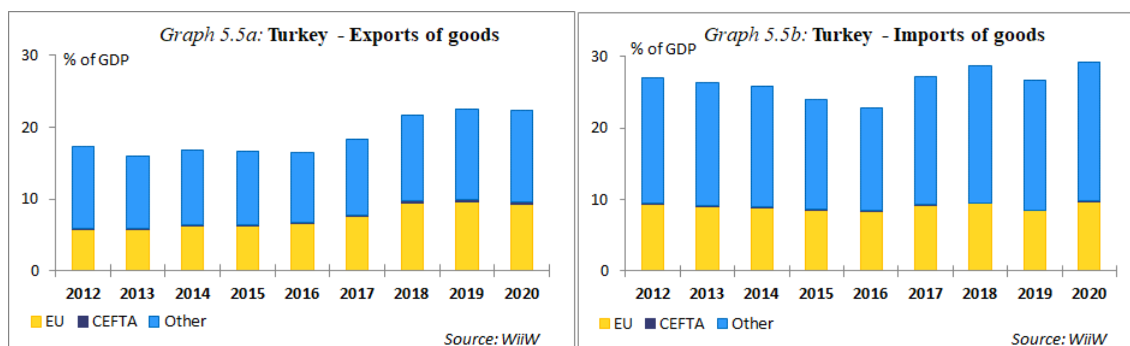
Sectoral and enterprise structure

The services sector continued to dominate the economy, but has been strongly impacted by the COVID-19 pandemic. Its share in total value added decreased from 57.2% to 54.9% between 2019 and 2020, mainly as contact-intensive sectors, such as hospitality and travel, were hard hit by the pandemic-related restrictions. Some sectors, like financial and insurance activities, and information and communication, however, performed very well, increasing also their economic weight. The construction sector, which had been one of the main sectors driving economic growth before 2018, saw its share falling from 8.5% in 2017 to 5.2% in 2020 – a level not seen in 15 years. Employment in the construction sector decreased from 7.5% in 2017 to 5.6% of total employment in 2019 and remained largely unchanged in 2020. Industry accounted for 20.6% of employment in 2020, up by 0.7 pps. from its 2019 level. In spite of the pandemic, it managed to increase its share of GDP from 21.1% to 22.1% between 2019 and 2020. Although representing only 6.7% of GDP in 2020, agriculture continues to be an important sector, employing 17.7% of the workforce (down by 0.4 pps. from its 2019 level).

Small and medium-sized enterprises (SMEs) are the backbone of the economy. SMEs employ around three quarters of Turkey's workforce and generate more than half of the economy's total value added. Turkey continued to implement various economic support schemes, mostly targeting SMEs. In order to limit the negative effects of the COVID-19 pandemic, Turkey adopted support mechanisms for enterprises consisting of labour-related schemes (partial redundancy, short-time work, wage subsidy) and payment deferral measures (taxes, social security premiums, utility bills), while also providing financial support through loan guarantees, direct lending and subsidies. The SME support administration KOSGEB extended the scope of its TechnoInvest support programme to new products such as personal protective equipment and disinfectants and granted additional grace periods for eligible companies. Further assistance was provided in support of SMEs' digitalisation and internationalisation. There were also limited direct cash transfers to restaurants and cafes in order to compensate their turnover loss due to repeated lockdowns.

Economic integration with the EU and price competitiveness

Despite a notable Brexit effect, economic integration with the EU remained high. In 2020, Turkey remained the EU's sixth largest trading partner, while the EU remains by far Turkey's largest trading partner. The share of the EU in Turkish exports decreased from 42.4% in 2019 to 41.3% in 2020 while the share of Turkish imports coming from the EU-27 slightly increased from 32.3% to 33.4% between 2019 and 2020. Trade with the United Kingdom represented 6.6% of total exports and 2.5% of imports in 2020. The EU remained the largest source of foreign direct investment (FDI) in Turkey. The EU's share in the overall stock of FDI declined from 72% in 2013 to 62% in 2020 (58% in 2019). Trade openness declined slightly in 2020, as the pandemic led to a contraction of exports of services. The fall in the lira's value intensified in 2020, leading to a significant further depreciation of the real effective exchange rate, which reached its lowest level on record since 1994. Turkey maintained the additional duties, of which the scope significantly increased during the COVID-19 pandemic, on a large number of products of non-EU origin and in free circulation within the EU-Turkey Customs Union. The forced localisation policy in the pharmaceutical sector, which the EU has challenged at the World Trade Organisation, remained in place, while non-tariff barriers such as import surveillance and customs checks, which were intensified during the pandemic, continued to hinder trade flows.



Graph 5.5a: **Turkey - Exports of goods**

Source: WiiW

Graph 5.5b: **Turkey - Imports of goods**

Source: WiiW

6. BOSNIA AND HERZEGOVINA

6.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Bosnia and Herzegovina has made **limited progress** and is at an **early stage** of establishing a functioning market economy. The country took measures to counter the negative effects of the COVID-19 pandemic on the economy and the labour market. The Central Bank undertook significant measures to improve its analytical capacities. Some steps were taken to strengthen the financial sector's shock resilience. However, there have been no significant measures to improve the functioning of the product markets. Cooperation and coordination among the country's stakeholders has further deteriorated. Resistance from the *Republika Srpska* entity against EU *acquis*-related country-wide reforms has further slowed down the country's compliance with the EU accession criteria. As a result, the country's institutional set-up as well as its internal market remains fragmented. No improvement has been reached with respect to the rule of law and the functioning of country-wide supervisory and regulatory institutions. This continues to impede the country's business environment. The quality of public spending has not improved, while the public sector has remained inefficient and oversized. The implementation of last year's country report recommendations for improving compliance with the functioning market criteria has been limited.

In order to improve the functioning of the market economy, Bosnia and Herzegovina should in particular:

→ Improve the business environment by streamlining, simplifying business registration and licencing procedures and strengthen the country's internal market by harmonising and mutually recognising licences and certificates between entities;

→ In order to improve the efficiency of tax collection, ensure an effective exchange of taxpayer information between the country's tax authorities, and in particular create in line with the EU *acquis* a central (i.e. country-wide) registry of bank accounts of private individuals;

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

→ Increase the transparency and efficiency of the public sector, in particular by establishing an adequate institutional and regulatory framework for a better, de-politicised governance, and by improving the efficiency and governance of publicly owned enterprises to reduce their burden on tax-payers;

→ Support formal employment by reducing the tax wedge, especially for low-income earners.

Economic governance

Economic policy suffered from a further deteriorating cooperation at entity level and disagreements on implementing country-wide reforms in line EU-accession

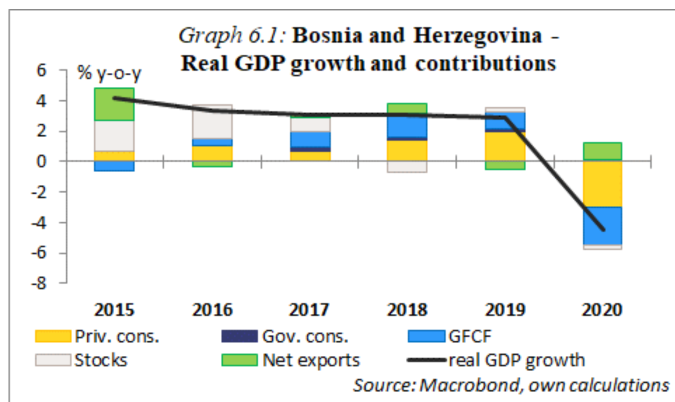
requirements. In order to mitigate the negative effects of the COVID-19 pandemic, the authorities supported the health sector, enterprises and households, by financing medical equipment, providing loan guarantees and co-financing social security contributions and wages. Furthermore, the country's two banking agencies have adopted and extended loan repayment moratoria for restructuring credit arrangements for individuals and legal entities that were severely affected by the COVID-19 pandemic. However, allocated funds (about 2.5% of GDP for financial assistance and another 0.5% of GDP for loan guarantees) and the efficiency of spending have been relatively low. Coordination of the authorities as well as consultations with the social partners in the context of COVID-19 were limited. Furthermore, the implementation of adopted measures has been inadequate, in particular in view of protecting the most vulnerable parts of the population.

Political disagreements have further aggravated, leading to a further deterioration of cooperation between the various levels of government and institutions. The country's IMF arrangement from 2016 expired (the country withdrew less than a third of the total amount available) and after lengthy negotiations the authorities failed to reach an agreement with the IMF on a new loan arrangement. Implementation of the policy guidance jointly adopted at the Economic and Financial Dialogue with the EU in May 2020 has been partial, with financial sector-related measures having the highest degree of implementation. The Economic Reform Programme (ERP) continued to demonstrate significant weaknesses in cooperation and country-wide policy formulation as well in data availability and quality.

