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Progress towards Meeting the Economic Criteria for EU Accession

The EU Commission's 2022 Assessments

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EUROPEAN ECONOMY

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European Commission
Directorate-General for Economic and Financial Affairs

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EUROPEAN ECONOMY

Institutional Paper 186

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

CONTENTS

INTRODUCTION

In this Institutional Paper the Directorate General for Economic and Financial Affairs brings together into a single document the economic chapters of the European Commission's country reports for the seven enlargement countries Albania, Bosnia and Herzegovina, North Macedonia, Kosovo[*], Montenegro, Serbia and Türkiye. 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 12 October 2022 as part of its 2022 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 2022 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 2022 Enlargement package (europa.eu).

The economic sub-criteria

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

− high quality of economic governance

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

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

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

− proper functioning of the labour market;

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

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

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

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

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

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

1. ALBANIA

1.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Albania has made **good progress** and is **moderately prepared** for developing a functioning market economy. Supported by a broadly appropriate policy mix, the Albanian economy showed resilience and rebounded faster than expected in 2021, making up for most economic losses caused by the COVID-19 pandemic. Russia's war against Ukraine has hit the Albanian economy indirectly through higher commodity prices and lower growth in its main EU trading partners, but did not translate into a negative impact on growth in the first quarter of 2022. However, risks are clearly on the downside ahead. The budget deficit and the public debt ratio increased less than projected in 2021, but fiscal space remains limited, heightening the country's vulnerability to external shocks. There was good progress on revenue-related reforms, but weaknesses persist on investment expenditure planning and execution. The regular use of normative acts for frequent revisions to the budget and the budget law weakens fiscal credibility. Inflation has increased to above the target, which prompted the central bank to raise the policy rate in several steps. The business environment benefitted from a higher level of digitalisation of the public services. This also contributes to the formalisation of the economy, along with the rising financial inclusion and successful activities to reduce underreported labour, although a large part of the economy remained informal. Consultations of the public by the government did not improve significantly. As some of last year's recommendations to improve the functioning of the market economy were not fully implemented, in the coming year Albania should in particular:

→ provided the economic recovery is well entrenched, foresee in the medium-term fiscal plan a gradual reduction of the public debt ratio and arrears, using the regular legislative process when amending the budget,

→ implement the reform of public investment management procedures;

→ begin implementing the medium-term revenue strategy after broad public consultation and based on an operational plan.

Economic governance

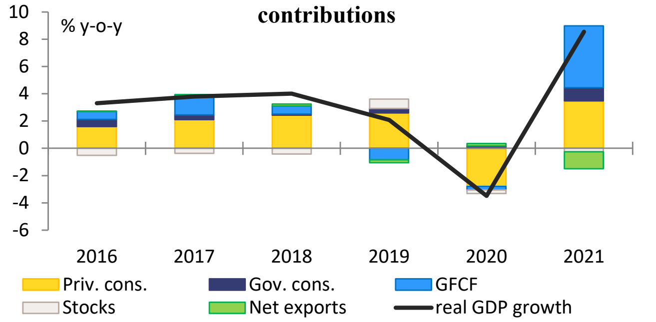
Albania remained committed to stability-oriented policies but some weaknesses in economic governance persist. Following the sharp increase in Albania's public debt and deficit in 2020, due to the COVID-19 pandemic, the IMF and the EU provided financial support to cover financing needs. EU support included EUR 180 million macro-financial assistance, which were fully disbursed in 2021 following Albania's fulfilment of the policy conditions attached to the assistance, including public finance, good governance and social policy. The government used normative acts instead of the regular legislative procedure (i) to amend the 2021 and 2022 budgets multiple times, (ii) to suspend the fiscal rule requiring a decreasing debt ratio and (iii) to postpone the new primary balance rule to 2024. This practice, which is contrary to jointly adopted policy guidance, which Albania partially implemented. Post-earthquake reconstruction progressed.

Albania submitted its Economic Reform Programme 2022-2024 to the European Commission at the end of January 2022, in which it confirmed its commitment to return to its pre COVID-19 fiscal consolidation path as soon as the economic recovery allows, and underlined its plan to achieve a positive primary balance in 2024. In March and September 2022 Albania revised its budget to accommodate the high cost of energy subsidies and the social support extended in relation to the price hikes in the wake of the impact of the Russian aggression against Ukraine.

Macroeconomic stability

Albania's economy showed resilience during the COVID-19 pandemic. Previously, Albania's real GDP growth averaged 2.7% (2013-18). Following a smaller-than-projected contraction of 3.5% in 2020, a stronger-than-expected economic recovery pushed real growth of GDP to 8.3% in 2021. Most expenditure categories exceeded their 2019 levels, driven by both public and private investment, private consumption, and external demand. The continuing post-earthquake reconstruction and a stable and liquid financial sector supported exceptionally strong investment growth (negative since 2019). Increasing employment in the second half of 2021 helped the labour market to recover almost all the ground lost during the COVID-19 pandemic. This, coupled with increasing wages, fuelled private consumption. Goods exports, mainly electricity and construction material, exceeded 2019 levels, while exports of services remained slightly below their pre-pandemic level, despite growing tourism from neighbouring countries. Growth in investment and consumption drove a rise in goods imports, leading to a negative real growth contribution of net exports in 2021.

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

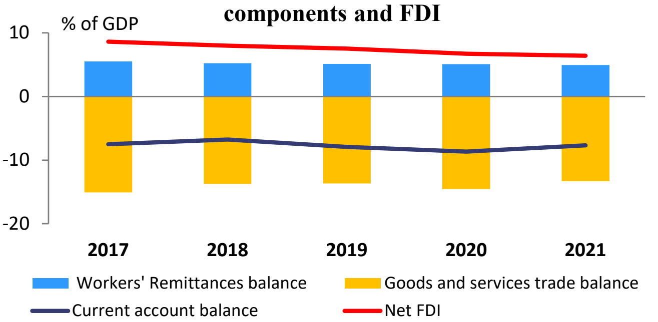


Source: WiiW, INSTAT, own calculations

Russia's war against Ukraine is indirectly hitting Albania's economy. The economic importance of rainfall-dependent hydroelectric production remains a key contributor to the volatility to GDP growth. A real growth rate of 6% in the first quarter of 2022 showed the continuing recovery of the Albanian economy, supported by private consumption, exports and investment. Business and consumer confidence remained upbeat in April and May, despite even more strongly increasing transport and food prices. The price hikes have prompted the government to provide about 2% of GDP in support for pensioners, vulnerable households, farmers and transport companies in addition to the general support to keep regulated electricity prices stable. Eurostat data shows that convergence to EU income levels has been slow, with per-capita GDP (at purchasing power parity) remaining at 30% of the EU average until 2020 and increasing to 32% in 2021.

A smaller trade deficit, coupled with high GDP growth and rebounding remittances, helped to narrow the current account deficit in 2021. In 2016-2020, rising service exports and remittances helped the current-account deficit to narrow from an average 10.9% of GDP in the five-year period 2010-2014 to an average of 7.7% in the 2015-2019 period. Following the widening of the current account deficit in 2020 to 8.7% of GDP, due to the drop in the export of services (i.e., tourism) and private transfers from Albanians abroad, the rebound in exports and remittances, in combination with the high GDP denominator, reduced the current account deficit by 1 ppt. to 7.7% of GDP in 2021. In the first quarter of 2022, the same elements continued to support the further decrease of the 4-quarter moving average current account deficit to about 7% of GDP.

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



Source: IMF and Central Bank of Albania

Table 1.1: **Albania - Key economic figures**	**2013-18** average	**2019**	**2020**	**2021**
GDP per capita (% of EU-27 in PPS)[1)]	30	30	30	32
Real GDP growth	2.7	2.1	-3.5	8.5
Economic activity rate of the population aged 15-64 (%), total	64.4	69.6	69.1	69.3
female	*55.4*	*61.7*	*61.2*	*61.4*
male	*73.8*	*77.6*	*77.1*	*77.3*
Unemployment rate of the population aged 15-64 (%), total	15.7	12.0	12.2	12.1
female	*14.4*	*11.8*	*12.4*	*12.4*
male	*16.7*	*12.1*	*12.1*	*11.8*
Employment of the population aged 15-64 (annual growth %)	3.0	2.4	-1.9	-0.4
Nominal wages (annual growth %)[2)]	2.6*	3.8	2.7	6.3
Consumer price index (annual growth %)	1.8	1.4	1.6	2.0
Exchange rate against EUR	136.5	123.0	123.7	122.5
Current account balance (% of GDP)	-8.4	-7.9	-8.7	-7.7
Net foreign direct investment, FDI (% of GDP)	8.5	7.5	6.7	6.4
General government balance (% of GDP)	-3.3	-1.9	-6.7	-4.5
General government debt (% of GDP)	69.8	65.8	74.5	73.2

Notes:
1) Eurostat
2) average gross monthly wages, average of 2015-2018
Source: national sources

FDI remained below pre-crisis levels and debt-creating capital flows continued to contribute to financing the current account deficit. Foreign direct investment (FDI) inflows, which already started to decrease from their peak levels above 8% of GDP in 2015-2019, due to the completion of a few large energy projects, fell to 6.4% of GDP in 2021, but it started to recover in the second half of 2021, and rose by 24% year-on-year in the first quarter of 2022. In the five years until 2020, FDI fully financed the current account deficit, but since 2020 debt-creating inflows contributed to around 15% of its financing. These flows included two EUR 650 million sovereign Eurobonds issued in 2020 and 2021, the latter lasting 10 years[2], the longest maturity bond issued so far. External debt, mostly consisting of long-term government debt, climbed from 60% end-2019 to 64.3% of GDP in 2020, then fell to 63.1% in 2021 (due to the high GDP). Foreign exchange reserves rose from EUR 3.9 billion in 2020 to EUR 4.9 billion in 2021 and continued to increase in 2022, supported by interventions of the Bank of Albania. Their import coverage increased from an average equivalent of about 7 months in 2015-2019 to almost 9 months of imports in 2021 and continued to provide an adequate safeguard against external shocks in the first quarter of 2022. In 2021 the Albanian lek's exchange rate to the euro returned to its pre-2020 trend of continuous appreciation, albeit at a very moderate pace. Except for a short period of volatility in March 2022 the moderate appreciation to the euro continued in 2022, whereas the Lek depreciated to the USD by 10.8% year-on-year in June 2022.

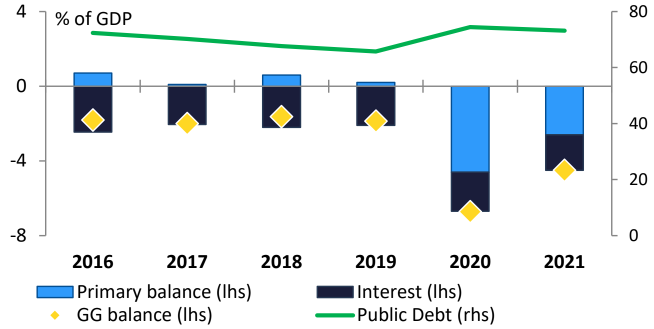
Annual inflation has accelerated sharply since end-2021 and led the central bank to start raising its policy rate. The monetary and exchange rate policy framework has not changed. The Bank of Albania (BoA), which operates under an inflation-targeting regime (with a target of 3%) coupled with a floating exchange rate, supported the economy with its record low policy rate of 0.5% (set in March 2020) during the pandemic-induced slowdown and the large gap to the inflation target. Annual inflation averaged 1.8% over the last five years, edging slightly higher to 2% in 2021, but still below the BoA's target. Prices rises for food and transport pushed the inflation rate towards the central bank's target at the end of 2021 and accelerated strongly in the first half of 2022, in particular as of March, pushing the overall inflation rate to

[2] With an initial yield of 3.75%, just 0.1 pp. higher than for the 7-year maturity Eurobond issued in June 2020.

a historic high of 7.5% in July, more than double the target. In response to the persisting price pressures, the central bank began a gradual policy normalisation in March 2022 and raised the policy rate in several steps to 1.75% in August 2022.

High GDP and revenue growth helped to lower fiscal deficit and public debt ratios in 2021. The fiscal deficit remained below 2% of GDP in 2015-19, supported by increasing revenue and decreasing interest expenditure, but increased sharply in 2020 to 6.8% of GDP, due to the impact of the pandemic. The strong economic rebound fostered higher-than-expected revenue growth (19.3% y-o-y) in 2021, which, along with high GDP growth, and lower-than-planned public investment spending, helped to reduce the public deficit to 4.5% of GDP, 2 pps. lower than expected. The high GDP denominator also led to a decrease of the public debt ratio from its peak of 74.5% in 2020 to 73.1% in 2021, compared to its pre-crisis level of 65.8% in 2019. Revenue growth remained strong in the first half of 2022, while expenditure lagged slightly behind plan resulting in a fiscal surplus in June 2022.

Graph 1.3: **Albania - Fiscal developments**



Source: National sources

Revenue reforms have progressed, but weaknesses in public investment management persist. Revenue administration reforms in 2021 erased the high VAT refund arrears, sped up the VAT refund process, and increased collection efficiency. Public consultations on the long foreseen medium-term revenue strategy (MTRS) began at the end of 2021 but were suspended by the government in March 2022, reportedly because of the impact of the Russian invasion of Ukraine. The MTRS aims to increase revenue and collection effectiveness, reduce exemptions, and make tax policy more reliable and balanced in its distributional effects. It should also contribute to reducing informality and the use of cash and overall will be a crucial tool for a sustainable, growth-friendly increase in revenue needed to finance the large spending needs on health social protection, education and research. Although investment spending has increased strongly since 2017, it lagged behind the frequently revised plans, and remained very much backloaded, with a third of total capital expenditure in 2021 executed in December alone. This signals a continuing weakness in public investment management, which, in combination with the related contract arrears and the frequent budget revisions by normative act, weakens the credibility of the budget.