Macroeconomic stability

The COVID-19 pandemic led to a marked drop in economic activity in 2020. While during 2015-2019 a relatively favourable external environment helped to achieve average economic growth of 3.5%, economic output dropped by about 4.5% in 2020. On a quarter-to-quarter base, the seasonally-adjusted output dropped by 10.4% in the second quarter, but recovered by 3.9% and 2.9% in the third and fourth quarters. In the first quarter of 2021, a moderate year-on-year recovery of 1.5% set in, largely benefitting from a strong export performance. The downturn in 2020 predominantly reflected the impact of travel restrictions and lockdown measures on private consumption and exports, in particular of tourism services. Investment also dropped markedly as a result of the pandemic from an already relatively low level, which reflected a poor business environment and high political uncertainties. The drop in domestic demand triggered a severe contraction of merchandise imports, which turned the contribution of net exports to growth into

Graph 6.1: **Bosnia and Herzegovina - Real GDP growth and contributions**

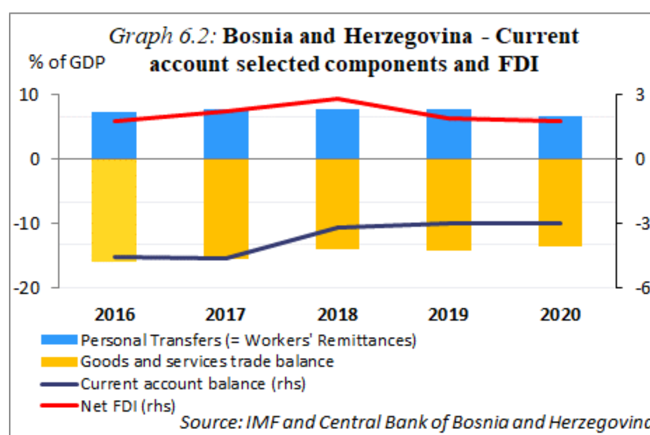


Source: Macrobond, own calculations

positive territory. Per capita GDP stood at some 33% of the EU-27 average in 2020, only slightly higher than in previous years.

The current account deficit remained stable in 2020, as weaker exports were largely compensated by lower imports due to weak domestic demand. After a slight drop in the current account deficit to 4.1% of GDP on average during the last five pre-pandemic years, the deficit remained at a similar level (3.2% of GDP) in 2020 as in the year before, and improved in the first quarter of 2021 to a deficit of 1.4% of GDP, mainly benefitting from stronger exports. The trade deficit continued to be largely financed by inflows of transfers, such as remittances. Net foreign direct investment remained remarkably stable at a low level, accounting for 1.9% of GDP in 2020 and increasing to 2.9% of GDP in the first quarter of 2021, mainly consisting of reinvested earnings. Official net foreign exchange reserves rose on the back of foreign currency inflows in the form of emergency assistance as well as due to declining imports, reflecting weak domestic demand. As a result, reserves reached a comfortable level of about 10 months of imports at the end of 2020, compared to 7.8 months a year before. Short-term debt accounts for only 0.1% of foreign exchange reserves. The coverage of imports of goods and services through exports improved during 2015-2019, reaching 73% in 2019, largely thanks to a favourable export performance in this period. In 2020, the coverage dropped back to 70%, as the reduction in exports was more significant than the drop in imports.

Graph 6.2: **Bosnia and Herzegovina - Current account selected components and FDI**



Source: IMF and Central Bank of Bosnia and Herzegovina

The monetary policy regime has supported stability. The currency board arrangement (CBA) with the euro as the anchor currency was maintained. This approach has served the economy well so far. The fact that the CBA remained stable and did not get under stress even during the pandemic demonstrates the public confidence and trust it enjoys and thereby this is an important pillar of macroeconomic stability. However, it also implies that the burden of adjustment to external shocks has to be accommodated by other policy areas, in particular fiscal policy, necessitating the build-up of sufficient fiscal buffers and a stronger emphasis on medium-term stability, and structural reforms to improve the functioning of markets. The credibility of the Central Bank's independence has been threatened during last year by the highly politicised appointment by the Presidency of three member of its board in 2020, as well as by the failure of the Presidency to appoint a new governing board ahead of the expiration of its mandate in August 2021, due the boycott of State-level institutions by politicians from the *Republika Srpska* entity. As a result, the governing board is operating with a caretaker mandate only.

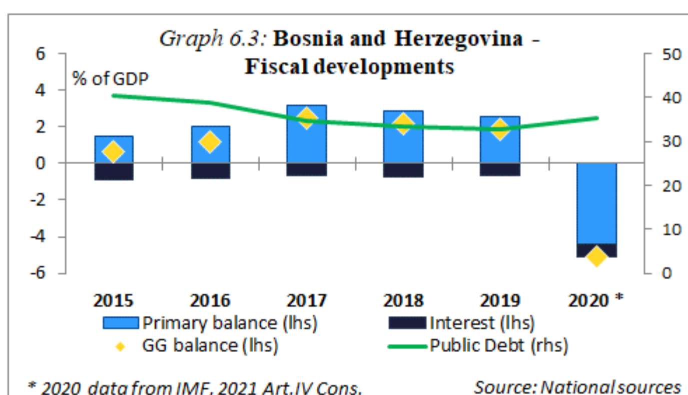
Table 6.1: **Bosnia and Herzegovina - Key economic figures**	**2012-17** average	**2018**	**2019**	**2020**
GDP per capita (% of EU-27 in PPS)[1]	31	32	32	33
Real GDP growth	2.2	3.1	2.9	-4.6
Economic activity rate of the population aged 15-64 (%), total	54.2	54.2	55.5	58.2
female	*42.0*	*41.8*	*44.4*	*46.1*
male	*66.2*	*66.4*	*66.4*	*70.4*
Unemployment rate of the population aged 15-64 (%), total	26.6	18.9	16.4	16.2
female	*29.8*	*21.0*	*19.7*	*19.0*
male	*24.7*	*17.6*	*14.2*	*14.4*
Employment of total population (annual growth %)	2.5	2.9	1.6	-2.0
Nominal wages (annual growth %)	0.7	3.1	4.3	3.8
Consumer price index (annual growth %)	0.0	1.4	0.6	-1.1
Exchange rate against EUR	1.96	1.96	1.96	1.96
Current account balance (% of GDP)	-5.7	-3.3	-3.0	-3.0
Net foreign direct investment, FDI (% of GDP)	1.9	2.9	1.9	1.8
General government balance (% of GDP) [2]	-0.3	2.1	1.9	-5.1
General government debt (% of GDP) [2]	38.0	32.7	31.7	35.2

Notes:
1) Eurostat
2) 2020 data based on IMF, 2021 Art.IV Consultation
Source: national sources

Consumer price inflation turned negative in 2020, due to low import prices and low domestic price pressures. Average consumer prices dropped by 1.1% in 2020, compared to an increase by 0.6% the year before. In the first seven months of 2021, average consumer prices were 0.4% higher than a year before, although from May onwards, inflation registered a marked year-on- year increase towards nearly 2%. Besides low prices for imported energy, price declines for clothing and footwear contributed to the low overall inflation rate in the first half of the year. Prices for transport, accounting for nearly 13% of the basket, also contributed negatively to overall consumer price inflation in the first three months of 2021, but were a key contributor to the overall price increase since then. However, the inflation measure still suffers from an outdated consumer basket and insufficient cooperation among key data providers.

The general government accounts deteriorated markedly in 2020, as a result of a decline in revenues, while COVID-19 related spending rose sharply. Due to the poor quality of country-wide fiscal data, the country's overall fiscal position is still difficult to assess. During the last five pre-pandemic years, public finances have registered frequent surpluses of up to 2% of GDP, largely due to politically induced delays in implementing investment projects. In 2020, the pandemic resulted in a sharp drop in revenue, while spending increased, transforming the surplus of 2.2% of GDP in 2019 into a deficit of more than 5% of GDP in 2020. Overall, the authorities adopted additional spending measures, amounting to about 2.5% of GDP for health related spending and general support measures, such as providing support to troubled

companies and subsidising wages and social security contributions. Furthermore, up to 0.5% of GDP has been reserved for providing pandemic-related loan guarantees. These figures largely reflect funds, which the country received as emergency assistance, in particular from the IMF and the World Bank. This relatively limited approach probably mirrors the country's financing constraints, administrative bottlenecks and in particular political stalemates, delaying the decision process and the implementation of spending decisions. The required financing of the deficit, coupled with the fall in nominal GDP, increased the country's debt ratio from 31.7% of GDP in 2019 to 35.2% in 2020. In terms of quality of public finances, policy decisions are primarily focused on short-term issues, while the spending structure is still plagued by a strong emphasis on current spending for wages and transfers, while investment continued to be neglected.



Graph 6.3: **Bosnia and Herzegovina - Fiscal developments**

Overall, the country's macroeconomic policy mix still suffers from an insufficient medium-term orientation and a missing focus on growth-enhancing policy measures. While macroeconomic stability has been preserved during the pandemic, fiscal planning for the post-pandemic years is still insufficiently geared towards growth enhancing measures. Given that the country's currency board regime limits the room for monetary policy, fiscal policy is one of the country's key macroeconomic policy tools. However, due to the strong focus of policy makers to maintain the status quo, this tool is not adequately used to steer the country towards stronger growth and a faster catching-up with EU income levels. An insufficient degree of cooperation among the various fiscal policy stakeholders, the limited role of the country's fiscal council and the lack of conflict resolution mechanism contribute to the limited effectiveness of fiscal policy with respect to enhancing the country's growth potential.

Functioning of product markets

Business environment

Barriers to market entry and exit have remained high and barriers within the country's internal market persist. On entity level, some efforts were made to proceed with the implementation of electronic registrations of businesses and to facilitate foreign investment. However, no progress has been achieved in removing the barriers to the country's internal market. In order to be able to operate in the whole country, multiple registrations are still required, increasing costs of establishing a company and protecting incumbent companies from competition. So far, no data for 2020 is available concerning the number of registered companies. The country's ranking in the World Bank's doing business report in terms of business environment has been on a declining trend in recent years. The country's position dropped among 190 countries from the 79th in 2015 to the 90th place in 2019, largely reflecting a lack of reforms in Bosnia and

Herzegovina, as political uncertainty is impeding the functioning of markets and institutions. Contract enforcement, in particular settling commercial disputes, remains problematic, together with a substantial backlog in court cases, problems with establishing property rights in some areas, such as real estate registration. Cooperation and coordination among the various stakeholders has further deteriorated and is a major impediment to the rule of law and a proper functioning of the judiciary, impeding the establishment of a level playing field on a country-wide level, with wide-ranging negative effects on the country's business environment. Overall, the country's business environment is still hampered by numerous and lengthy procedures, political interference, corruption and diverging rules in different parts of the country, complicating the operation of companies and creating additional costs.

The institutional and regulatory environment for the functioning of the country's internal market remains a crucial weakness. During the last year, no significant progress has been achieved in this area. The resource endowment and independence of numerous regulatory and supervisory institutions continue to be insufficient.

The informal economy has remained significant during the pandemic. Despite some progress in improving the degree of registration in the labour market by increasing labour market controls, the informal sector may still account for up to one third of GDP. Thus, informality still provides substantial (unregistered) employment and income, but also distorts competition and erodes the base for taxation and social security contributions. The resulting narrow tax base requires rates for taxes and social security contributions to be higher than would otherwise be necessary. This also adds to a significant fiscal burden on labour, which in turn impedes formal employment and negatively affects Bosnia and Herzegovina's international competitiveness.

State influence on product markets

Government policy and legislation still leads to significant distortions in the economy. The still oversized public administration as well as poorly performing publicly owned enterprises (SOEs) are negatively affecting the economy. Transparency on COVID-19 related spending has remained limited so far. Anecdotal evidence points to bureaucratic procedures and a poor targeting of support measures, leading to overall limited effectiveness of COVID-19 related public spending. The amount of contingent liabilities has increased as a result of governmental anti-crisis measures, such as providing loan guarantees. Many public companies rely on state support or delay due payments to the social security systems or to private suppliers, in order to remain in operation. This creates substantial liquidity imbalances in other areas of the economy. Public procurement, which represents a significant share of public spending and thus plays an important role for the private economy, continues to be managed on the base of overly complex procedures, which facilitate corruption and still contain 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 administrated prices and during the pandemic, prices of certain products, such as hygiene products, have been regulated.

The level of officially recorded state aid has still been relatively low (about 1.3% of GDP in 2019). However, in view of significant indirect state support, the level

playing field nevertheless is impeded. In 2020, as part of the COVID-19 crisis support package, many companies benefitted from discretionary state assistance. Unfortunately, so far available data on provided assistance is incomplete. Nevertheless, in combination with the accumulation of payment arrears of taxes and, in particular social security contributions, the level of de-facto state aid appears to have been significant in 2020. The monitoring of state aid control is still hindered by the 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 in the country.

Privatisation and restructuring

No significant progress was achieved in proceeding with the privatisation process. Due to the COVID-19 crisis, measures to restructure or to dissolve public enterprises remained very limited. Strategic sectors such as transport and energy are still dominated by poorly managed and often inefficient state-owned companies. The share of the private sector, in the country's value added, has remained rather stable over the last 5 years at around 80%, and it generates a similar share of the country's employment.

Functioning of the financial market

Financial stability

The fragmentation of the institutional and regulatory set-up continues to impede banking supervision. The institutional and regulatory environment for the functioning of the financial market is largely in place, although key elements are decentralised and the Central Bank's role is limited to coordinate the local regulatory and supervisory agencies. Furthermore, the *Republika Srpska* entity contests the Central Bank's competence in regulating and monitoring certain aspects of the country's financial markets, such as the registration of bank accounts of natural persons. The functioning of the Federation's Security Commission had been impeded for more than one and a half years, due to politically driven difficulties in agreeing on filling top-level vacancies. Among others, this delayed the increase of capital endowment of some banks through the capital market. The new Deposit Insurance Law contributed to the confidence in the sector's stability. However, the bank resolution framework is not completed yet and the absence of a country-wide Financial Stability Fund increases the risk that financial sector tensions could spill over into the real sector and increase fiscal costs. The monitoring of macroprudential indicators has been a positive development, although there are still obstacles to a country-wide, uniform macro-prudential framework.

The banking sector's stability has been maintained during the COVID-19 pandemic, although credit growth decelerated and the sector's profitability declined in 2020. Annual loan growth decelerated to 1.1% in 2020 and turned negative in the first quarter of 2021. This was mainly driven by weak corporate lending. Household lending, accounting for some 29% of total credits, largely stagnated. However, loans to public enterprises, accounting for some 3% of total loans, rose markedly. Bank deposit growth remained relatively strong, at 5.6% in 2020 and some 5% in the first quarter of 2021. The share of non-performing loans (NPLs) in total loans declined during 2020 and reached 6% in the first quarter of 2021 as the implementation

of stricter accounting standards at the beginning of 2020 accelerated NPL write-offs but also affected credit growth. Banking sector profitability deteriorated during 2020, but recovered markedly in the first quarter of 2021, with the return-on-equity ratio rising from 6% at the end of 2020 to 10.8% at the end of Q1, and the return-on-assets ratio recovering from a low of 0.8% at the end of 2020 to 1.4% at the end of the first quarter of 2021. The banking system's overall capital adequacy ratio improved during 2020, reaching 19.2% at the end of 2020, and 18.9% in the first quarter of 2021. The main reasons for these improving indicators are (i) the entering into force of stricter rules before the outbreak of the pandemic, requiring among others higher capital endowments, (ii) the sector's efforts to improve shock resilience by increasing the banks' capitalisation, largely using undisbursed 2019 profits and (iii) aligning risk assessment rules with EU standards. However, there are big differences among the country's 23 banks, with some pockets of vulnerability remaining, in particular in the case of some smaller local banks. Furthermore, there is a notable difference between foreign and domestic banks in terms of soundness indicators, with the former being more successful in reducing NPLs or improving loan provisioning. The central bank has significantly improved its analytical capacities by strengthening its forecasting and risk assessment activities.

The banking agencies introduced measures to enable recovery from negative economic consequences of COVID-19, including debt repayment moratoria, as well as the suspension of dividend payments and stricter rules on the remuneration of board members. Furthermore, the governments of the two entities supported lending by providing temporary guarantees to private sector loans. The volume of those guarantees amounts up to about 0.5% of GDP.

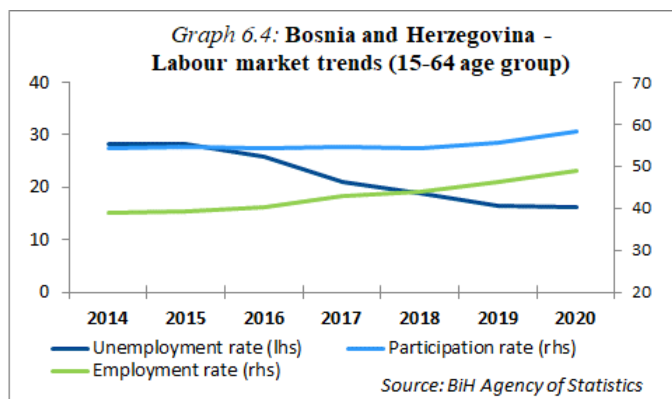
Access to finance

Lending continued to increase during 2020, but small firms' access to finance remained particularly constrained. The loan-to-GDP ratio increased slightly during the last five years from 56% in 2015 to close to 58% in 2020. The improvement in 2020 is to a large extent due to the drop in nominal GDP by 2.2%, while lending increased by 1.1%. Interest rate spreads for consumer loans have declined, dropping during the last 5 years from above 6 percentage points to around 4 percentage points. However, this level is still relatively high, suggesting elevated risks and/or a lack of competition. The five largest banks account for about 80% of the sector's assets. Private sector debt accounted for some 54.5% of total debt at the end of 2020, which is higher than at the beginning of the year, and also markedly above the country'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 has remained small, with a market capitalisation of the country's stock markets of about 26.5% of GDP at the end of 2020. The use of venture capital has continued to be very limited. The governments' loan guarantees had a positive impact on the private sector's access to finance. However, for many micro and small companies gaining access to those guarantees appears to have been difficult.