The macroeconomic policy mix supported the strong recovery. The original fiscal plans for 2021, and the decision to advance the Eurobond placement to pre-finance the 2022 deficit, were prudent. Good revenue performance and the decrease of the still high debt ratio have slightly improved the limited fiscal space to deal with the initial economic fallout of Russia's invasion of Ukraine, but tightening financing conditions may restrict the budgetary room for a more active fiscal policy. The BoA's continuation of a very loose monetary policy stance until March 2022 was appropriate in view of the persistently below-target inflation rate and supported the economic recovery. Its provision of liquidity and its temporary money market intervention supported financial and external stability. The policy response to the in 2022 has so far proven effective in limiting the increase in the inflation rate compared to regional peers. However, this is also due to the costly general electricity, support for the energy sector which has constituted a volatile and non-transparent fiscal liability already before the recent energy price increase because of the rainfall-dependency of Albania's hydro-electricity production and low energy efficiency.

Functioning of product markets

Business environment

A higher level of digitalisation supports the formalisation of the Albanian economy. Pushed by the COVID-19 pandemic, e-learning, digital training services and e-commerce are rising among businesses. More online public and financial services are being made available as the government aims to offer 95% of public services online (though the rapid shift has raised questions on delivery and accesibilty). This goes hand in hand with efforts of the Bank of Albania and commercial banks to increase the digitalisation of payment services, which already strongly increased the use of payment cards.Efforts to digitalise the Albanian cadastre within the next two years are ongoing, however so far delays and discrepancies regarding the information on property deeds persist. In line with the recommendations of FATF/ICRG, Albania has established a "Beneficial Ownership Registry", in which all owners of existing commercial or non-profit entities have to be registered by 30 June 2022. The registry adds to transparency of economic actors and implements a key requirement of the EU anti-money-laundering directive. Nevertheless, the informal economy remains large – is the IMF estimated that it accounted for about one third of GDP[3] in 2019, and it is most widespread in trade, tourism, manufacturing and construction.

Progress on improving legal certainty for businesses has been mixed, while concerns about the effective consultation and implementation of legislation and strategies persist. The adoption of the new "Unified Law on Investment", originally planned to be adopted in 2020, has been further postponed, delaying the expected improvement of legal security of investors. In mid-2021 Albania adopted a new "Business Investment Development Strategy" (BIDS) 2021-2027. This provides the basis for the government's support to SMEs and investment and foresees progress in deregulation by eliminating licenses. Businesses increasingly report challenges in finding skilled staff, and a low level of know-how and digital skills, which has led to strong salary increases in some sectors. The introduction of an online consultation platform as the government's main channel to consult the public on draft legislation and strategies has actually reduced effective consultation when the public does not use it, which was the case for the Economic Reform Programme 2022-2024.

State influence on product markets

High food and energy prices triggered increased government support and intervention in the price-setting mechanism of the private sector. In the last quarter of 2021 food and energy prices were already rising in response to high demand, strong growth and supply chain problems, but the prices jumped even higher following Russia's invasion of Ukraine. Albania adopted a financial support package ("social resiliance package") in March 2022 and extended it in July 2022 of estimated 2% of GDP for targeted cash assistance and for the long-established but increasingly costly subsidisation of the electricity prices[4]. In the face of popular protests against steep fuel and food price increases, the government established two temporary boards ("Transparency Boards") with representatives of the government and the private sector in March 2022, which are empowered to set ceilings for wholesale and retail prices of selected petrol-based and food commodities. These are updated regularly to reflect international price changes while keeping the profit margin stable.

The state's presence in the economy is limited and Albania's reported state aid fell below 0.5% of GDP. According to recently established sector accounts, the public sector's share of gross value added of the economy was about 10.5% in 2018. The share of public sector employment[5] decreased from 16.3% of total employment in 2014 to 14.3% in 2017 before picking up to 15.3% in December 2021. Following an increase in tate aid in 2020 to about EUR 248.5 million, or 1.96% of GDP, almost triple the level in 2019

[3] 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.

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

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

(5% of GDP), it then reportedly dropped to 0.25% of GDP in 2021. The share of horizontal aid in particular dropped in 2021 to about 50% of its level in 2019. However, the State Aid Office still lacks insititutional independence and the comprehensiveness of the data reported remains therefore unclear.

Privatisation and restructuring

Efforts to define and monitor public sector corporations and their fiscal risks are ongoing. Using ESA2010 methodology, in 2020 the Institute of Statistics distinguishes between 167 extra-budgetary units of the central (including some enterprises) and local government (water utilities and football clubs) and 26 non-financial public corporations and 2 public financial corporations, not including the Albanian Investment Corporation (AIC) which is owned and funded by the state to manage state assets and mobilise private capital for the development of investment projects of public interest. The last budget amendment of 2021 allocated a capital transfer of ALL (Albanian lek) 2 billion (about EUR 16 million) to the AIC, but the 2022 budget foresees a return of these funds to the budget. Established end 2019, the AIC became operational in July 2021 and has begun to review state assets, formalise partnerships with governmental institutions and to prepare a project pipeline.

Albania reports that it has initiated a valuation of the state's shares in 21 corporations, with less than 50% state capital in 2022, in order to evaluate the State's voting power in these corporations. It has reportedly merged 6 state-owned companies in 2021, and prepared the privatisation, restructuring and liquidation of several other state-owned companies for 2022. The Ministry of Finance and Economy (MOFE) continued its regular monitoring of public-private partnerships (PPPs), for which the direct budgetary liabilities remained stable[6] below 3% of revenue, and expanded its fiscal risk assessment to state owned enterprises (SOEs) in the water and energy sectors.

Functioning of the financial market

Financial stability

The financial sector remained stable and asset quality improved in 2021, though risks persisted from the high use of the euro in the domestic economy. In 2021 the BoA ended the temporary measures it had introduced in view of the impact of the COVID-19 pandemic without a negative impact on key indicators. The ratio of non-performing loans to total loans continued to decline from 8.4% in 2019 to a historic low of 5.3% by the end of the second quarter of 2022. Banking sector profitability improved during 2021, but fell sharply in the first quarter of 2022 (with return on equity decreasing to 7.4% in March 2022 from an average of 12.2% in 2021, and return on assets falling from average 1.3% to 0.8% in the same period), but overall the banking sector remained stable, sufficiently capitalised and liquid. The banking sector's capital adequacy remained well above the regulatory requirement at average 18.1% in 2021 and 17.9% in March 2022, and the liquidity ratio[7] fell from average 33.6% in 2021 to 28.0% in March 2022. However, the banks' relatively large exposure to government securities (about 2% of bank assets) and the ongoing high use of euro in the domestic economy[8] continue to pose risks, although the share of loans not hedged against security risks decreased compared with 2020. The small but growing non-bank financial sector expanded to 38 institutions[9] but its share of GDP was unchanged at 12%. This includes the insurance market, which is estimated at about 2.3% of GDP, dominated by non-life insurance.

[6] According to the budget law, budgetary expenses related to PPPs are to be limited to below 5% of previous year's revenue. However, this does not include PPP related liabilities, which are below the line, e.g. linked to powere purchasing agreements and the like.

[7] Liquid assets as share of total assets.

[8] Foreign currency loans accounted for 51% of the loan portfolio end-2021, while the share of unhedged loans decreased by 4.9 pps.

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

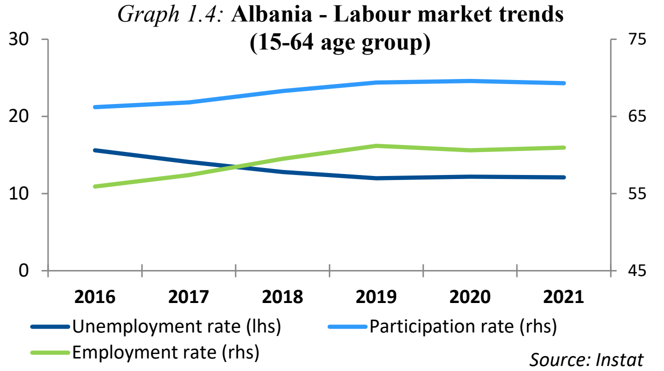
Access to finance

Favourable financing conditions and the modernisation of payment systems improved access to finance. Total credit growth averaged 6.9% in 2021, up from 6% in 2020, and it accelerated further to 11.9% (y-o-y) in the first quarter of 2022. Lending to the private sector[10] also accelerated, to 13.8% year-on-year in June 2022, increasing the private credit-to-GDP ratio from average 37.8% in 2020 to 38.5% in March 2022. The implementation of the "National Retail Payment Strategy[11]" progressed well and led to an increase in financial inclusion (around 69% of adults had a bank account in 2021, up from 40% in 2017) and in electronic payments (up by 29.5% in 2021). The creation of a depository of biometric data of the population supports the security of the rapidly-increasing online banking sector. In addition, the BoA initiated an enhanced regulation of consumer loans and consumer protection from unjustified or intransparent interest rates, based on EU best practice. The operation of a new domestic settlement platform for interbank euro payments since January 2022, is also part of the strategy, and is expected to reduce costs for payment sevices. Following a positive assessement of its supervisory framework in 2021, BoA requested the formal equivalence process with the EU framework, which would further reduce costs and support the competitiveness of the Albanian banking sector.

Functioning of the labour market

Following a slight increase of unemployment and inactivity in 2020, rebounding growth supported the recovery of the labour market in 2021. Solid employment growth averaging 3.7% in the 2015-2019 period helped lower the unemployment rate (age group 15-64) from 17.5% to a record-low of 11.7% by Q1 2022. Following a deterioration of all labour market indicatorsin 2020, the reboundig economy 2021 improved the situation on the labour market: the unemployment rate returned to 12.05%, the inactive population decreased by 1.5 pps. and labour-force participation increased to 69.3% but remained slightly below the average 2019 level of 69.6%. The gap between male and female labour force participation remained large and unchanged at 15.9 pps. since 2019. However, in 2020 and 2021 there were some structural changes in the labour market. The unemployment rate of tertiary educated persons dropped strongly, while it increased for workers with primary education and also for young people (15-24). Emigration dropped by almost 50% in 2020 compared with 2019 due to international COVID-19-related mobility restrictions, but jumped back in 2021, in particular the number of young people (20-29) dropped more than double as much as in 2020. Coupled with a falling birth rate this led to a high population decrease of 1.3% in 2021. However, due to the rising participation rate, the decrease in the labour force (- 0.5%) was more moderate, roughly at the same level as in 2020 and 2019.

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



Source: Instat

Nominal wage growth accelerated to 6.6% in 2021 from 2.4% in 2020, partly reflecting a reduction in under reported wages. Shortages of skilled labour and increases of public setor wages, mainly in health and education, pushed the average nominal monthly wage to EUR 465 in 2021. A leak of salary data of about 630 000 citizens in 2021 enabled a recently established special anti-informality unit of the government to target the widespread practice of under reporting salaries on individual business level, a and the tax authorities repeated their call on businesses and self-employed to correct their respective

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

[11] The implementation of the strategy achieved key legislation for transposing the EU Payment Services Directive 2, including low cost basic current accounts and licensing and supervision of payment services providers by the BoA as of January 2022.

revenue declarations. These measures significantly reduced the number of employees receiving the minimum wage (about EUR 243) and contributed to the statistical wage increase.

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** to cope with competitive pressure and market forces within the EU. Energy and transport infrastructure, the digitalisation of the economy and 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 persistently low spending on R&D. Efforts to improve vocational training and to address the skills mismatch continued and institutional preparations for the Youth Guarantee Plan progressed. 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 some of the Commission's 2021 recommendations to improve competitiveness and to sustain long-term growth were not fully implemented, in the coming year Albania should in particular:

→ Finalise the Youth Guarantee Implementation Plan and begin its implementation;

→ Improve business support services as well as consultation mechanisms with businesses and social partners and with their cooperation develop a strategic action plan for implementing anti-informality policies;

→ Continue to increase the shares of spending in total public expenditure on education and R&D, as well as on health and social protection to fund the agreed improvement of social services and the higher reimbursement of medical costs for vulnerable groups.

Education and innovation

Efforts to improve the labour market relevance of education and vocational training progressed but skill mismatches and high unemployment of young people persist. The share of young people in tertiary education among the 20-24 age group gradually increased, from 12.3% in 2016 to 14.9% in 2021, but the shares of young people in vocational training or upper secondary education hardly changed. In contrast to 2020, the unemployment rate of tertiary educated persons fell below the total rate (15-64 age group) and that of low educated increased. Simultaneously, businesses reported increasing shortages of skilled labour, while the still high unemployment rate of secondary educated jobseekers indicates that skill mismatches and quality issues of vocational training persist, and the ongoing reforms of the vocational education and training (VET) system have still to show results. In 2021, Albania updated the professional and qualification standards and the respective curricula for three of the eight[12] of its National Catalogue of the professional qualifications, in cooperation with vocational training facilities and business representatives, to better reflect market needs and to encourage a diversified offer of qualifications. Albania also progressed in aligning the Albanian qualification framework with the European qualification framework (EQF) [13] and receive the approval[14] of the EQF Advisory Board for its framework. Preparations for drafting and coordinating the implementation plan of a Youth Guarantee Scheme in Albania have started.

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[12] So far levels 2-4 (of 8 levels) were revised, they describe skills comparable to lower secondary (2), upper secondary and vocational diploma (3 and 4).

[13] The EQF helps to understand and compare the skill levels of national qualifications across countries, and promotes lifelong learning. Since 2012 all new qualifications carry a EQF reference in the EU.

[14] This means that certificates and diplomas awarded according to the Albanian framework can include the reference to the corresponding EQF level.

Statistics on research and innovation remain below standard and funding of education and research below needs. Data availability related to the research and innovation capacity of Albania is very limited, and therefore, unlike its regional peers, the country is not included in the European Innovation Scoreboard. In addition, Albania does not report reliable comprehensive data of public expenditure on research and development, because of institutional weaknesses in reporting. However, the allocated budgetary funds of the main ministries remain negligible and below 1% of GDP as do the planned budget allocations. Although Albania was ranked one place higher in 2021, the Global Innovation Index (GII) still assigned it the lowest rank among 39 European countries. This is mainly the result of low scores in the areas of "human capital and research" and in "knowledge and technology outputs" (below the average of the upper middle-income group) in combination with low secondary schooling expenditure and university ranking. Albania continued to participate in the Horizon 2021 programme, however it had the second lowest number of projects and funding in the region (after Montenegro) and was ranked 15th of 214 countries. In 2021, Albania became a member of the EUREKA network and under the "EU for Innovation" project Tirana universities established "Tirana Inc." to support entrepreneurship and innovation among students, while a governmental working group is about to draft a follow-up national strategy on scientific research.

Physical capital and quality of infrastructure

Following several years of decline, investment recovered in 2021, benefitting mainly real estate and ICT. Private investment fell from 19.1% of GDP in 2015 to 16.8% in 2019, and 15.7% in 2020 while total investment decreased from an average of 24.5% of GDP in 2015-2017 to 22.3% of GDP in 2019. However, from mid-2020 investment started to recover and in 2021 real gross fixed capital formation (GFCF) rose to 24.1% of GDP, fuelled by public-financed post-earthquake reconstruction, but also private and foreign investment in other sectors, such as trade, hospitality and ICT picked up. Public investment (including that of local governments) averaged 5.4% of GDP over the 2015-2019 period, before jumping to 7% of GDP in 2020 and 2021. FDI-inflows, which contracted by 13% in 2020, rose by 10% in 2021, mainly in the mining and real estate sectors, but remained slightly below 2019 levels. The revival of the deteriorated railways network started with support of multilateral development banks in 2021, when a contract was signed to restore the connection between Tirana and Durres, the main port. Digital infrastructure continued to improve and the share of enterprises with faster (>10MB/s) network connection increased from 79.8% in 2020 to 90.5% in 2021, but internet use and websites of enterprises show only small growth. In June 2022, the government adopted a digital agenda with a corresponding action plan for 2022 – 2026.

Albania has started to establish a power exchange and adopted a new national energy and climate plan. Following the amendment of the power sector Law, which improved compliance with the EU *acquis* on energy and allowed for the effective separation of the electricity distribution system operator from the production operator, Albania was ranked 25th in the Energy Transition Index (WEF) in 2021, the highest in the Western Balkans. Early 2022, it began to establish the Albanian power exchange, another milestone for an integrated organised electricity market agreed with the energy community. Almost all electricity in Albania is produced from hydropower, which creates a dependency on unpredictable rainfall exacerbated by climate change. This in turn results in fluctuating electricity import needs and calls for more efforts to diversify electricity sources, for which the government mainly involves private investors, as is the case for two new photovoltaic parks it agreed on in 2022. In December 2021, the Government adopted a draft National Energy and Climate Plan 2020 – 2030, but has yet to substantially improve the plan by addressing the comments of the Energy Community Secretariat regarding a missing link between the targets, policies and measures, the lack of public consultation, and to base it on sound cost-benefit analysis.

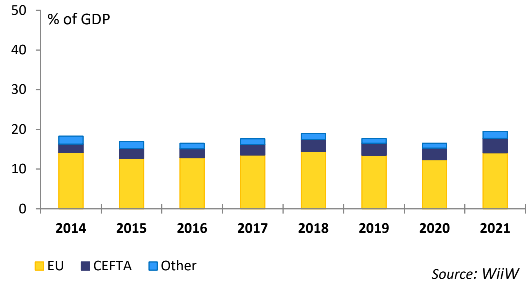
Sectoral and enterprise structure

The economic struture continued to shift gradually away from agriculture and towards services and industry. The weight of the agricultural sector in GDP gradually declined from 19.7% in 2015 to its lowest level in the last decade of 17.7% in 2021, when the sector experienced a 1.5 pps. drop in investment and a 3.2% drop in real growth. Manufacturing's share in GDP recovered in 2021 to 6.2% while that of industry as a whole rose by 1.3 pps. to 13.3%. Construction's share climbed from 9.0 to 9.5% of GDP in 2021. Services gradually increased their value added in real GDP to 48.4% in 2020 but decreased to 47.7% in 2021, and they also represent the largest share of employment (44.3% in 2021). Employment in the manufacturing sector, which had gradually increased to 11.2% in 2020, remained at the same level in 2021, whereas the decline in agricultural employment accelerated by 2.4 pps. to 33.7% of total employment in 2021. Agricultural employment decreased in almost all parts of the country, however, in more than half of the Albanian prefectures it still accounted for over 50% of employment and agricultural wages remained the lowest of all sectors, reflecting the still low productivity. **Business registrations recovered, and the number of enterprises with more than five employees increased**. Following a 1.5% decrease in 2020, the overall number of active non-agricultural enterprises increased by 1.1% in 2021, and new registrations were 20% higher than in 2020. Continuing the trend seen in 2016-2019, the number of enterprises with more than five employees rose significantly in 2021. In particular, enterprises with 5-49 employees increased their share from 8.8% to 12.7% of all enterprises and played a stronger role in terms of investment and value added. The share of enterprises with more than 50 employees climbed by 0.5 pps. to 1.7% and they employed more than half of all employees. Although microenterprises with 1-4 employees, mostly farms and small traders, remained the vast majority, their share decreased to about 85.6%, down from 90% in 2020.

Economic integration with the EU and price competitiveness

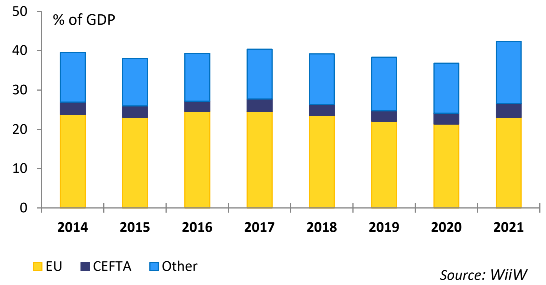
The EU remained Albania's main trading and investment partner, despite Albania's gradual diversifcation of trade partners. Overall external trade averaged 77.3% in GDP 2015-2019, dropping to 61% of GDP in 2020 before re-bounding to 76.4% of GDP in 2021. Exports remain dominated by services, and the EU remained the main destination for both goods and services exports. Due to faster growth in trade with non-EU countries, the EU's share in Albania's foreign trade has decreased somewhat, with exports to the EU accounting for 72.2% of the total in 2021 (down from an average of 76.4% in 2015-2019), while the share of imports from EU, which averaged 60% in 2015-2019, fell to 54.4% in 2021. On the other hand, the goods trade volume with CEFTA countries gradually increased from 5.7% in 2019 to 7.6% of GDP in 2021. Kosovo remained Albania's main export destination in CEFTA, whilst most of its imports in CEFTA came from Serbia. FDI flows to Albania from the EU increased by 26.5% in 2021, much more than from the rest of the world (7.8%), and they made up 59.7% of all FDI inflows. The EU's share in FDI stocks remained high at 54%. The index of the real effective exchange rate of the Albanian lek continued to increase, by 1.8% in 2020 (3.5% in 2019) albeit at a slower pace than its 2015-2019 average of 3.7%.

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



Source: WiiW

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



Source: WiiW

2. MONTENEGRO

2.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Montenegro has made **good progress** and is **moderately prepared** in developing a functioning market economy. After experiencing a sharp recession in 2020, the economy recorded a strong rebound in 2021 and kept growing at a steady pace in the first half of 2022, as the removal of COVID-19 restrictions buoyed both domestic and external demand. The economic recovery and rapidly rising inflation led to surging revenues and a very large improvement in the budget balance. The fallout from Russia's war against Ukraine has been limited so far, notwithstanding these two countries' very important contribution to Montenegro's tourism in the past. Driven by surging global commodity prices, inflation increased significantly. The government adopted an ambitious fiscal reform programme (called 'Europe Now'), to support the post-pandemic recovery while providing fiscal stimulus measures easing the burden on households from rising energy and food prices. External imbalances decreased significantly thanks to the rebound of tourism, while the situation of the labour market started to improve even if structural problems persist. The banking system remained stable, and non-performing loans did not increase significantly in 2022 after the loan moratorium adopted in the context of the COVID-19 crisis expired in 2021. However, close supervision is needed to monitor and address risks in view of tightening financing conditions.

Last year's recommendations were partially addressed. 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 targeting further public debt reduction;

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

→ adopt a strategic plan to perform an analysis of all state-owned enterprises and prepare a proposal for the optimal portfolio of state ownership;

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

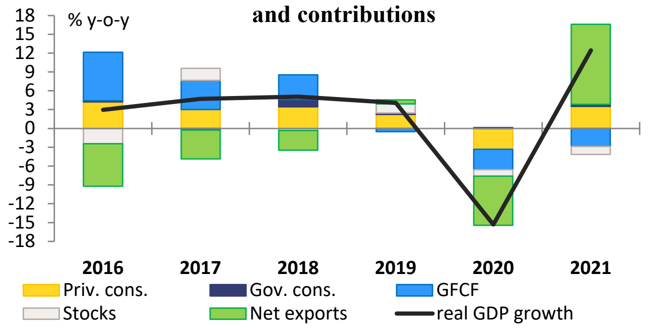
Economic governance

A broad consensus was maintained on key economic policy fundamentals notwithstanding changes of government. The last two governments reaffirmed their strong commitment to the EU path and related economic reforms. Important elements were the support to further diversify the economy according to a smart specialisation strategy based on partnerships between businesses, public entities and academia, and the continuation of the Europe Now programme, a major fiscal reform initiative introduced at the end of 2021 to support post-pandemic recovery. The government expects to limit some of the negative impacts from the war on Ukraine on the local economy by reducing taxes on basic consumption goods and fuels, providing support for agriculture production, and focussing on alternative tourist markets to compensate for the loss of Russian and Ukrainian visitors. The new minority government formed in April 2022, endorsed the conclusions of the Economic and Financial Dialogue between the EU and the Western Balkans and Türkiye on 24 May 2022, agreeing to implement macro-fiscal and structural policies and reforms to foster a strong recovery outlined in the previous government's Economic and Reform Programme (ERP). The policy guidance set out in the conclusions of the Economic and Financial Dialogue of 12 July 2021 were partially implemented.

Macroeconomic stability

A strong rebound of the economy in 2021 was largely driven by a revival of tourism. After recording annual growth of some 4.6% on average since 2017, in 2020 Montenegro's economy registered one of the deepest contractions in Europe (-15.3%) due to the COVID-19 crisis and the large role of tourism in the economy. GDP growth rebounded strongly by 12.4% in 2021, following the reopening of borders and the ensuing robust revival of tourism. The recovery of tourism had positive spillover effects across the economy, including on net exports and, to a lesser extent, private consumption. Government consumption increased only moderately, as COVID-19-related support measures started to expire. Investment activity remained weak, contracting by 10% y-o-y in 2021. The outbreak of Russia's war against Ukraine in February 2022 had so far limited direct impact on Montenegro's economy, as the country is not reliant on Russian gas or oil. However, Montenegro is exposed to Russia and Ukraine in terms of tourism and investment (the latter mostly in real estate). Further withdrawal of COVID-19 containment measures and strong growth in tourism activity boosted annual GDP growth in the first quarter of 2022 too, rising by 7.2% over the year. Domestic demand was fuelled by a two-digit surge in private consumption, while government consumption and capital formation grew at a more moderate pace. However, net exports had a negative contribution to economic growth, as strong demand and rising import prices broadened the trade deficit. Overall, the rebound of the economy brought partially back Montenegro's level of per-capita income in purchasing power standards to 47% of the EU-27 average in 2021, compared to 45% in 2020, but still remains below the 50% level registered in 2019.

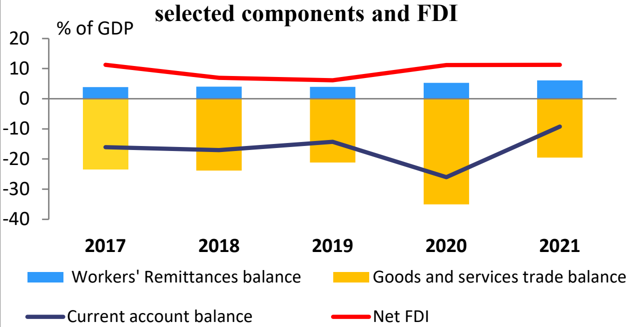
Graph 2.1: **Montenegro - Real GDP growth and contributions**



Source: WiiW

The strong recovery of tourism helped reduce the external deficit. Montenegro has been recording very high current account deficits in the last five years, averaging 16.5% of GDP since 2017. The current account gap narrowed to 9.2% of GDP in 2021, compared to 26.1% of GDP a year before. This sizeable improvement was mainly driven by a surging surplus in the services account, which reached 19.5% of GDP in 2021 compared to 4.2% in 2020 thanks to recovering tourism, and almost equalled its pre-pandemic level. Moreover, inflows from compensation of employees working abroad and from remittances also expanded in 2021. By contrast, the merchandise trade deficit widened to 39.0% of GDP in 2021 due to a fast growth in imports driven by stronger domestic demand and rising global commodity prices. The rapid increase in exports did not suffice to compensate for stronger import growth, as merchandise exports covered only 21.5% of total imports. The reopening of the economy resulted in a fast recovery in net FDI too, which surged 23.5% y-o-y in nominal terms and totalled 11.2% of GDP in 2021, thus surpassing the external deficit. Investment in real estate was almost 2.4 times higher than a year earlier. On the other hand, investment into intercompany debt dropped by 24.6% y-o-y, as local firms required less support from their foreign parent companies. The recovery in FDI inflows continued in the first half of 2022. The current account deficit increased significantly in the first half of 2022, by 31% year-on-year, driven by a sharp rise in the value of imports. The stock of international foreign exchange reserves declined from the equivalent of 6.8 months of imports of goods and services at the end of 2021, to 5.3 months in the second quarter of 2022.