Functioning of the labour market

The immediate effects of COVID-19 on the labour market have remained limited, due to governmental support measures. In the first half of 2021, the number of registered employed was some 0.8% (7 thousand persons) lower than a year before, while the number of unemployed was 1.8% lower. (7.5 thousand persons). This resulted in a further decline in the labour force by about 1.2%, or 14 000 persons. During the last year, the largest job losses took place in trade and tourism, while some limited employment increases were registered in the health and IT sectors. Due to the high share of informal employment, in particular in the trade and tourism industry, administrative data might underestimate job losses. According to Labour Force Survey (LFS)-based data, the unemployment rate in the age group 15-74 increased to 19.1% in the first quarter of 2021, compared to 16.7% in the first quarter of 2020. Youth unemployment (15-24 years) stood at 40.4% in the first quarter of 2021, compared to 36% in the first quarter of 2020. Key factors for the persistently high unemployment are a lack of adequate employment possibilities in the economy, a mismatch of education curricula with labour market needs, and the high tax wedge, in particular for low-wage earners. The labour market participation of women and the youth is still low, while unemployment rates of those two groups are significantly higher than for men in core working age cohorts. Long-term unemployment has remained high, with about 75% of the unemployed looking for a job for more than one year. During the last year, the authorities have continued to implement active labour market measures, although the efficiency of the measures is not sufficiently rigorously evaluated. These active measures support the employment of vulnerable or disadvantaged groups. The still substantial discrepancy between unemployment data according to administrative and according to survey based data points to the need to further improve the country's labour market statistics.

Graph 6.4: **Bosnia and Herzegovina - Labour market trends (15-64 age group)**



Source: BiH Agency of Statistics

The labour market suffers from a lack of qualified labour. Labour mobility within the country is low. The shortage of qualified labour, partly due to emigration, has supported relatively high increases of nominal wages in some sectors (+3.8% in 2020 for the country as a whole, and +4.6% in the construction sector). In combination with a negative overall consumer price inflation, those wage increases translated in real increases of nearly 5%. Public sector wages are also relatively high, in particular when taking into account the sector's productivity, which to some extent crowds out qualified labour supply from the private sector.

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

Bosnia and Herzegovina has made **limited progress**, and remains at an **early stage** in terms of capacity to cope with competitive pressure and market forces in the EU. The overall quality level of education has remained low, while measures to improve the transport and energy infrastructure have remained insufficient. The extent of structural adjustment has been limited. The implementation of last year's recommendations to support long-term growth was largely limited to some education-related measures.

In order 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 by measures to improve public investment management and through an accelerated implementation of those investment projects that have been subject to a clear positive cost-benefit assessment.

→ Support further trade integration with the EU and CEFTA, among others by supporting alignment with European safety and quality standards, such as those envisaged in the context of the implementation of the Common Regional Market Action Plan.

Education and innovation

Investment in education remains inadequate. Public spending on education accounted for some 4% of GDP in 2019. When adding private spending and foreign donors, the overall amount stands at nearly 5% of GDP. Despite this significant spending, in particular when taking into account the number of students, it fails to provide the country's labour force with the skills and knowledge necessary for a smooth integration in the labour market. This is one factor for a particularly high youth unemployment rate (40.4% at the end of the first quarter of 2021 according to LFS), twice the country's overall unemployment rate.

The education system is highly fragmented and poorly coordinated, leading to varied standards within the country. There has been some progress by adopting a Common Core Curriculum Framework which should provide common learning standards for pre-university education. However, overall the lack of common standards for various levels of education is still substantial, as well as in differences in the quality of teachers' training and performance evaluation. Teaching curricula still continue to be outdated and are still not sufficiently aligned with the country's needs. The country participated for the first time in the 2018 PISA study. Results indicate that the students' performance ranks well below the OECD average, in particular with respect to the minimum skills, which is a clear impediment for the country's competitiveness and growth potential. The country's illiteracy rate continues to be around 3%, largely as a result of a relatively high illiteracy rate among women.

Research and innovation policy is impeded by the large number of stakeholders involved and the low degree of cooperation and coordination, leading to a low efficiency of the overall system. The absence of an efficient funding system is another factor, preventing the country's innovation policy from achieving better results for the funds spent. The country's research capacities remain very limited, while the trend of a 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

In addition to the COVID-19 related uncertainty, investment in the country's capital stock remained impeded by continued political tensions and uncertainties and administrative weaknesses. In the context of the COVID-19 crisis, gross capital formation dropped by nearly 13% in 2020, after an increase by 6.2% the year before. During the five years before COVID-19, average gross fixed capital formation amounted to some 18.4% of GDP. Public investment remained low, reflecting a focus on COVID-19 related current spending. Inflows of foreign direct investment (FDI) remained at 1.8% of GDP in 2020, which is only slightly lower than the 2.1% average during the five years before COVID-19. A large share of those FDI inflows are actually re-invested earnings of foreign investors in the financial sector as well as in tourism. As in the case of gross fixed investment, the low level of inflow of foreign investment is impeding the country'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 country's labour force and constituting an additional factor supporting the brain drain. Overall, the insufficient momentum in investment and negligence of environmental standards continues to hamper improvements in the country's growth potential and labour productivity.

COVID-19, as well as delays in the implementation of investment projects due to political disputes, also had a negative impact on investment in transport and energy infrastructure. After some positive developments with the connection of new renewable energy projects to the grid in 2018 and 2019, as well as efforts to diversify natural gas imports, the need to focus on the crisis response as well as continued delays in government formation in the Federation had a negative impact on public infrastructure investment. Furthermore, necessary steps for updating the regulation of the energy and transport markets were further delayed. As a result, the markets for electricity and gas remain fragmented and dominated by key incumbent companies. Infrastructure connections with neighbouring countries as well as the country's level of digitalisation remain on an inadequate level.

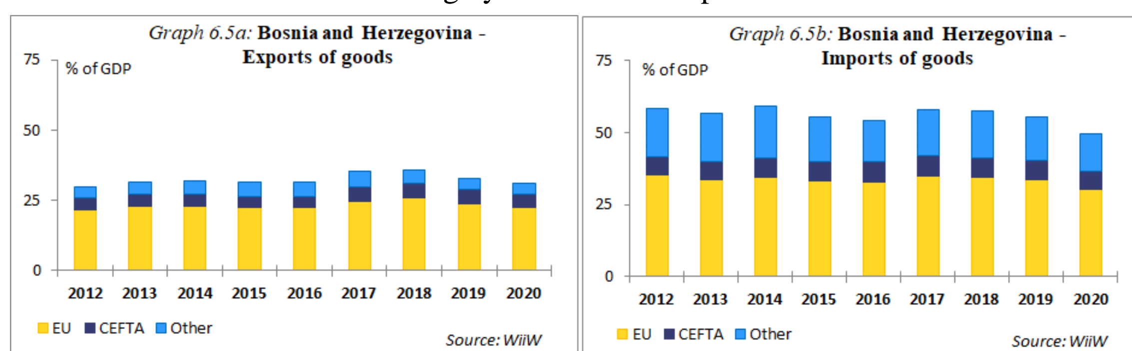
Sectoral and enterprise structure

As a result of COVID-19, the recently observed trend of structural change from the public sector to trade and manufacturing has been put on hold. At the end of 2020, the share value-added of trade and manufacturing was some 2.5 percentage points of GDP lower than a year before, while the share of public administration and agriculture had increased, by some 0.9 pps. and 0.8 pps., respectively. In the five years before the pandemic, the company structure registered some increase in the share of

medium-sized companies, employing between 50-249 employees. However, the majority of new companies were micro companies (0-9 employees), which are often trading companies with lower value added, and which are disproportionally affected by the COVID-19 crisis. Some 95% of all companies are in the group of small and micro businesses, i.e. with less than 50 employees.