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



Source: IMF and Central Bank of Montenegro

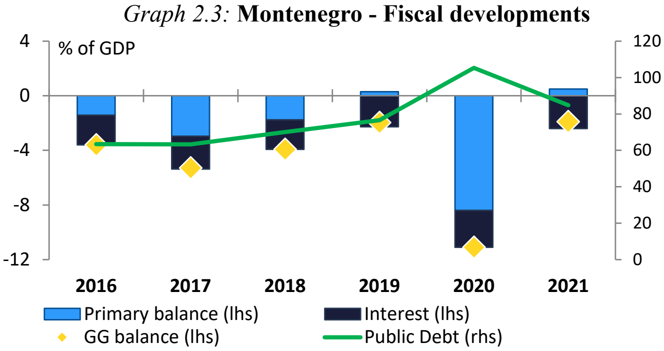
Table 2.1: **Montenegro - Key economic figures**	**2013-18** average	**2019**	**2020**	**2021**
GDP per capita (% of EU-27 in PPS)[1)]	44	50	45	47
Real GDP growth	3.6	4.1	-15.3	12.4
Economic activity rate of the population aged 15-64 (%), total[1)]	62.5	66.2	61.5	59.2
female	*55.8*	*59.1*	*54.7*	*52.9*
male	*69.0*	*73.3*	*68.3*	*65.5*
Unemployment rate of the population aged 15-64 (%), total[1)]	17.6	15.4	18.3	16.8
female	*17.5*	*15.9*	*18.8*	*16.1*
male	*17.7*	*15.0*	*17.8*	*17.3*
Employment of the population aged 15-64 (annual growth %)	2.7	2.6	-10.1	-2.4
Nominal wages (annual growth %)	0.9	0.8	1.3	1.4
Consumer price index (annual growth %)	1.4	0.5	-0.8	2.5
Exchange rate against EUR	1.0	1.0	1.0	1.0
Current account balance (% of GDP)	-14.0	-14.3	-26.1	-9.2
Net foreign direct investment, FDI (% of GDP)	10.7	6.2	11.2	11.2
General government balance (% of GDP)	-4.8	-2.0	-11.1	-1.9
General government debt (% of GDP)	62.9	76.5	105.3	84.8

Notes:
1) Eurostat
Source: national sources

Inflation has been increasing substantially but Montenegro has a very limited set of monetary policy tools to tackle it. Inflation remained low in the period 2017-2020, averaging 1.3%. However, since March 2021, higher food and energy prices kept generating inflationary pressures, with the harmonised index of consumer prices rising on average by 2.5% in 2021 and by 4.5% y-o-y at the end of year, compared to -0.8% average contraction in 2020. Russia's war against Ukraine exacerbated price pressures and inflation has remained elevated throughout 2022. In the first seven months of 2022, consumer prices increased in Montenegro by an average of 13.7% y-o-y, compared to (8.9%) in the euro areas.

Public finances recorded a significant improvement since 2021, but both revenue and expenditure reforms are still needed to support a sustainable consolidation path. the strong increase in budget revenue, together with capital budget under-execution and lower spending on goods and services, enabled a significant improvement of the fiscal position in 2021. The budget deficit came in at 1.9% of GDP, lower than the originally planned 2.8% of GDP. This was a very sizeable improvement compared to the deficit of 11.1% of GDP recorded in 2020 or the average deficits of some 5.2% of GDP registered since 2017. Apart from the economic rebound, budget revenue was supported by the introduction of higher excise rates, the electronic fiscalisation of businesses' cash registers, increased tax discipline and the transfer of public companies' profits to the central budget. In 2021, public expenditure declined by 2% y-o-y, thanks to lower needs to finance COVID-19 support measures and social transfers, and delays in public investment. The 2022 budget, which was adopted in December 2021, introduced a progressive income taxation system and abolished mandatory health insurance, thereby significantly reducing labour costs, but also entailing a

Graph 2.3: **Montenegro - Fiscal developments**



Source: National sources

permanent reduction in revenue. At the same time, some of the planned revenue-increasing measures were rejected by the parliament while new social initiatives were adopted without accompanying financing measures, putting at risk the targeted budget balance once these are implemented in the second half of the year. With budget revenue boosted by the economic recovery and high inflation, the central government deficit amounted to only 0.6% of the projected GDP in the first half of 2022, compared to a deficit target of 5% for the year as a whole. On 25 May, the parliament adopted a budget revision as the new government established in April increased the number of ministries.

A high level of public debt continues to be a key vulnerability, even though the debt ratio recorded a strong decline. The public debt stock reached a record high level of 105% of GDP at the end of 2020. In 2021, the government made use of its reserves to pay back maturing debt, which, combined with the strong economic rebound and the budget primary surplus, resulted in a reduction of the debt ratio to 83.3% of GDP. In the first quarter of 2022, the public debt decreased further, to 76.6% of GDP. However, with global financing conditions worsening, debt-related vulnerabilities remain high.

Montenegro macroeconomic policy mix is constrained by the lack of an autonomous monetary policy and a complicated political situation compromising the efficiency of the fiscal policy. The unilateral use of the euro means that the Central Bank of Montenegro cannot influence interest rates and money supply, and therefore the country would need to tighten fiscal policy to constrain price growth. In spite of the complex situation, the authorities' policy response managed to reduce significantly the budget deficit and public debt, orderly unwinding the COVID-19 support measures in 2021, and providing households with a significant increase in real disposable income since beginning of 2022. Overall, despite two changes of government (in December 2020 and April 2022) economic and fiscal policies remained broadly sound, notwithstanding some hasty social spending measures and overambitious public investments plans.

Functioning of product markets

Business environment

The recovery of economic activity has been reflected in the growing number of registered businesses. So far, electronic registration remains only available for single-member limited liability companies. This does not seem to represent a major obstacle given the increasing number of newly registered businesses. The reduction of a significant number of local taxes and fees, and the availability of some 40 support programmes in addition to the pandemic support measures helped to promote entrepreneurship. Thus, at the end of 2021, the number of business increased by 8.7% to 65,621; this compares to 60,361 in 2019 before the COVID-19 crisis. Also in December 2021, the government adopted a program to attract digital nomads, offering tax reliefs on personal income to foreign companies' teleworkers.

The out of court's bailiff system remains the key pillar for enforcement of debt claims, but needs to be reinforced. In 2021, the number of debt claim cases increased by 15.6% y-o-y. However, almost two thirds of cases received during 2021 are still pending, stressing the need to reinforce the debt collection system. The Commercial Court presents a higher rate of successful case handling, receiving 1,065 cases in 2021 and solving 95.4% the same year, with an average time for resolution of bankruptcy proceedings of 221 days compared to 234 days a year before. Overall, Montenegro's bankruptcy system is relatively well functioning, but some extreme cases are negatively affecting the average proceeding time.

Government efforts to reduce informality need to continue and require more focus in the coming years. The abolition of health contributions in 2022 reduced some of the disincentives for employers to formalise employment. However, the government still needs to adopt a comprehensive action plan (pending the completion of a survey on informality among enterprises and households) for fighting the informal economy, including the strengthening of enforcement capacities, and in particular, tax and labour inspections.

State influence on product markets

State influence on the economy remains limited, despite some recent measures aimed to contain price increases. The ministry of economic development proposed in December 2021 the free formation of prices of white bread as of January 2022. As a result, bread price surged by 30% as of 10 January 2022. In an effort to contain the increase in the cost of living, the Parliament approved on 11 May 2022 a special law allowing the government to set temporary price caps on key essential products. Following this, the government reduced in June 2022 the amount of excise duty for the sale of unleaded fuel and gas -oils by 50% and limited the price margins of flour, sugar, table salt and cooking oil by up to 5% on the wholesale price of the products and by 7% the retail price. The government has also approved additional EUR 1 million to be used, amongst others, for market interventions to ensure price stability of agricultural commodities. Overall, the allocated amount for subsidies in the general government budget has remained limited, averaging 0.8% of GDP annually since 2017. The Agency for Protection of Competition (APC) increased the number of competition and state aid investigations and established a general register of state aid to ensure better transparency and monitoring of public aid. Thus far, the major beneficiary of state aid has been Montenegro Airlines. The company has been under bankruptcy procedures since mid-2021. In December 2021, the parliament adopted a law annulling the decision from 2019 that granted Montenegro Airlines EUR 155 million over a 6-year period. However, a plan to recover the funds already disbursed still needs to be adopted.

Privatisation and restructuring

The privatisation process is quite advanced considering the limited number of state-owned enterprises (SOEs); however, important challenges remain in terms of their governance and profitability. In July 2022, the government decided to liquidate the public company 'Montenegro Works' established less than one year earlier by the previous administration. The goal of this company was to relaunch the privatisation agenda, define an optimal portfolio of state ownership after transforming SOEs' management structures, eliminate political patronage and improve financial performance to reduce fiscal risks (a challenging task considering that financial statements of 53% of SOEs audited are not aligned with international financial reporting standards and several companies are running losses). The government intends instead to develop a system to monitor public companies' business operations and the related fiscal risks. This new system would be supported by a dedicated department at the Ministry of Finance as well as the independent analysis of a fiscal council, yet to be established. These plans do not seem to address, however, the fundamental issues of optimising state ownership portfolio and improving overall SOEs governance and fall short on Montenegro's Economic Reform Programme commitments.

Meanwhile, the government increased its founding capital as shareholder of the new national airline company "To Montenegro". However, the sustainability of this company is yet to be ensured, as debt started soon to accumulate since its first year of operation. The second stage of the tender procedure for a 30-year concession of the two international airports (Podgorica and Tivat) remains on hold as the new government has not decided yet whether to cancel or continue the procedure. After establishing a commission to audit past sales contracts, the privatisation council has not held any sessions since July 2021.

Functioning of the financial market

Financial stability

The banking sector proved to be resilient and the financial sector stability has overall been maintained. The banking sector further consolidated after recording two mergers in 2021, reducing the total number of banks in Montenegro from 13 to 11. Yet, the ownership structure of the banks' capital did not change significantly. At the end of 2021, bank's capital was predominately foreign with an 85% share, originating mainly from large banking groups from the EU in control of 79.9% of the banking market, while the share of domestic capital totalled 15%. The Central Bank of Montenegro (CBCG) concluded in September 2021 an asset quality review (AQR) for all domestic banks according to the ECB methodology. Results confirmed the stability and strong position of the domestic banking system at the start of the COVID-19 crisis. During the pandemic, the CBCG adopted ten packages of temporary measures aimed at preserving the liquidity and solvency of domestic banks. As a result, the balance sheets of domestic banks recorded significant growth, and the capital adequacy ratio totalled 18.5% at the end of 2021, well above the statutory minimum of 10%. The phasing-out of fiscal support and targeted loan moratoria did not lead to a significant deterioration in the quality of the loan portfolio, but risks remain and should be closely monitored, in particular in the context of a worsening growth outlook and tightening financing conditions. The NPL ratio increased to 6.2% at the end of 2021 up from 5.5% the year before, to peak at 6.9% in January 2022 and to start declining gradually afterwards, reaching 6.3% in June.

Access to finance

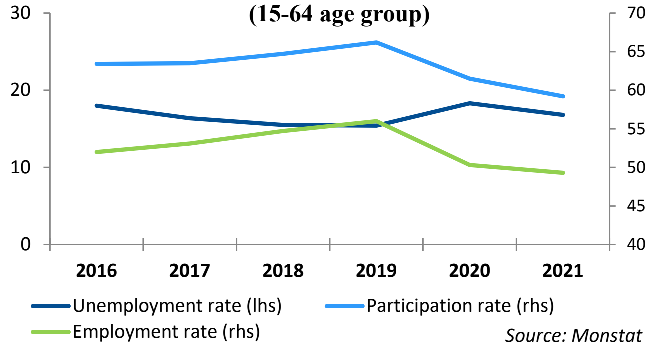
Credit activity has been growing continuously since 2019, supporting the corporate sector in particular. Total loan growth accelerated from 5.0% y-o-y in 2020, to 6.6% y-o-y in 2021 and further 6.8% y-o-y in June 2022. The rapid increase was led by lending to the corporate sector, while the increase in loans to households remained moderate and loans to the public sector decreased. The recovery of the economy has been reflected in a fast increase in banks' deposits too, which went from a 2.6% y-o-y contraction in 2020 to a 12.8% y-o-y expansion in 2021, and a surge by 21.4% y-o-y in June 2022, again led by the corporate sector. Although trending down, lending interest rates are still high presenting one of the major obstacles to access finance, in particular for small businesses. In March 2022, the government adopted a law to establish a national Credit Guarantee Fund. With the support from the EBRD, work commenced to establish a roadmap and overarching framework for the new institution.

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 (0.95% of GDP in 2021), while the assets of insurers represent around 2% of GDP. Microfinance is the most commonly used source of alternative finance, with assets accounting for some 1.6% of GDP in 2021.

Functioning of the labour market

The labour market continues to suffer from structural deficiencies. The outbreak of the COVID-19 in March 2020 was rapidly followed by a sharp decline in employment and a surge of unemployment due to the collapse of tourism. Despite several state-support packages, employment kept contracting until June 2021. As a result, employment declined on average by 2.4% y-o-y in 2021, after recording a 10.1% y-o-y plunge a year before. By contrast, the unemployment rate witnessed some relative improvement in 2021, falling to 16.9% compared to 18.4% a year earlier. However, the reason for this decrease in unemployment was a lower participation in the labour market, which fell from a peak of 66.2% in 2019 to 59.2% in 2021. The employment rate bounced back to 54.4% in the first quarter of 2022, up from 44.8% a year before, practically recovering pre-pandemic levels. The reduction of the unemployment rate was particularly pronounced for women, reaching 15.5% in 2022 Q1 compared to a much higher rate of 19.7% a year ago, as services – where a majority of women work– recovers faster than the industrial and construction sectors, where men are majority. As a result, the pace of reduction of men's unemployment rate was significantly slower, declining to 18.3% in 2022 Q1 compared to a 19.5% rate a year earlier. Overall, the pandemic highlighted the structural deficiencies of Montenegro's labour market. Youth and long-term unemployment remain high and there are considerable regional disparities (e.g. 5% unemployment rate in the coast, compared to substantially higher levels in the central and northern areas of 11.9% and 36.7%, respectively). Overall, the provision of active labour market policies is not effective in activating people on the labour market. Moreover, the country lacks a continuous monitoring mechanism of active labour

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



Source: Monstat

market measures, which should be carried out by the Employment Agency of Montenegro. However, the reform of the currently ineffective institutional setup of the Agency has not been implemented. The effective application of the labour law has been hampered by poor implementation and malpractice. For instance, to avoid dismissal costs employers request new hires to sign resignation letters upon recruitment. Moreover, there has been no cases where a foreign investor has been successful in court in relation to the application of the labour law. Real wage growth was negative between 2017 and 2021, except for a deflationary period in 2020. Despite accelerating inflation, the government boosted households' real disposable income in 2022, after rising the minimum gross wage by 43% (which translates into an 80% increase in net terms), and reducing significantly the tax wedge on labour. As a result, the net average wage climbed to EUR 707 in April 2022, up from EUR 537 at the end of 2021.