Economic integration with the EU and price competitiveness

Trade and investment integration with the EU remained largely unchanged in 2020, despite the COVID-19 shock. The country's international trade shrank by 11.6% in 2020, mainly due to a 13.4% decrease in commodity imports, while exports dropped by 8.5%. More than two thirds of this decline is due to lower exports to neighbouring countries, including Italy as well. However, during five years before the pandemic, trade slightly shifted towards the neighbouring region, reflecting stronger export increases with countries such as Serbia, but also Croatia. Exports to the EU-27 accounted for 72.4% of total exports in 2020, compared to 73% in 2019. Exports to CEFTA countries dropped slightly during 2020, to 16% of total exports. The country's openness to trade (exports and imports as a percent of GDP) dropped sharply in 2020, from nearly 95% in 2019 to 83.4% in 2020, which is a level last seen in 2013. Even before the pandemic, the country's openness to trade was relatively low, in particular in view of its relatively small economic size. The export structure relies mainly on manufactured goods, machinery and transport equipment, chemicals and related products, food and live animals, furniture, textiles and basic metals. While some further progress has been achieved in addressing non-tariff barriers to trade with the EU, such as required phytosanitary and sanitary standards, overall compliance with these requirements remains weak. The integration of the country's financial and capital markets with the EU is 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 is originating from the EU countries. Annual FDI inflows largely show a similar pattern.



The country's overall price competitiveness still appears intact, despite a relatively high wage growth. During the last five years, the real effective exchange has supported Bosnia and Herzegovina's international price competitiveness by registering a slight depreciation by some 3% during 2015-2020, benefitting from the country's low inflation rate, in particular when using the CPI as indicator for inflation. However, in nominal effective terms, the currency appreciated by nearly 6%, mainly reflecting the exchange rate movements of the US dollar, the Turkish lira and the Russian rouble against the euro, to which the Convertible Mark is pegged.

7. KOSOVO*

7.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Kosovo has made **limited progress** and is at an **early stage** of developing a functioning market economy. The economy plunged into recession in 2020, but this trend was reversed in the first half of 2021. Long-standing structural problems, such as the lack of economic diversification and the dependence on financial flows from the diaspora made Kosovo very vulnerable to the pandemic-related lockdown and travel restrictions. In response to the crisis, the authorities suspended the fiscal rule and adopted two fiscal packages. A strong increase in spending and shrinking tax revenues resulted in a large budget deficit in 2020 but recovery in tax revenue helped achieve a budget surplus in the first half of 2021. The business environment saw little improvement. Private sector development remains constrained by a widespread informal economy, a slow and inefficient judiciary, a high prevalence of corruption and the overall weak rule of law. Last year's recommendations were partly addressed.

In order to improve the functioning of the market economy, Kosovo should in particular:

→ support post-crisis recovery by targeting most affected and vulnerable firms and households while planning the return to the deficit ceiling of 2% of GDP in the medium term;

→ prepare a review of the social security system, including war veteran pensions, and a review of tax expenditure with a view to improving the cost-efficiency and fairness of the social security schemes;

→ improve the quality of public spending by reforming the public wage system and addressing bottlenecks in the management of capital investment;

→ implement relevant business environment measures, in particular the simplification, merging and abolishment of licences and permits;

→ implement active labour market measures to support employment, increase labour force participation and incentive measures with an aim to formalise informal employment.

Economic governance

Kosovo's economic governance focused on mitigating the crisis impact on households and firms through the adoption of subsequent support packages and the suspension of the deficit rule. The initial emergency package (EUR 180 million) adopted in March 2020 was supplemented by an additional provision of EUR 185 million for the economic recovery programme in the revised budget adopted in July, bringing the budgeted 2020 crisis-related stimulus to a grand total of about 5.2% of 2020 GDP. The economic recovery programme targeted broadly the same categories as the emergency package. It mainly supported affected businesses and most vulnerable households, formal and informal employment, the health sector, and provided liquidity to financial institutions through credit guarantees and regulatory measures. The

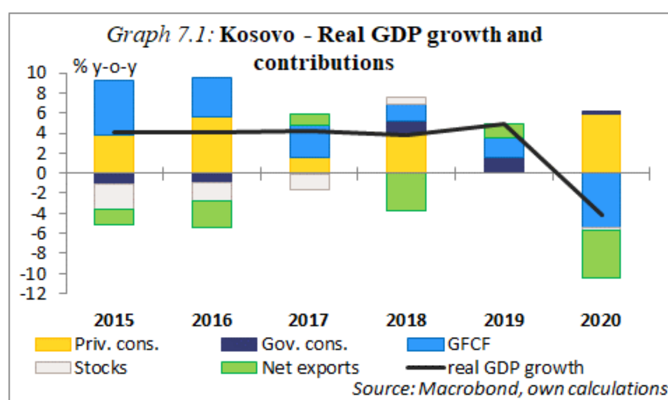
implementation of the recovery package in the second half of 2020 was slow, as some support was not possible without the approval of the Law on Economic Recovery, which was adopted with a considerable delay. Once adopted, the law added a new ad hoc spending item to support operational expenses of private firms (EUR 200 million) without transparent allocation criteria. Moreover, the Law on Economic Recovery allowed early, tax-free withdrawals of 10% of pension savings from the Kosovo Pension Saving Trust (KPST) (EUR 200 million or 3% of 2020 GDP), which the government promised to reimburse from 2023 onwards. To bridge the financing gap, Kosovo was granted concessional loans by donors, including Macro-financial Assistance (MFA) from the EU, the IMF emergency liquidity loan (Rapid Finance Instrument, RFI), as well as loans from the World Bank and the Council of Europe.

The policy guidance, jointly agreed at the May 2020 Economic and Financial Dialogue between the EU and the Western Balkans and Turkey, has seen limited implementation. The 2021-2023 Economic Reform Programme, which was submitted by the outgoing government, focuses on economic recovery, but is vague on reform priorities. The return to the 2% deficit ceiling is planned by 2023.

Macroeconomic stability

Following five years of robust growth, Kosovo's economy plunged into recession due to COVID-19-related restrictions. Annual GDP contracted by around 4% in 2020, driven by a strong fall in private and public investments and a strong negative contribution of net exports. The impact of the crisis on financial flows from the diaspora, notably tourism exports and investment, was a key transmission channel. Declining imports and elevated government spending resulting from fiscal stimulus packages provided some cushion against the economic downturn. In addition, exports of goods held up well and increased by a solid 12.6%, reflecting a strong performance of base metals, which account for more than a third of total goods exports. The reported increase in private consumption seems at odds with falling imports and domestic trade, and likely reflects weaknesses in statistics. Economic activity rebounded in early 2021 with GDP expanding by 5.6% year-on-year in the first quarter, supported by fiscal stimulus and recovering investment. The upward trend accelerated in the summer months due to a massive return of diaspora tourism, stronger remittances and a strong growth in consumption loans. The pandemic underlined the vulnerability of Kosovo stemming from low economic diversification, which was advancing at a slow pace despite robust GDP growth before the crisis.

Graph 7.1: **Kosovo - Real GDP growth and contributions**



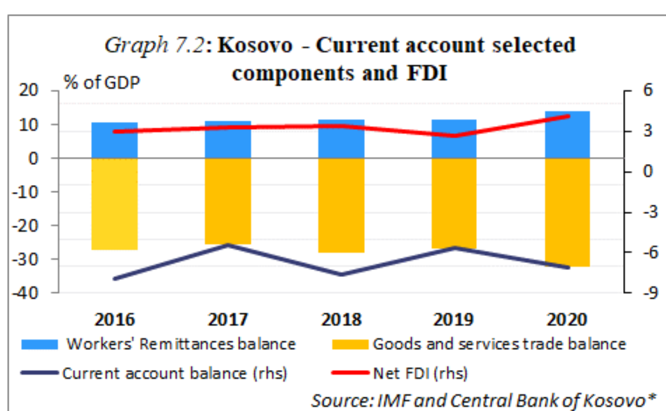
Source: Macrobond, own calculations

Kosovo's per capita GDP remains the lowest in the region. It stood at about 26% of the EU average in 2020. COVID-19 had a negative impact on employment, wages and

poverty. Inequalities remain widespread due to a large informal sector and high inactivity rates, especially among women.

The current account deficit increased to 7.1% of GDP in 2020 and widened further in the first half of 2021. In 2020, the deterioration was driven by the collapse of exports of services, mainly diaspora tourism from Western Europe, which fell by 25.7% compared to the previous year. While strong performance of goods exports and declining imports led to a marginal improvement in the merchandise trade deficit, the overall deficit of goods and services rose to 29% of GDP from 27% in 2019. The key offsetting factor was an increase in remittances, which reached 14% of GDP in 2020. The increase of remittances sent via official channels was mainly driven by travel restrictions that made less formal ways of transferring money to Kosovo less viable. In the first half of 2021, the current account deficit more than doubled as compared to the same period in 2020. An impressive return of diaspora tourism led to an increase in the surplus of services trade by 88.3% year-on-year, but the balance of goods trade deteriorated by 37%. Remittances increased by 27% over the same period.

Graph 7.2: **Kosovo - Current account selected components and FDI**



*Source: IMF and Central Bank of Kosovo**

Table 7.1: **Kosovo - Key economic figures**	**2012-17** average	**2018**	**2019**	**2020**
GDP per capita (% of EU-27 in PPS)	23.6	25.0	25.9	26.0
Real GDP growth	3.3	3.8	4.9	-4.1
Economic activity rate of the population aged 15-64 (%), total	39.7	40.9	40.5	38.3
female	*19.5*	*18.4*	*21.1*	*20.8*
male	*59.6*	*63.3*	*59.7*	*56.0*
Unemployment rate of the population aged 15-64 (%), total	31.2	29.6	25.7	25.9
female	*37.6*	*33.4*	*34.4*	*32.3*
male	*29.1*	*28.5*	*22.6*	*23.5*
Employment of the population aged 15-64 (annual growth %)	3.7[1)]	-3.4	5.2	-4.0
Nominal wages (annual growth %)	2.4[1)]	5.1	5.3	-2.3
Consumer price index (annual growth %)	1.0	1.1	2.7	0.2
Exchange rate against EUR	1.0	1.0	1.0	1.0
Current account balance (% of GDP)	-6.3	-7.6	-5.6	-7.1
Net foreign direct investment, FDI (% of GDP)	3.7	3.4	2.7	4.2
General government balance (% of GDP)	-2.0	-2.9	-2.9	-7.0
General government debt (% of GDP)	11.9	16.9	17.5	21.8

Notes:
1) average of 2013-2017
Source: Kosovo statistics, World Bank and IMF

Net FDI inflows in 2020 increased to 4.2% of GDP on the back of reinvested earnings in the financial sector. Gross FDI fell by 4%; in particular, FDI in real estate, accounting for the bulk of FDI in 2018-2019, were affected by travel restrictions and the resulting drop in diaspora arrivals in Kosovo. Kosovo does not attract any portfolio investments. In the first quarter of 2021, net FDI inflows increased further to 6.2% of GDP while official reserve assets stood at 3.2 months of imports of goods and services.

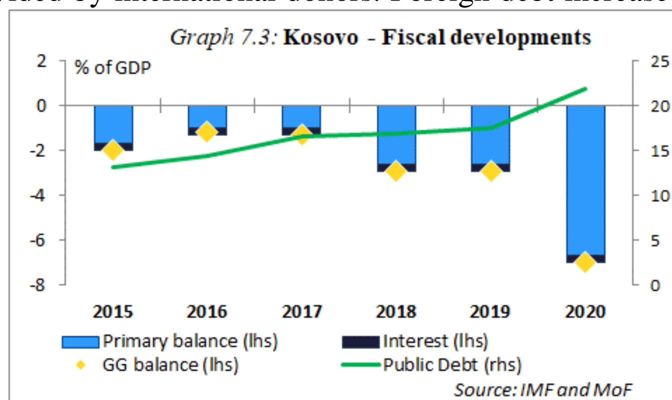
In line with contracting economic activity, average annual inflation declined to 0.2% in 2020. Weak demand pressures, low imported inflation and the removal in April of 100% import tariffs on products originating from Bosnia and Herzegovina and Serbia led to a steady deceleration of annual consumer price inflation, which turned negative in the summer despite a positive contribution from food prices. In the first five months of 2021, inflation picked up and averaged 1.2% year-over-year with monthly readings turning positive in February. Inflation's positive trend has continued to increase every month, reaching a record-high figure of 3.5% year-over-year by July 2021.

In 2020, the budget deficit widened significantly on the back of shrinking revenues and increased pandemic-related spending. The headline budget deficit reached 7% of GDP in 2020, which corresponds to a deficit of 5.3% of GDP under the fiscal rule definition.[19] The fiscal rule was suspended due to the crisis, allowing the deficit to exceed the prescribed ceiling of 2%. Tax revenue contracted by 9.6% while public spending rose by 6.7% as compared to the outcome of 2019. Tax and non-tax budget revenue fell also short of projections of the revised 2020 budget, with the collection rates from direct and indirect taxation standing at 94% and 96%, respectively. The implementation of the revised 2020 budget was uneven among different categories. Due to the implementation of the economic recovery programme in 2020, social transfers at the general government level rose by 39%. The recurring under-execution of capital spending hit a new record-low in 2020 due to the political stalemate, the pandemic-related restrictions and the resulting inability to advance donor-financed projects. Total capital spending contracted by nearly 28% as compared to 2019. This trend was reversed in the first half of 2021, as the increase in public revenue (19.6%) outpaced growth in expenditure (9.8%) resulting in a budget surplus three times as big as compared to the same period of 2020. Capital spending increased by 27.7% year-on-year largely due to base effects.

Due to a widening financing gap in 2020, the debt-to-GDP ratio increased to 23.2% in June 2021 from 17.5% at the end of 2019. Domestic debt, which is held by a narrow investor base, rose by 34% during this period with a large share of new issuances absorbed by the Kosovo Pension Saving Trust (KPST). The share of domestic debt held by the KPST has increased to 45% from 38% in 2019, while the amount held by commercial banks declined from 35% to 31%, respectively. Meanwhile, the share held by the Central Bank of Kosovo (CBK) shrunk by 2 percentage points (pps.) to 20%. As Kosovo does not have sovereign credit rating and access to international bond

[19] 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. As a part of the fiscal rule, the wage bill rule provides that the increase in the public wage bill cannot exceed nominal GDP growth. The government deposits used as fiscal buffers are legally required to stay at 4.5% of GDP as long as the government is using privatisation proceeds. The debt rule provides that public and publicly guaranteed debt cannot exceed 40% of GDP.

market, foreign financing was provided by international donors. Foreign debt increased by nearly 40% from end-2019 to mid-2021 on the back of external loans, including the EU macro-financial assistance (EUR 100 million), World Bank loans (EUR 76 million) and the IMF Rapid Financing Instrument (EUR 52 million).



Fiscal governance made little progress in 2020. While the draft 2021 budget was based on reasonable assumptions, the adoption of the Law on Economic Recovery, which included an additional stimulus package of EUR 200 million and some tax exemptions, made the 2021 budgetary projections obsolete. The 2022-2024 medium term expenditure framework (MTEF) assumes a very large increase in public investment, which appears overly optimistic, given the repeated under-execution of capital spending over the last years. In June, the government approved the mid-year revision of the 2021 budget, projecting higher tax revenue (8% above the MTEF value) due to a rebound in GDP growth. Public spending is also set somewhat higher as the revised budget includes the economic revival package amounting to EUR 420 million, out of which EUR 190 million was part of the original budget and a further EUR 230 are expected to be financed through additional borrowing, including diaspora bonds. Little progress was made in reforming the pension system, in particular the war veteran pension scheme, which needs adjustments in order to bring its costs into line with the legislated cap. In contrast, allowing the withdrawal of 10% of pension savings from KPST under the stimulus measures undermines the credibility of the contributory system and adds a liability to the public sector. First steps have been taken towards improving the financial oversight and fiscal risk assessment of publicly owned enterprises (POEs) by making POE financial data publicly available. However, these reports have been discontinued in the government's most recent financial statements for the final quarter of 2020.

While the overall policy mix of temporary loosening of fiscal and financial policies was appropriate, the implementation of the economic recovery programme in 2020 suffered from delays and not clearly defined allocation criteria. In 2020, some transfers to private firms (EUR 60 million or 1% of GDP) were done universally without analysing whether beneficiaries were hit by the pandemic. As the implementation of the recovery programme continues in 2021, steering recovery-related policies towards growth-enhancing activities is key. While fiscal stimulus is important to support the fragile recovery in 2021, rapidly increasing public debt and the quality of public finance raise concerns. Kosovo's tax base is narrow and is weakened by tax exemptions and preferential tax rates, while public spending is burdened by category-based specific transfers, leaving little space to target poverty and employment policies. The recurrent under-execution of capital investment hinders the enhancement of production base.

Functioning of product markets

Business environment

The gap between newly registered and terminated firms increased in 2020 due to the slowdown in business closures. The total number of new businesses in 2020 was 9 805, which marks a decrease of 2% compared to 2019 (10 004 registered new businesses). The number of closed businesses in 2020 was 1,326, a decline of 25% compared to the same period of the previous year (1 769). The gap was especially large in the second quarter when Kosovo had a lockdown.