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 last two governments worked to improve innovation capacities and to set the basis for a green and digital transition in an effort to diversify Montenegro's narrow production base. In particular, modern telecommunication and ambitious green energy projects are being deployed. However, infrastructure gaps persist, as the country administrative and financial capacities to identify, prioritise and to implement major public investments remain limited, hampering the use of EU support. The education system still faces numerous challenges with a chronic shortage of science, technology, engineering and mathematics (STEM) graduates. In addition, the low value - added of domestic products, the small size of local companies and their low level of participation in exports represent obstacles for increasing the productivity and competitiveness of local firms.

As some of the 2021 recommendations have not been fully implemented, in the coming year Montenegro should in particular:

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

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

→ Implement the public investment management assessment (PIMA) recommendations, prioritising key public infrastructure works without endangering public finances.

Education and innovation

Montenegro's education system faces numerous challenges. Due to the COVID-19 pandemic, little progress has been made in advancing reforms to improve the quality of education on the basis of agreed action plans. Recent tests had confirmed that both the quality and relevance of the education system, including the lack of practical experience of graduates from vocational and higher education, remain key challenges. The occupational mismatch appears particularly high for tertiary education graduates, with a chronic shortage of medical and STEM graduates, putting at risk Montenegro's smart specialisation strategy. The high transition rate from vocational education to some higher education programmes without occupational demand in Montenegro's labour market aggravates youth unemployment. The recent strategy for digitalisation of the education system (2022-2027) aims to make internet available in all schools.

Montenegro increased the budget allocation for research and development but it still remains modest, totalling 0.15% of GDP in 2022, compared to the EU average of 2.3%. In 2021, only 18% of Montenegrin firms introduced a new product or service compared to a 37% average in the Western Balkans. Moreover, 80% of local firms declare that that they do not invest in R&D. To improve this situation, the government established the Innovation Fund in September 2021 as a state-owned limited liability company. The main activity of the Fund is to provide financial resources for the development of innovative entrepreneurship and to encourage cooperation between the scientific and economic sectors. In April 2022, the Fund launched its first two calls for support schemes for entrepreneurs. After some initial delays, the construction of a large Science and Technology Park in Podgorica is in progress. Works also continues on the development of an information and communication technology cluster to support the implementation of the smart specialisation strategy. The local IT industry is relatively small but it has been developing fast in the last three years. In March 2022, the Ministry of Economic Development and the University of Montenegro decided to establish a National Technology Transfer Office within the Science and Technology Park in Podgorica.

Physical capital and quality of infrastructure

Efforts are ongoing to support the digital and green transition but infrastructure gaps remain. In December 2021, the Government adopted the Strategy for the Digital Transformation of Montenegro (2022-2026), which takes a comprehensive, horizontal approach and contains objectives related to the development of digital infrastructure and connectivity. The telecommunications sector keeps developing fast. In December 2021, the first three 5G frequency licences were granted and one operator already launched commercial *5G* mobile *network* services. Access to green finance has been strengthened with the establishment of the Eco Fund (2020), providing financial support for the development of projects in the fields of preservation, sustainable use, protection and improvement of the environment, energy efficiency, and use of renewable sources. Reconstruction of the Pljevlja thermal power plant to reduce its environmental impact was launched in April 2022. In order to advance gradually with the transition away from coal, Montenegro's national utility company is preparing a study for the construction of gas-fired power plants. The government withdrew concessions for several smaller hydropower plants, but continues with plans for larger ones, while the private sector advances with plans for constructing new wind and solar capacities. The first section of the Bar-Boljare highway was opened to traffic in July 2022, with a three-year delay. The EU-financed feasibility study and cost-benefit analysis for the entire Bar-Boljare highway, including on recommended construction standards and means of financing for the remaining sections, is underway and it should be completed in 2022. Meanwhile, works on the Adriatic-Ionian expressway could not start yet as preparation of the Budva bypass section preliminary design work was not mature enough. The upgrade of the railway network continued but with delays in some sections.

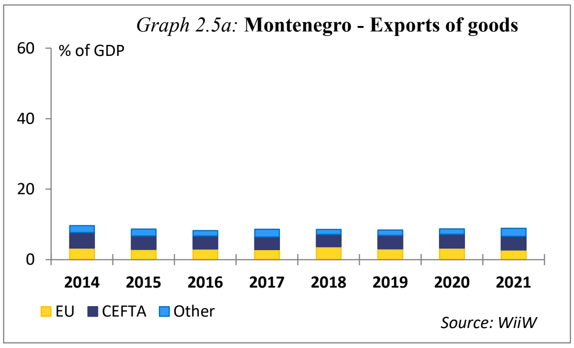
Sectoral and enterprise structure

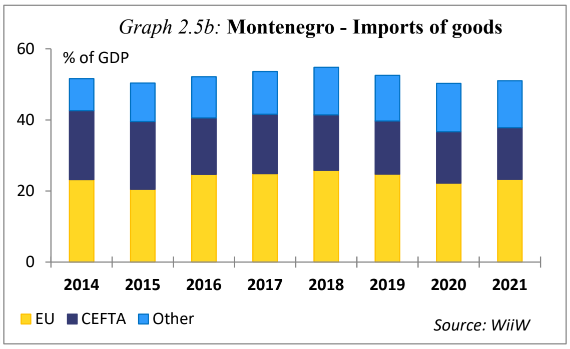
The structure of the economy has remained broadly unchanged, but adjustments are taking place within sectors. Overall, small and medium size companies remain the backbone of Montenegro's economy, accounting for some 94% of total firms. The distribution of employment remained stable, with the services sector absorbing roughly three quarters of total employment in 2021, while industry and construction (16.9%) as well as agriculture (6.4%) accounted for a much lower shares. Within services, tourism is predominant, contributing a quarter of Montenegro's GDP. The sector was severely hit by the COVID-19 crisis but recovered better than expected in 2021 and 2022. Visitors from Russia and Ukraine used to make up a significant share of foreign tourists. In order to limit the negative impact of the war against Ukraine, the sector has shifted its focus to other markets. The metallurgical sector recorded a major adjustment following the surge in energy prices resulting in the stoppage of the aluminium smelter as well as of the Niksic's ironworks due to unsustainable production costs. The halt in production of the metal producers provided a major opportunity for the energy sector, which exported at substantially higher prices[15] the electricity surplus not consumed by the industry. The energy sector is currently engaged into its green transition, developing a number of renewable generation plants.

[15] Large industrial consumers enjoyed significant rebates in energy prices.

Economic integration with the EU and price competitiveness

The economic recovery boosted external trade and brought the trade openness ratio back to its pre-pandemic level. During 2021, Montenegro's foreign trade expanded by 19.1% y-o-y, while bilateral trade with the EU followed the same trend, growing 12% over the year. Overall, the total exchange of goods and services recovered to pre-pandemic levels, totalling 105.8% of GPD in 2021, after having plunged to 86.3% in 2020 as a consequence of the recession induced by the COVID-19 crisis. The EU remains Montenegro's main foreign partner, accounting for 31.1% of total exports and 45.7% of total imports of goods. CEFTA countries also remain an important market, accounting for 43.2% of Montenegro's total exports and 28.5% of total imports of goods. The EU also remains the main source of FDI inflows for Montenegro, registering 36.4% of total FDI inflows in 2021, compared to 27.0% a year before. The low processing level of domestic products and the very small size of local businesses represent two key challenges for boosting Montenegro's export performance. To remedy this, the government's micro- and small-sized enterprises strategy supports establishment of vertical clusters, especially in agriculture and tourism.





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. In 2021, the economy largely recovered from the COVID-19 crisis, partly reflecting fiscal support measures implemented to help the recovery. Simultaneously, the government stepped up public investment although capital spending still lagged behind plans. Helped by rebounding tax revenue, the fiscal deficit declined to 5.4% of GDP in 2021, while the general government and the public debt levels stabilised after a large increase in 2020. With the rise in food and energy prices accelerating in early 2022, the government adopted a new set of fiscal measures to contain the negative impact on the economy. These measures were though not well targeted to those most in need. The central bank tightened its policy stance in view of rising inflationary pressures.

Important policy reforms to improve fiscal governance and the sustainability of public finances stalled. The management of public investment remains to be improved; the new framework for governing public-private partnerships has not yet been adopted by the government; and the indexation of pensions has been changed to also reflect wage developments alongside inflation, implying further expenditure pressures on the already strained Pension Fund. After long delays, the new Organic Budget Law, which provides for fiscal rules and a fiscal council, was adopted by the Parliament in mid-September.

The banking sector remained sound, liquid and profitable, and financial stability was bolstered by progress on some key legislation. Credit growth to the private sector accelerated, in particular to companies. Regulatory measures to ease borrowing requirements were phased out in 2021. The business environment continued to be impeded by the large size of the informal economy and slow progress in streamlining para-fiscal charges.

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

→ Improve the targeting of fiscal support to help vulnerable households and companies facing rising food and energy prices and ensure its the temporary nature; improve revenue collection and broaden the tax base in line with the Tax System Reform Strategy, including by streamlining tax exemptions;

→ Implement the Organic Budget Law and ensure the timely establishment of the Fiscal Council;

→ To improve the business environment, widen the range of services available for businesses and citizens on the government's e-portal and streamline para-fiscal charges in line with the established inventory.

Economic governance

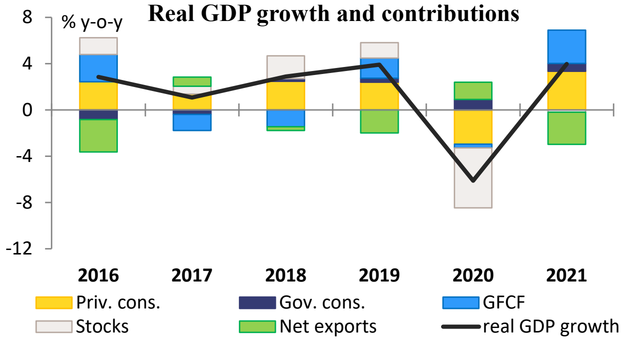
The government provided large-scale fiscal support to the economy to cope with rising price pressures, but progress on important reforms was slow. While continuing to implement pandemic-related anti-crisis measures from six packages adopted in 2020 and 2021, the government agreed on a new set of measures, in March 2022, to ease the burden of high food and energy prices on the economy. At the same time, it bolstered public investment, by raising capital expenditure in 2021 and launched a new Growth Acceleration Plan for the period 2022 to 2026, which foresees sizeable public investment to leverage additional private financing. Yet, some important reforms have progressed only slowly or stalled, such as improvements in public investment management; the broadening of the tax base; the establishment of a fully functioning state-aid registry; and the adoption of a new legal framework for public-private partnerships. The new Organic Budget Law, which provides for fiscal rules, a fiscal council and a proper medium-term budgetary framework was submitted to the Parliament in December 2021 and was finally adopted in mid-September 2022. There was reform reversal with regard to the move back to a price and wage-linked indexation formula for pensions, which is likely to raise the pensions bill considerably.

The policy guidance jointly agreed at the July 2021 Economic and Financial Dialogue between the EU and the Western Balkans and Türkiye has been partially implemented. The government fulfilled all conditions for the disbursement of the second tranche (EUR 80 million) of macro-financial assistance from the European Union.

Macroeconomic stability

Domestic demand recovered in 2021 amidst accelerating inflation. After output dropped by 6.1% in 2020, the economy rebounded by 4% in 2021, driven by domestic demand. Remittances from abroad returned to pre-crisis levels, bolstering household's disposable income, and wage subsidies from the government helped to keep employment stable. COVID-19-related containment measures were gradually lifted. Growth dynamics slowed down towards the end of 2021, as external demand weakened, disruptions in global supply chains aggravated, and food and energy prices started to rise rapidly. Due to strong import growth, driven by steeper global commodity prices as well as reinvigorated domestic demand, net exports' contribution to GDP growth turned negative in 2021. In the first half of 2022, annual GDP growth averaged 2.6%, driven partly by a robust rise in investment. Convergence with EU income levels has remained 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.

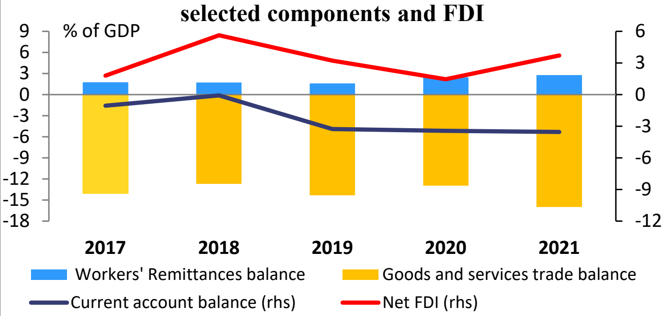
Graph 3.1: **North Macedonia - Real GDP growth and contributions**



Source: WiiW

The external position started to deteriorate in late 2021, as the post-pandemic recovery strengthened while import prices rose sharply. In 2021, the current account deficit remained at the same level as one year earlier, at 3.5% of GDP, above its average of the period 2017 to 2019 (1.5%). However, since the last quarter of 2021, the merchandise trade balance has deteriorated steadily, largely on account of rising energy prices, reflecting the country's high dependence on energy imports. This led to a widening in the current account deficit, even though private transfers from abroad, including workers' remittances, picked up markedly in 2021 and beyond, after their pandemic-related decline in 2020, and the surplus in the services balance increased, as containment measures were lifted. The shortfall in the current account in 2021 was covered by net FDI inflows, which reached 3.7% of GDP, from a low 1.5% in 2020, hence surpassing their average in the period 2017 to 2019 (3.5%). After having decreased each year between 2016 and 2019, the external debt ratio jumped by 7.3 pps. in 2020 to 80.3% and it rose further to 81.4% in

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



Source: National Bank of North Macedonia and State Statistical Office

2021, mainly as a result of continued foreign financing for crisis-induced needs. However, the structure of the debt implies moderate risks. Long-term debt makes up about 70% of the total, and the share of intercompany debt and trade credits, which constitute less volatile components of foreign debt, is high.

Foreign reserves came under pressure in early 2022 which abated somewhat over the summer. Foreign reserves were bolstered in 2021 (+8.4% year-over-year at end-2021, representing five months of prospective imports) by financial inflows, including the second tranche of macro-financial assistance from the European Union, a pickup in foreign direct investment, as well as portfolio inflows. However, in the first quarter of 2022 and beyond, due to a large increase in the energy trade deficit, domestic conversion pressures into euro-denominated assets, and public debt repayments, foreign reserves declined. Partly due to a seasonal increase in private transfers, reserves increased slightly over the summer. However, at end-August they were still lower by 9.8% compared to end-2021.

The central bank continued its accommodative monetary policy in 2021, but started tightening in early 2022, in light of accelerating inflation. The central bank raised the key policy rate four times between April and July 2022, from the historic low of 1.25% to 2.5%, effectively putting an end to its accommodative policy stance during the pandemic. Beginning in late 2021, import price increases accelerated, and domestic price pressures firmed up, including from sustained wage growth, which was further fuelled by an 18.5% hike in the minimum wage as of March 2022. The consumer price index rose by 3.2% in 2021, compared to 1.2% in 2020, with increases accelerating further each month since the beginning of 2022, to an average of 11.6% in the first eight months. The currency is in a stable, *de facto* pegged exchange rate regime with the euro. Concerns arose about the operational independence of the central bank, as it has not been exempted from the draft laws on administrative servants and the law on public sector employees. Overall, the monetary policy stance has been in line with current economic fundamentals, responding to market expectations of further rising inflation, while mitigating the negative impact on the economy stemming from the pandemic and the energy crisis.

Table 3.1:

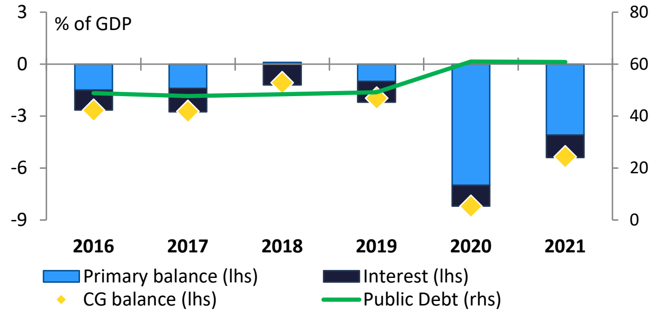
North Macedonia - Key economic figures

	2013-18 average	**2019**	**2020**	**2021**
GDP per capita (% of EU-27 in PPS)[1)]	37	38	37	42
Real GDP growth	2.9	3.2	-6.1	4.0
Economic activity rate of the population aged 15-64 (%), total[1)]	65.1	66.3	65.5	65.5
female	*52.0*	*54.8*	*54.0*	*53.4*
male	*77.8*	*77.3*	*76.7*	*77.1*
Unemployment rate of the population aged 15-64 (%), total[1)]	25.2	17.4	16.6	15.8
female	*24.7*	*18.6*	*16.1*	*14.7*
male	*25.5*	*16.6*	*16.9*	*16.6*
Employment of the population aged 15-64 (annual growth %)	2.5	5.4	-0.5	0.2
Nominal wages (annual growth %)	2.5	5.1	8.3	5.7
Consumer price index (annual growth %)	0.8	0.8	1.2	3.2
Exchange rate against EUR	61.58	61.51	61.67	61.63
Current account balance (% of GDP)	-1.3	-3.3	-3.4	-3.5
Net foreign direct investment, FDI (% of GDP)	3.0	3.2	1.5	3.7
General government balance (% of GDP)	-3.1	-2.0	-8.2	-5.4
General government debt (% of GDP)	38.3	40.5	51.9	51.8

Notes:
1) Eurostat
Source: national sources

Public finances improved in 2021, as tax revenue recovered. In the 5 years preceding the pandemic, the general government fiscal deficit was declining each year, in terms of GDP, partly on the back of under-execution of budgeted capital expenditure, before jumping to 8.2% of GDP in 2020 as the COVID-19 crisis hit public finances. Driven by higher tax income, public revenue recovered gradually through 2021 from the pandemic-related trough. Capital spending, at 79% of the revised budget, was, again, severely under-implemented, yet much increased compared with 2020.[16] The deficit (5.4% of GDP) remained below the revised target, and substantially below the 2020 deficit. Implementation of measures in 2021 from the six sets of anti-crisis measures amounted to some 2.5% of GDP. The 2022 budget foresees a gradual phasing out of pandemic-related support amidst a large increase in capital expenditure. In March 2022, the government adopted measures totalling some EUR 400 million, to mitigate the negative economic impact from rising food and energy prices. This includes transfers to the state-owned electricity producer to subsidise prices on the regulated market, as well as temporary reductions in the VAT rate on fuel, gas oil and liquified petroleum gas (LPG) from 18% to 10% (these measures expired on 1 June), and an extension of the lower VAT rate on electricity, delaying the gradual return to the regular 18% rate,[17] as well as a temporary zero rate on basic food products. To accommodate this package, the government, in May 2022, revised the budget, raising the deficit target to 5.3% (+1pp compared to the original 2022 budget), in spite of an inflation-driven boost to tax income in the first quarter.

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



Source: National sources

Debt levels stabilised in 2021 after the pandemic-induced surge in 2020. Both general government debt and public debt declined marginally in 2021 as a share of GDP. Government debt amounted to 51.8% of GDP at end-2021 (-0.1pp y-o-y), after surging by 10.4 pps. y-o-y in 2020. The share of foreign currency debt increased in both years, because financing requirements were covered to a large part through borrowing abroad. Apart from funding the still elevated budget deficit in 2021, the government needed to roll over a Eurobond worth EUR 500 million, which it had refinanced through a new Eurobond issued in March 2021 (EUR 700 million). With no Eurobond maturing, debt rollover needs are benign in 2022, but financing the still elevated budget deficit requires careful debt management amid tightening global financial conditions.

Deficiencies in public finance management remain. 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. The rising pensions bill poses further risks to fiscal sustainability, exacerbated by the recent change in the indexation formula, a steep rise in minimum wages, and a one-off pension increase in the first half of 2022. Further fiscal risks emanate from the recent resurgence of high budget arrears in the health sector.

Implementation of fiscal governance reforms has been sluggish. Implementation of the Action Plan for improving public investment management (PIM) is heavily delayed, including the setting up of a dedicated PIM unit in the Ministry of Finance. A draft law on public-private partnerships (PPPs) to address shortcomings in the current framework governing PPPs and concessions, was finalised in 2021, but is still awaiting adoption by the government. The law, which also provides for improved monitoring of fiscal risks arising from PPPs, would facilitate the planned increase in public investment. The government did not progress much on the implementation of its March 2021 Action Plan operationalising the 2020-2023 Tax System Reform Strategy. Rather, the tax base was further narrowed through new,

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

[17] The planned increase from 5% to 10% has been postponed from July to December 2022.

partly permanent exemptions, such as for personal income tax in the IT industry. In August, the government announced plans for tax reforms aimed at expanding the tax base, including the introduction of progressive income taxation, to be implemented in the period 2023-25.

Progress on the implementation of the Organic Budget Law is slow. The new Organic Budget Law was adopted by the Parliament in September 2022 after a lengthy procedure, requires substantial secondary legislation, the development of which is only in its initial phase. Moreover, its implementation depends heavily on the introduction of the new integrated IT system (IFMIS), which is yet to be established as well.

The policy mix aimed to cushion the impact of the pandemic and the rise in the cost of living, but fiscal support could have been better targeted in view of the available fiscal space. With pressures on the budget increasing, broad-based fiscal support, such as tax exemptions for energy products, poses a risk to fiscal sustainability. The government faces the challenge of targeting support to vulnerable households and companies, and to keep support temporary. Shortcomings in the planning, implementation, and monitoring of measures, as well as in their transparency and accountability, impact on their effectiveness.[18] The government also needs to envisage a gradual return to fiscal consolidation once the recovery is firmly entrenched. The recent tightening of monetary policy was appropriate, in light of increasing price pressures.

Functioning of product markets

Business environment

Streamlining the array of para-fiscal fees has progressed slowly. After the government took a first step in early 2021 towards reducing the number of para-fiscal fees, the process of assessing and optimising the published list of 377 charges at central and local level has not progressed much. The implementation of other key measures to improve the business environment is also protracted, such as the implementation of the 2019 Law on inspection supervision and implementing transparent and consistent procedures for inspections. The new bankruptcy law, intended to facilitate market exit by reducing the cost and time of procedures, has not yet been adopted. The use of fast-track procedures for public consultation has not abated, while quality control and ex post follow up to consultations remains deficient. The scope of digital services available on the national e-service portal with full electronic interaction has not much increased, with implementation suffering from low institutional capacity. In general, the government's approach to simplifying the business environment is not sufficiently systematic and consistent.

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 38% of GDP.[19] Implementation of the government's Strategy and Action Plan to combat the informal economy remains sluggish, in particular regarding the formalisation of undeclared workers. In October 2021, the government adopted a report assessing the implementation of this Plan, and also adopted a new, 2021-2022 Action Plan. The country's informal sector takes various forms, of which the most prominent are unregistered labour, partially undeclared wages and other irregularities in the enforcement of the Labour Relations Act.

State influence on the product market

Transparency and efficiency of state aid remains deficient. State aid was stepped up in 2020 (7.9% of GDP) and 2021 (6.8%), compared to the pre-COVID-19 period (average 2017-2019: 5.3%), but its governance deteriorated further. While the authorities have ensured public dissemination of information related to the adoption of the COVID-19 support measures, including through a dedicated webpage, the information provided remains incomplete and the criteria for the selection of beneficiaries are often unclear. Anti-crisis measures suffer from inadequate planning, implementation and monitoring, as well as

[18] See also the findings of the April 2022 Performance Audit Report on the government's COVID-19 measures by the State Audit Office of North Macedonia.

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

transparency and accountability. There is little *ex-ante* analysis of potential impact and little *ex-post* efficiency evaluation, as the April 2022 report from the State Audit Office found. The government also provided liquidity support to companies, in the form of interest-free credit. Overall, 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. As a precondition for the establishment of a state aid registry, the government is setting up a management information system connecting different institutions, but overall, the process is delayed. The energy market was fully liberalised in 2019. However, in 2021, reforms in the energy sector slowed down since there was no tangible progress, either in the unbundling of the gas transmission system operator GA-MA AD, although a long-standing dispute over its ownership was finally settled. In 2021, 53.5% of the electricity needs are provided on the open electricity market. This share increased compared to 52.24% in 2020. Over 20 000 retail customers switched suppliers in 2021.

Privatisation and restructuring

The public sector's stake in the economy remains low. In 2021, the number of companies in full-state ownership went up by one (GA-MA AD Skopje, gas transmission), to 17, compared to the three preceding years. The number of companies in partial ownership decreased by one, to 39, most of these with a state ownership share of below 1% of issued capital).[20] The total value of state ownership in enterprises amounted to some 10% of GDP. There are currently no plans for further privatisations.

Functioning of the financial market

Financial stability

The banking sector remained sound throughout the crisis. Banks are well-capitalised, liquid and profitable. The capital adequacy ratio increased further in 2021 and was above its level of five years earlier (+2.1 pps. at 17.3% of risk-weighted assets), much exceeding the regulatory minimum. Liquid assets accounted for over one third of total assets at end-2021 and covered more than half of short-term liabilities. Return on equity (12.9%) was higher than one year earlier. Bank funding was stable, with the loan-to-deposit ratio unchanged year-on-year (82%). However, financial diversification progresses slowly, with banks accounting for some 80.5% of financial sector assets at end-2020, lower by 5.3 pps. compared to end-2015. The share of foreign equity in total bank equity has been consistently high in the past five years, at about 75%.

Demand for foreign currency deposits remains strong. The appetite of savers for euro-denominated deposits, induced by, first, the COVID-19 crisis, followed by the energy crisis, continued. The share of foreign currency in total bank deposits has increased each quarter since end-2020, amounting to 47.4% at the end of the first quarter 2022 (+5.2 pps. year-over-year). This prompted monetary authorities, in late March 2022, to amend reserve requirements, in order to promote local currency deposits in line with its 2018 denarisation strategy. The share of foreign-denominated in total loans, on the other hand, dropped in the same period. The ratio of non-performing loans (NPL in total loans to the non-financial sector has been decreasing continuously since the end of 2013, to a record low of 3.1% at the end of the first quarter 2022. Households and corporates benefitted from regulatory easing with regard to lending, including measures enabling banks to approve a temporary moratorium on loan repayments, which were phased out in 2021.

Steps have been taken to strengthen the institutional framework for ensuring financial stability. Amendments to the Financial Stability Law, which would assign the central bank the leading role in developing and implementing macro-prudential and financial stability policies remain to be adopted. A regulation to facilitate the sale of NPLs was adopted in March 2022. Improved instruments to deal with NPLs are vital, as the economy might still face a rise in NPL, following regulatory normalisation and renewed cost pressures on companies from rising import prices and the war in Ukraine. Also, in July

[20] The figures are based on information from the government. A new harmonised and internationally standardised Global Database of State-Owned Enterprises (SOEs) by the World Bank shows that there are 88 SOEs, of which 35 owned by the Government of North Macedonia at 100 percent ownership.

2022, the National Bank adopted a decision to increase the countercyclical capital buffer to 0.5% as of August 2023.

With a view to improving financial literacy, the financial regulators, led by the central bank, adopted the first national Strategy for Financial Education and Financial Inclusion in 2021. On this basis, the central bank adopted a Code of Good Practices for Financial Education, establishing the principles to be respected by institutions offering financial education programmes.