Due to pandemic-induced challenges little progress has been achieved in improving the business environment. The general inspection reform aiming to reduce the number of overlapping and parallel inspections from 36 to 15 has stalled in 2020, but the new government is committed to complete the process. Within the Administrative Burden Reduction Programme, aiming to achieve 30% reduction of the administrative burden over the next eight years, Kosovo initiated a baseline measurement identifying all administrative burdens on businesses. The structural reorganisation of the Kosovo Investment and Enterprise Support Agency (KIESA), whose task is to help businesses and investors, remains behind schedule. The lack of a coherent policy for industry development throughout the supply chain undermines the competitiveness of SMEs.

Despite measures aimed at fighting the informal economy, it still accounts for more than 30% of GDP.[20] There was some success in tackling informality and improving voluntary compliance, as the number of registered workers increased in the construction sector due to financial incentives, included in the first emergency package, to join formal employment.

State influence on product markets

Kosovo's state aid policy framework is at an early stage and needs to be aligned with EU rules and principles. Kosovo lacks a coherent approach to state aid as well as a comprehensive strategy and cost-benefit evaluations for aid and subsidies granted. The authorities have established an inventory of aid schemes, as provided in the Stabilisation and Association Agreement (SAA), but their alignment with the existing legislation on state aid is at an early stage. In September 2020, the State Aid Commission (SAC) initiated an assessment of the financial assistance package approved by the government in response to the COVID-19 outbreak. While state aid to public and private companies increased, its allocation is not always well targeted, e.g. the distribution of EUR 60 million to all active private businesses or the suspension of mining royalty for five months in 2021. The SAC currently consists of three members instead of five that might affect its ability to function and carry out decision in a timely manner.

Privatisation and restructuring

Privatisation of socially-owned enterprises[21] (SOEs) is advancing very slowly. Due to frequent government changes and their decisions to suspend and subsequently resume all activities related to privatisation/liquidation proceedings, in 2020 the Kosovo

[20] IMF 2020 Article 4 consultation.

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

Privatisation Agency (PAK) sold only 93 SOE assets in the value of around EUR 8 million, compared to 222 sold assets in 2019, in the value of EUR 32 million. There is a lack of transparency in SOE financial reporting and recruitment. During 2020, 36 of 589 SOEs have been put into liquidation, while only one liquidation proceeding dated from 2014 was concluded. Historically, most POEs have underperformed financially – a situation that was further deteriorated by the COVID-19 crisis. During the reporting period, both the Hoti government and the Kurti government took decisions to dismiss several boards of Publicly Owned Enterprises (POEs) due to poor performance and replace them with temporary boards. Furthermore, in May 2021 the Assembly dismissed the board of PAK: new board members were elected in August 2021. The board's tasks will be centred on auditing the privatisation undertakings of former PAK boards. The government has announced its plan to dissolve the agency and replace it by a sovereign fund, which would be responsible for investments aiming to increase the value of strategic POEs such as mining company Trepca and Post and Telecom of Kosovo, among others.

Functioning of the financial market

Financial stability

Supported by regulatory measures, the financial sector continued to expand in 2020 and the first half of 2021 while maintaining adequate capitalisation and liquidity buffers. The predominantly foreign-owned banking sector accounts for 67.9% of financial system assets, followed by pension funds, insurance and microfinance institutions with 25.3%, 2.8% and 4%, respectively. In response to the crisis, the Central Bank of Kosovo (CBK) allowed for a 3-months loan repayment moratorium in spring 2020 and loan restructurings of up to one year in June-September 2021. In February 2021, the CBK issued a third guide on loan restructuring which remained open until the end of March 2021. The CBK also applied regulatory forbearance on loan loss provisions and capital requirements on reprogrammed loans. These measures helped contain the impact of the crisis on the banking sector and supported credit growth in 2020, but there might be lagged effects on asset quality once the measures expire. While declining from 18.9% in 2019, banking sector's return on average equity (RAE) remained high at 14% in 2020, and increased to 20% in mid-2021. Profitability increased in the insurance sector, while it dropped sharply for micro-financial institutions, mainly due to the impact of the pandemic. The ratio of bank non-performing loans (NPLs) registered only a small increase to 2.6% in mid-2021 from 2% in 2019, as the deteriorating economic situation was mitigated by the CBK measures on reclassification of loans, but the NPLs might rise as the regulatory flexibility is gradually phased out. The ratio of banks' regulatory capital to risk-weighted assets stood at some 17% in mid-2021, comfortably exceeding the regulatory minimum of 12%. Banks continued to be financed by deposits, predominantly from households. The loan-to-deposit ratio declined to 74.5% in 2020 from 77.6% a year earlier, as deposit growth (11.5%) outpaced the expansion of loans (7.1%). High deposit growth was supported by the one-off stimulus measure of allowing the 10% withdrawal of pension savings from the KPST, a stable inflow of remittances and precautionary savings. Credit growth accelerated in 2021 and by mid-year the loan-to-deposit ratio increased to 77%.

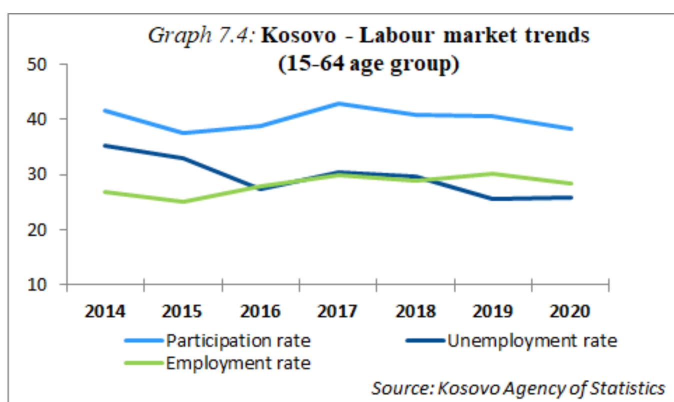
Access to finance

Financial intermediation has continued expanding from a low base. Despite the pandemic, bank lending increased by 7.1% in 2020, while in April-June 2021 it accelerated to over 10% year-on-year. Loan growth was facilitated by low interest rates, a continued increase of deposits, improved contract enforcement, and increased guarantees extended by the Kosovo Credit Guarantee Fund (KCGF) for lending to micro, small and medium-size enterprises to cushion the impact of the crisis. Lending to both firms and households continued to grow, by 7.2% and 7.1%, respectively. The average interest rate spread increased slightly to 4.7 pps. in June 2021 from 4.4 pps. in late 2019, suggesting more cautious bank behaviour. The amount of credit compared to the size of the economy remained moderate even by Western Balkan standards, at around 40%. The lack of easily accessible and affordable credit serves as a barrier to the growth of SMEs. 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 Kosovo's capital market remains at an early stage of development. The main activities remain in the government securities market, auctioned and recorded by the CBK. A first-ever 'diaspora bond' issuance was made during the summer of 2021 through commercial banks in collaboration with the ministry of finance. Targeting the Kosovo diaspora abroad, this issuance managed to raise EUR 10 million of the EUR 20 million initially offered.

Functioning of the labour market

The economic downturn resulted in a fall in employment and a shrinking labour force. The labour market situation, which had been a concern already before the outbreak of COVID-19, deteriorated further in 2020. While the unemployment rate (15-64) rose only slightly to 25.9% in 2020 from 25.7% in 2019, employment and labour force participation rates declined to 28.4% and 38.3% from 30.1% and 40.5% respectively over the same period. The wide gap between male and female employment rates (42.8% and 14.1% respectively) narrowed slightly due to a fall in male employment (down from 46.2% in 2019). While the impact of the pandemic was more pronounced in the manufacturing and trade sectors, employment in the construction sector held up rather well despite contraction in output, due to the financial incentives, included in the emergency package, to join formal employment. Very high rates of inactivity (61.7%), in particular for women (79.2%), and an alarming rate of youth unemployment (49.1% for the age group 15-24) persisted, implying structural problems such as undeclared work and misalignment between education outcomes and labour market needs. The share of young people not in employment, education or training aged 15-24, increased

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



Source: Kosovo Agency of Statistics

somewhat to 33.6% in 2020. Active labour market policies, pre-qualification schemes and vocational training programmes remain inadequate to labour market needs. Kosovo endorsed the Western Balkans Declaration on ensuring sustainable labour market integration of young people in the summer of 2021, and committed to gradually establish and implement the Youth Guarantee scheme.

Even before the pandemic, an inadequate system of social assistance was creating disincentives to join formal employment. Unemployed people do not have social insurance rights, while the social assistance scheme has a limited coverage due to restrictive eligibility criteria. Moreover, category-based social transfers, e.g. war veteran pension scheme, undermines the soundness and fairness of the social benefit system and motivates other specific groups to request similarly generous allowances. In 2020, the spending on transfers and subsidies exceeded 12% of GDP while within this amount payments on social assistance was less than 1%. Relatively high public wages and remittances increase the reservation wage and hamper private-sector employment. The lack of childcare and elderly care facilities hinders female employment.

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

Kosovo has made **limited progress** and is at an **early stage** in terms of capacity to cope with competitive pressure and market forces in the EU. Little progress was made on improving the quality of education and addressing skill gaps in the labour market. Kosovo made some progress in improving road infrastructure and increasing investment in renewables, but the coal-based, outdated and unreliable energy supply remains a concern. Kosovo made some progress as regards the digitalisation of the economy. Structural changes are emerging only slowly as the economy remains highly reliant on small and very small firms which cannot compete internationally, while the export structure remains dominated by a few products, such as base metals. The recommendations from 2020 were not fully implemented and remain valid.

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

→ improve the quality of vocational training and education at all levels and align the curricula with labour market needs;

→ increase energy efficiency incentives in the residential and private sectors;

→ 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 in reforming the education system. Public spending on education stood unchanged at 4.7% of GDP in 2020, which is comparable to the EU-27 average, but given Kosovo’s young population, the spending per student is insufficient, focusing mainly on remuneration of teachers. Moreover, schools lack educational material, while the selection of teachers suffers from political influence.

The new Law on Textbooks and Educational Material, aiming to improve the quality of learning material, is still in the process of preparation. The enrolment of children in primary, lower and upper secondary education is universal, but a participation of children in early school education and care (3-5 years) is still quite low. Despite some progress achieved with the participation rate increasing to 38.1% in 2020 from 30.9% in 2016, it is still far below the EU average of over 80%. A persistent problem remains due to the urban-rural divide, extreme poverty and a lack of educational facilities. Following the expulsion from the European Association for Quality Assurance in Higher Education, Kosovo Accreditation Agency (KAA) continued efforts to regain membership. A new KAA board was appointed in June 2021, following a competitive process. The draft law on KAA has not been approved due to political situation in 2020, which has a negative impact on the independence of the agency.

Little progress has been achieved in improving Kosovo's research, development and innovation system. Public research spending remained very low at 0.1% of GDP, and there is a lack of strategic approach on promoting research activities. In November 2020, Kosovo joined the GÉANT research network, which is Europe's leading collaboration on network and e-infrastructure services.

Physical capital and quality of infrastructure

Kosovo is making significant investments in road and railway infrastructure. The preparatory work on route 7 has been completed, and two segments of the "Peace Highway" part of route 7 received financing from the EU, EIB, WBIF and EBRD, as part of the EU Connectivity Agenda. The Railway Route 10 rehabilitation works, aimed at linking Kosovo with the wider European railway network continued at a slow pace, and are expected to be completed between late 2021 and 2023, with the signalling and telecom project beginning late 2021 until 2025. While Kosovo achieved a significant decline in road fatalities (53.7%) in 2010-2020, the transport system still faces a number of challenges in terms of road safety, inadequate road maintenance, and weak administrative capacity of regulatory institutions.

Despite some progress on renewables, the unreliable and health-hazardous energy supply, which mainly relies on coal, remains a concern. The bulk of power supply (880 MW) is produced by two highly polluting lignite power plants which the new government plans to upgrade. The new government does not intend to proceed with the construction of Kosova e Re. In 2020 Kosovo has achieved its target share of energy from renewable sources, which rose to 25.7% in gross final energy consumption. By the end of 2020, Kosovo registered a total of 139 MW of renewable energy capacity, out of which 95 MW of hydropower, 34 MW of wind and 10 MW of solar. Compared to 2019, the increase came entirely due to an additional 19 MW of hydropower, which in some cases implied environmental costs.

Further options are explored in order to diversify energy supply. The development of natural gas infrastructure is still to be determined in the upcoming Kosovo's Energy Strategy, currently still being drafted along with the National Energy and Climate Plan (NECP). Preparatory work is continuing for the connection and expansion of the Trans-Adriatic gas pipeline. Assessment of the interconnection between Kosovo and Albania has been already completed, while a pre-feasibility study for the Kosovo-North

Macedonia pipeline is still ongoing. Both projects have the potential to assist in the diversification of energy sources away from coal, as well as in energy-grid stability. Kosovo achieved an important objective with the entry into force of the new Connection Agreement between the Kosovo transmission system operator (KOSTT) and the European Network of Transmission Systems Operators for electricity (ENTSO-E), which allowed for the operationalisation of the interconnection line between Kosovo and Albania, and the formation of the Control Area within Albania-Kosovo Control Bloc (Control Block AK). Following the appointment of the boards of directors, the Energy Efficiency (EE) fund became operational. Some progress was made in extending EE support schemes in private and public buildings, but most of EE investment is done by international donors. The distribution network still suffers from high losses.

The digitalisation of the economy is progressing. After achieving the mid-term targets of its 2013-2020 digital agenda, with the penetration of fixed broadband internet exceeding 90% and the number of mobile phone users standing at 115.7% of the population, Kosovo is preparing a new strategy for 2021-2030. Since 2018, the implemention of a 5-year project, aiming to bridge the urban-rural digital infrastructure divide, and investing in the remote areas which are not attractive for private investors, is continuing.

Sectoral and enterprise structure

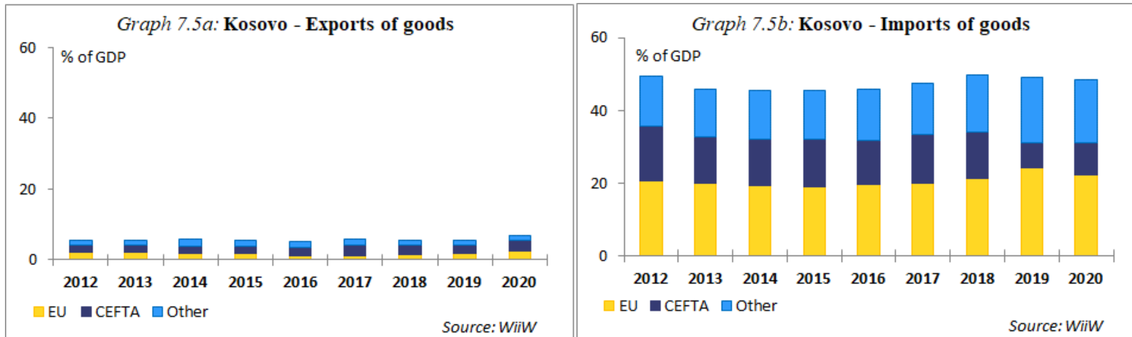
The hospitality and construction sectors were the hardest hit by the pandemic. Based on quarterly data, annual output in the hospitality and construction is estimated to have contracted by more than 20% in 2020, while manufacturing held up well (around 10% increase). More general medium-term problems, such as informal economy, lack of access to finance, insufficient implementation of standards in products, labour skills mismatch, lack of access to information and export opportunities, persisted.

Kosovo's private sector is dominated by small firms with difficult access to affordable finance. Due to delay in legislative approval, the increase of additional guarantees for SME loans via the KCGF has become operational only in January 2021. Guarantee windows, totalling EUR 40 million, focus on lending support to the manufacturing, agribusiness, services, trade sectors, with a particular focus on women in business and start-ups. The KCGF signed the guarantee agreements with its partner financial institutions for the guarantee windows within Economic Recovery Package, which envisage increasing the coverage with a credit guarantee of up to 80% of the loan value and ensures a more transparent process considering that its implementation relies on market mechanisms, i.e. the commercial banks' assessments on which businesses to support. Kosovo lacks an export risk insurance and finance institution to help promote exports and support market access.

Economic integration with the EU and price competitiveness

The balance of goods trade has slightly improved. Robust performance of base metals supported export growth while imports of goods declined in line with contracting economic activity. The merchandise deficit narrowed to 38.8% of GDP from 40.2% in 2020, but Kosovo's export structure remains dominated by base metals, which account

for about 36.9% of goods exports. In 2020, the EU accounted for more than 45% of the total imports of goods. CEFTA's share increased to 18.7%, as Kosovo abandoned the 100% import tariffs on goods originating from Serbia and Bosnia and Herzegovina. The share of goods exports to the EU and CEFTA rose slightly to 34.4% and 44.4%, respectively.



The EU remains the main investor in Kosovo. Net FDI inflows are estimated to have increased by 34% in 2020, on the back of lower profit repatriation in the financial sector and a drop in outward FDI. The shares of Germany and Switzerland (two countries with large diasporas from Kosovo) increased from the previous year to over 13% of net FDI stock each, while the overall share of the EU stood at 36%.

Due to severe contraction of service exports, trade openness dropped significantly in 2020. Although Kosovo preserved trade-friendly regulations, overall trade openness fell by 10 percentage points in 2020 to 75.6% of GDP. This is mainly due to the severe export contraction, driven by tourism services to the diaspora, which fell to 21.6% of GDP from 29% in 2019. The imports-to-GDP ratio declined less dramatically from 56% to 54% of GDP over the same period.

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