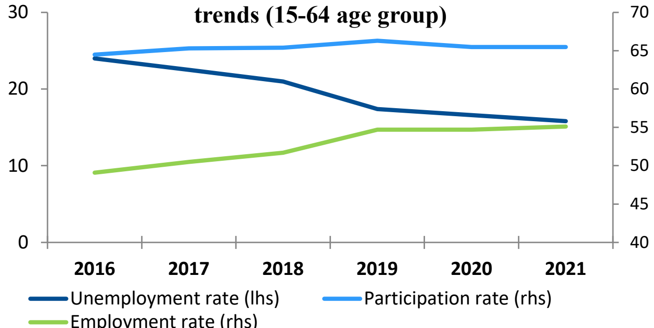
Access to finance

Bank lending has sped up, but financial deepening progresses only slowly. Central bank action as well as liquidity support from the government have eased access to finance for companies since the onset of the pandemic. Credit growth to the non-financial private sector picked up in 2021 (+0.3 pps. year-over year to 6.2% on average), and accelerated further in the first three months of 2022. Unhabitually, growth in lending to corporates exceeded the increase for households. Local currency lending rose faster than credit in foreign currency. At 88.3%, the ratio of total assets of the banking sector to GDP was below its level of one year earlier, but substantially above its level of end-2016 (74.8%).

Functioning of the labour market

The recovery and government support measures have bolstered the labour market, but structural problems remain. Wage subsidies and liquidity support from the government bolstered labour market resilience also in 2021 and beyond. According to data for the second quarter of 2022 from the Labour Force Survey, which has been based on the results of the 2021 population census since the first quarter of 2022, the labour force (15-64) dropped by 14.2% year-over-year (end of second quarter 2022), while the activity rate rose by 0.9 pps. in this period, to 66.4%, implying a large drop in the working age population.[21] The number of unemployed decreased even more sharply than the labour force, bringing the unemployment rate down to 14.7% (-1.3 pps. year-over-year). Labour market participation rates rose for both, men and women. Yet the gender gap widened for the second year in a row, after narrowing consistently between 2014 and 2019, as the participation rate for men rose by more during the pandemic than the rate for women. The gap widened by 2.5 pps., to 25.8 pps. (end of second quarter 2022), compared to the same period one year earlier. Youth unemployment remains high, at 30.9%, but is declining steadily (-6.9 pps. year-over-year. Compared to the first quarter of 2022, the unemployment rate for the age group 15-24 years declined by 3.9 pps, with the labour force in this cohort lower by 7.9%. Youth unemployment has declined significantly since the government's Youth Guarantee scheme entered into force in 2018. Around 80% of unemployed are so long-term, largely reflecting an entrenched skills mismatch. Given limited human and financial resources in employment agencies, the government faces the challenge of better targeting the vulnerable unemployed, with a view to their participation in active labour market policies. 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.

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



Source: State Statistical office (SSO)

[21] The new census implies a structural shift in labour market data, impacting the results of the LFS. Hence, as the Statistical Office points out, this affects the comparability with data from preceding years. Compared with the first quarter 2022, the labour force (15-64) rose slightly in Q2, by 0.1 pps., and the unemployment rate declined by 0.2 pps., partly reflecting seasonal effects.

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

North Macedonia has made **some progress** and is **moderately prepared** to cope with competitive pressure and market forces within the Union. Integration with the EU in trade and investment remained at a high level in 2021, in spite of lockdowns and disruptions of supply chains domestically and in trade partner countries. The share of high-value products in exports increased further. There was further progress towards improving vocational educational training (VET), but major skills shortages persist with regard to labour market needs, entailing long school-to-work transition. These, as well as large gaps in transport and energy infrastructure, coupled with low investment and innovation spending are restricting potential growth. The digitalisation of the economy is advancing, but the competitiveness of domestic businesses could be improved through a wider offering of public e-services.

As some of the 2021 recommendations have not been fully implemented, most requirements stay the same and North Macedonia should in particular:

→ Increase financial and human resources to speed up reforms of the VET system;

→ Adopt and implement energy efficiency legislation, including implementing legislation to the energy efficiency law and enhance related human and technical capacity;

→ Set up an energy efficiency fund.

Education and innovation

Progress in reforming education curricula and reducing skills mismatches is hampered by lack of funding and capacity. While North Macedonia has progressed 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. This is much below the EU-level (5%) and also below peer-country averages. It hinders an adequate implementation of the 2018-2025 education strategy. Moreover, spending is highly inefficient, mainly on account of outdated formulas for the redistribution of public education funds by the municipalities. There was substantial improvement in the 2018 PISA ranking, compared to 2015, but the country still ranks in the lowest quartile. Vocational training (VET) curricula are under revision since 2019, so as to adjust them to labour market needs. However, the modernisation of the country's three VET centers is hampered by slow parliamentary adoption of necessary legislation. Innovation activity remains, overall, low. At 0.4% of GDP, including a small share from the private sector, the economy's expenditure on research and innovation has not increased over recent years, and remains significantly below the EU average. The country remains an emerging innovator, according to the EU innovation scoreboard.

Physical capital and quality of infrastructure

Investment spending remains low in light of major needs to increase physical capital. Gross capital formation (GCF) as a share of GDP rose to 33.8% in 2021, up from 29.6% in 2020. The share of gross fixed capital formation (GFCF) in GCF amounted to 76% in 2020, or 22% of GDP (compared to 24% in 2015). The share of investment in construction has been rising in recent years and made up about 29.5% of GFCF in 2020, followed by industry (22%). Trade, transportation, food and services accounted for 17% of GFCF. In terms of ownership, public sector investment makes up about 22% of the total amount of GFCF, mainly on account of road construction through the Public Enterprise for State Roads. In the face of the current energy crisis, as well as the protracted works on a number of major road and rail projects, the need to modernise the country's capital stock, in particular the transport and energy networks, appears ever more pressing.

Regional transport connectivity progresses slowly. There has been some progress on upgrading major road sections to highway level, but the works on Rail Corridor VIII to Bulgaria are still stalled. After the second deadline to complete the construction of the Kicevo-Ohrid motorway was missed in June 2021, the period for completion was extended by another two years. Works on Road Corridor X have restarted with a new contractor. The construction of the Eastern end of Rail Corridor VIII towards Bulgaria, which suffered from the termination of contracts in 2020 upon lack of progress on site and poor implementation capacity, is still facing significant problems, and no new contractor has been selected. Regarding Rail Corridor X, the joint agreement with Greece for facilitation of the rail border procedures is still pending. There was some progress on the Joint Railway Border Station with Serbia, with the tender procedure to be launched by end-2022. Maintenance and service of regional and local roads and rail systems need to be improved.

The digitalisation 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.

Energy diversification needs are pressing, while measures to improve energy efficiency are lagging. The economy is characterised by high-energy intensity with low efficiency in energy production and consumption. Electricity generation is highly dependent on coal, and, with domestic coal reserves declining, on imports. The government plans to increase the share of renewable energy sources to 35-45% of energy consumption by 2040. The distribution of natural gas, as an intermediate step in the decarbonisation process, is advancing, with efforts made to increase the transmission and distribution network. The total distributed quantity in 2021 was around 426 million m^3 (+26.13% compared with 2020). Gas accounts for some 11% of electricity production, and 100% of the country's gas is imported from Russia through a single connection. The connection to regional gas pipelines progresses only slowly. Works on the gas interconnection with Greece have not yet started. This project would support diversification of natural gas sources and facilitate access to transit pipelines. Further improving energy efficiency, including in residential and public buildings, is important to lower the economy's dependence on energy imports and to allow for the reduction of fiscal subsidies for energy. Yet, partly on account of limited technical capacity, the government has not progressed with the adoption of the needed by-laws to implement the 2020 Law on Energy Efficiency. Also, the legal and regulatory framework for the establishment of the Energy Efficiency Fund remains to be adopted. The government is providing a range of financial initiatives to support the private sector in its greening efforts, including the recently adopted Plan for Accelerated Growth (2022-2026), which foresees two funds to finance green economy projects.

Sectoral and enterprise structures

The economy's output structure diversified further through the pandemic. Even through the past two years, in which economic activity was troubled by pandemic-related restrictions, the sectoral and business structure continued their gradual transformation towards a higher share of services, including trade, in value added and in employment. The output structure, too, is increasingly determined by the service industries, which together accounted for some 66% of total value added in 2021 (compared to 60.4% in 2016 and 64% in 2020). The share of manufacturing decreased slightly, compared to the preceding year, after having progressively gained ground in previous years. It stood at 14.8% of value added in 2021 (-0.3 pps. year-over year). Construction, too, weighed more lightly, overall (5.8% of value added, compared to 6.2% in 2020 and an average of 7.2% in the period 2016-2020), reflecting weak investment dynamics during the pandemic. The share of agriculture dropped further in 2021, to 9% (-0.8 pps.).

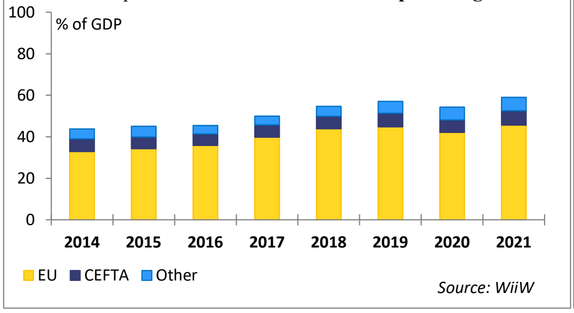
Employment in services remained robust in spite of lockdowns. Although services were badly hit by pandemic-related containment measures, they still accounted for over half of total employment in 2021 (57.6%), which is a stark increase compared to 5 years earlier (2016: 52.3%), and higher than in 2020 (57%), when lockdown rules were even stricter. In spite of the weak performance of the manufacturing sector in 2021, its share in total employment remained almost unchanged from the preceding year, possibly owing to government support schemes such as wage subsidies and reduced working hours. It is significantly above its level of five years earlier (19%). The agricultural sector is gradually becoming less significant for overall employment. Its share in total employment dropped further in 2021 (11.5%, down from 12% in 2020 and 16.6% in 2016). Overall, it is likely that financial support from the government's anti-crisis measures, which prioritised certain sectors of the economy, to some extent impacted on sectoral employment trends over the past 2 years.

The number of businesses increased again in 2021, after the large drop in 2020. The number of total companies in business decreased slightly further in 2021, on account of a furth drop in micro companies (1-9 employees). On the other hand, the number of SMEs increased (+1.4% year-on-year) again, after the pandemic-induced decline in 2020. Overall, the share of SME and micro enterprises in total enterprises increased by 0.2 pps. in 2021, to 99.8%, which is the average of the past five years. Micro and small companies account for 97.8% of total (+0.1 pps.), broadly stable compared to the pre-COVID-19 level.

Economic integration with the EU and price competitiveness

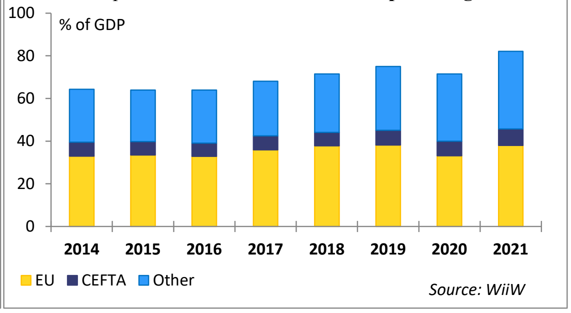
Trade openness remains relatively high. The economy posted a large increase in trade openness (exports and imports in goods and services as a share of GDP), to 148% of GDP in 2021, after a drop in 2020 (to 130% from 138% in 2019), when trade volumes declined by more than GDP. The share of higher-value added products in the export structure rose further in 2021, including chemicals (26.8%) and machinery and transport equipment (31.5%), at the expense of the traditional exports such as iron and textile (below 20%).

Graph 3.5a: **North Macedonia - Exports of goods**



Source: WiiW

Graph 3.5b: **North Macedonia - Imports of goods**



Source: WiiW

Mainly reflecting the product trade structure, which was impacted by the pandemic and its disruption of supply chains, exports to CEFTA countries increased, as a share of total, while those to the EU remained the same. In 2021, exports to the EU accounted for 77.3% of total exports, which is only slightly less than in 2020, and partly due to the continued weakness in automotive supply exports, for which EU economies are the most important destination markets. The EU's share of imports, at 46.2% of total, was about the same as in the preceding year. The share of exports to CEFTA countries (11.8% of total exports) was higher by 0.8 pps., while the share of imports from CEFTA countries remained about the same, at 9.5% of the total in 2021. EU countries remain the most important investors in North Macedonia, accounting for some 56% of total FDI inflows in 2021, but the EU-27 share in the total stock of direct investment has been declining since 2015 (66.1%), and amounted to 61.9% in 2020 (EU-27). Concerns over external competitiveness have increased as wage growth accelerated, fuelled by the recent 18.5% hike in minimum wages, coupled with compensating wage subsidies to employers, and by increases in public sector wages. The real effective exchange rate (CPI-based) continued to remain broadly stable also in 2021, appreciating somewhat in the last quarter, and depreciating in spring 2022.

4. SERBIA

4.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Serbia is **between a moderate and a good level of preparation** and has made **some progress** in developing a functioning market economy. After a relatively mild contraction in 2020, the Serbian economy rebounded strongly in 2021 followed by some deceleration in the first half of 2022. After decreasing in 2020, external imbalances started to widen in the second half of 2021, in particular due to high energy imports. Consumer price inflation surged from the second half of 2021, mostly driven by energy and food prices, which led the central bank to start tightening its policy stance. Banking sector stability was preserved and lending growth remained robust notwithstanding the phasing-out of pandemic-related liquidity-enhancing measures. The economic rebound and the reduction of fiscal support measures helped to substantially improve the budget balance in 2021, despite a further increase in capital spending. A slight increase in the unemployment rate in 2021 reflected in particular a rising labour market participation in the context of the economic recovery from the COVID-19 crisis.

There has been some progress with tax administration reforms and the privatisation of state-owned enterprises. However, other major reforms of public administration and of the governance of state owned enterprises (SOEs) continued to advance only slowly, prolonging long standing inefficiencies and increasing fiscal pressure. 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 regarding the tackling of corruption and judicial inefficiency, and in the enforcement of fair competition. Last years' recommendations have been partially implemented.

In the coming year, Serbia should in particular:

→ provided the economic recovery is well entrenched, plan a further gradual return to a deficit close to balance in the 2023 budget and in the medium-term fiscal framework;

→ adopt a credible and binding system of fiscal rules for entry into force in 2023;

→ contain overall spending on wages as a percentage of GDP and take preparatory steps towards an appropriately designed public sector wage system reform;

→ implement the time-bound action plan for the deployment of the new SOE ownership and management strategy to improve the governance of SOEs and reduce related fiscal risks.

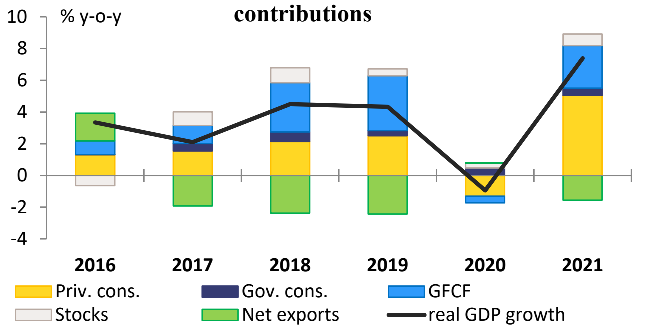
Economic governance

The authorities have remained committed to macroeconomic stability and economic reforms. The government took a series of additional fiscal measures in 2021 to support the rebound from the pandemic. Fiscal measures could however have been more targeted in the later support packages to preserve fiscal space. Structural reform implementation picked up in 2021 after having recorded a slow-down during the COVID-19 crisis. 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, especially as regards the e-fiscalisation and e-invoicing reforms. There also remain weaknesses in the way the state intervenes and manages its presence in the economy, in particular concerning state-owned enterprises (SOEs) as important reforms are delayed. Serbia has started the implementation of a new non-disbursing policy coordination instrument (PCI) with the International Monetary Fund (IMF) running from July 2021 to December 2023. The policy guidance jointly agreed at the July 2021 Economic and Financial Dialogue between the EU and the Western Balkans and Türkiye has been partially implemented.

Macroeconomic stability

After a strong rebound in 2021, economic activity decelerated in the first half of 2022. GDP growth averaged 3.6% in 2016-2019, followed by a relatively mild contraction by 0.9% in 2020, partly thanks to a substantial fiscal stimulus. In 2021, the Serbian economy rebounded strongly by 7.4% to well above its pre-COVID-19 crisis level. Real GDP growth was mostly driven by stronger private consumption and gross fixed capital formation, slightly offset by a negative contribution of net exports to growth. The rebound of private consumption was particularly supported by a new fiscal stimulus programme worth around 2% of GDP, accompanied by additional liquidity support measures of around 0.6% of GDP. On the supply side, the recovery was chiefly driven by services, construction and industry. In the first quarter of 2022, GDP expanded by 4.3% y-o-y, mostly driven by private consumption and higher inventories, followed by a 3.9% y-o-y expansion in the second quarter, mostly on the back of private consumption and government consumption Russia's war of aggression against Ukraine is set to hit Serbia's economy via various mostly indirect transmission channels, in particular via even higher energy and food prices fuelling inflation, reducing disposable incomes and private consumption. External trade, foreign direct investment and remittances are also set to be affected due to war-induced lower growth prospects in Serbia's main EU trading partners as well as new uncertainties and restrictions along Serbia's value-chains. After remaining broadly unchanged for most of the last decade, the income gap with the EU has slightly narrowed in recent years as per capita GDP in purchasing power standards rose to 44% of the EU average in 2021 from 41% in 2019 and 39% in 2009.

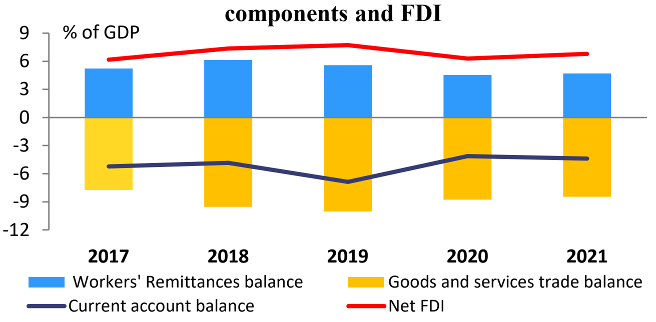
Graph 4.1: **Serbia - Real GDP growth and contributions**



Source: WiiW

After a decrease in 2020, the current account deficit has widened since the second half of 2021. Between 2016 to 2019, the current account deficit widened from around 3% to close to 7% of GDP, driven by growing merchandise trade deficits. It decreased substantially to 4.1% of GDP in 2020 mainly due to lower reinvested earnings and a lower goods trade deficit (mainly reflecting lower energy imports combined with relatively resilient exports, particularly supported by agricultural and mining exports). In the second half of 2021, the external deficit started to widen again, reflecting in particular higher energy imports and a rebound in reinvested earnings and dividends. As these effects were largely offset by a higher surpluses on the secondary income account (reflecting in particular a rebound in workers' remittances) and in the services trade balance, the deficit was contained at 4.4% of GDP in 2021, and was more than fully covered by net inflows of foreign direct investment that reached 6.8% of GDP in 2021 (after 6.3% of GDP in 2020). Increased energy imports, partly related to lower domestic electricity production following breakdowns in thermal power plants, and the continued increase in energy prices led to a further widening of the current account deficit to 9.6% of the GDP in the first half of 2022. 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 68.5% in 2021, reflecting in particular high public financing needs in 2020-2021. 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 2021 and, despite falling in early 2022, they still covered 4.5 months of imports in June 2022. High energy prices and substantial electricity imports in 2022 are expected to continue to put pressure on foreign exchange reserves.

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



Source: IMF and Eurostat

Table 4.1: **Serbia - Key economic figures**	**2013-18** average	**2019**	**2020**	**2021**
GDP per capita (% of EU-27 in PPS)[1)]	40	41	43	44
Real GDP growth	2.2	4.3	-0.9	7.4
Economic activity rate of the population aged 15-64 (%), total[1)]	65.0	66.9	66.4	70.3
female	*57.0*	*59.7*	*59.2*	*63.0*
male	*73.0*	*74.0*	*73.6*	*77.5*
Unemployment rate of the population aged 15-64 (%), total[1)]	17.4	10.9	9.5	11.4
female	*18.4*	*11.5*	*9.9*	*12.4*
male	*16.6*	*10.4*	*9.2*	*10.6*
Employment of the population aged 15-64 (annual growth %)	4.0	2.4	-0.2	2.6
Nominal wages (annual growth %)	3.1	10.5	9.4	9.4
Consumer price index (annual growth %)	2.9	1.8	1.6	4.1
Exchange rate against EUR	119.0	117.9	117.6	117.6
Current account balance (% of GDP)	-4.6	-6.9	-4.1	-4.4
Net foreign direct investment, FDI (% of GDP)	5.1	7.7	6.3	6.8
General government balance (% of GDP)	-2.4	-0.2	-8.0	-4.1
General government debt (% of GDP)	63.0	52.8	57.8	57.1

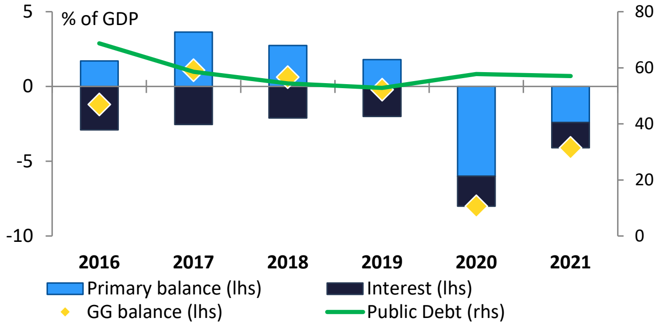
Notes:
1) Eurostat
Source: national sources

Consumer price inflation surged in the second half of 2021, gradually increasing further to around 12% year-on-year in the first half of 2022. Following a track record of low and rather stable inflation for seven consecutive years, consumer price inflation rose strongly in 2021 to an annual average of 4%. This was the result of a steady surge in the second half of the year, with the inflation rate reaching 7.9% year-on-year in December, well above the upper end of the central bank's target tolerance band of 3% ±1.5 pps. Inflation continued to rise further in the first half of 2022, reaching 11.9% year-on-year in June. The strong increase in headline inflation was mostly driven by food and energy prices while core inflation (excluding energy, food, alcohol and tobacco) rose more moderately to 3.5% by December 2021, but gradually accelerated to 5.5% in April 2022, 6.7%in June. The central bank reacted to rising inflation by tightening its policy stance, including by raising the key policy rate by a total of 150 bps between April and June 2022, thereby bringing it to 2.5%, i.e. above its pre-pandemic level. To stabilise the exchange rate in the face of alternating appreciation and depreciation pressures, the central bank continued to apply its policy of frequent interventions on both sides of the foreign exchange market.

The economic rebound and the gradual phasing out of fiscal support measures helped substantially improve the budget balance in 2021, notwithstanding strong increases in capital expenditure and substantial liquidity support to *Srbijagas*. Prudent fiscal policies in pre-COVID-19 led to budget surpluses in 2017 and 2018 and a fiscal outturn close to balance in 2019, which created fiscal space for sizeable crisis mitigation in 2020 and 2021. Following a deficit of 8.0% of GDP in 2020, the general government deficit almost halved to 4.1% of GDP in 2021 as revenue was boosted by the economic rebound. The deficit was thus close to the original 2021 target of 3.0% and substantially below the revised targets of 6.9% and 4.9% of GDP in the April and October amending budgets, despite very substantial new COVID-19 crisis support packages, as well as increased healthcare and capital spending and substantial liquidity support to *Srbijagas* at the end of the year. The actual direct fiscal cost of the additional 2021 support measures, which included wage subsidies, lump-sum cash transfers to all adults, benefits to the unemployed, sectoral support to hospitality and transport companies, as well as liquidity provision through guarantees, amounted to 2.2% of GDP, much below the 7.1% of GDP in discretionary fiscal support provided in 2020. The fiscal support could have been better targeted to the most vulnerable households and firms in order to improve its cost-effectiveness while saving fiscal space to address potential further needs at a later stage. Notwithstanding the crisis context, capital spending further increased from 5.4% of GDP in 2020 to a record level of 7.5% of GDP in 2021, also impacted by a further increase in defence spending, and was budgeted at 7.3% of GDP in 2022. The 2022 budget targets a further reduction of the fiscal deficit to 3% of GDP as confirmed by the fiscal strategy for 2023-2025 adopted in June 2022.

Public debt started to fall in 2021 following a moderate crisis-induced increase in 2020. The general government debt-to-GDP ratio had fallen from a peak of over 70% in 2015 to 53% in 2019 and thus moved closer to the ceiling of 45% laid down in the fiscal rules of the budget system law. It increased to 57.8% in 2020, as a result of the high crisis-induced deficit, and broadly stabilised at 57.1% in 2021, supported by the strong rebound of real growth and higher inflation. To cover financing needs, the debt management office succcessfully tapped international markets in 2021 by issuing three major Eurobonds worth a total EUR 2 750 million (including a EUR 750 million green bond) at favourable conditions in March and September. Financing conditions deteriorated in the first half of 2022 as indicated by low subscription rates at auctions of government debt on the domestic market.

Graph 4.3: **Serbia - Fiscal developments**



Source: National sources

Fiscal governance reforms have progressed unevenly. Revenue collection surpassed expectations in the two years preceding the COVID-19 crisis and has performed relatively well throughout the crisis and in the 2021 rebound, supported also by continuous improvements in the tax administration. Progress in addressing weaknesses in budget planning and implementation has been slow. Despite government commitments, public wage increases exceeded nominal GDP growth in three consecutive years, leading to an increase in the wage bill from 9.0% of GDP in 2017 to 10.5% in 2020. The share decreased to 10.0% in 2021 thanks to very high nominal GDP growth. The wage system reform has been postponed until 2025. However, a new central electronic public wage and employment registry is planned to be rolled out to most of the public sector (excluding military, security and higher education institutions) by end-2023 as an important preparatory step. In the absence of a comprehensive wage system reform, ad-hoc extraordinary increases for some categories of the public sector (such as the security forces) have been implemented.

While budget adoption broadly followed normal legislative procedures, the reform of fiscal rules is still pending. While the two 2021 amending budgets were adopted via urgent procedures, the 2022 budget was adopted in line with the normal legislative procedure, that included a series of parliamentary debates. 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. Moreover, there are no adequate sanctions in case of non-compliance nor effective enforcement mechanisms. Work on strengthening the fiscal rules has been postponed by another year in line with the 2021-2023 PCI programme with the IMF. The new fiscal rules are now expected to be finalised by end-October 2022 to be applied in the 2023 budget law.

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 terms of competitiveness and inclusive growth, thereby supporting real convergence with the EU.

Functioning of product markets

Business environment

Serbia has slowly improved its business environment as a number of heavy procedures have been simplified and costs reduced. In 2021, the number of registrations of new legal business entities rose by 5.0%, while the registrations of solo entrepreneurs rose by 15.3% (but still remaining 7.5% below the 2019 figure). In 2021, 5.7% fewer legal entities were deleted from the register than in 2020. The implementation of the action plan for the simplification of administrative procedures further advanced through the optimisation, digitalisation or discontinuation of administrative procedures as well as the establishment of a single public register of administrative procedures. However, administrative procedures are still numerous and burdensome especially for small and medium enterprises (SMEs). The law on foreign exchange transactions remains widely considered by the business community to be too restrictive in its design and unpredictable in its application.

The institutional and regulatory environment is still challenging. While the number of urgent parliamentary procedures decreased and the number of public consultations increased, public-private dialogue is yet to be systematically mainstreamed in the development of new legislation across all government institutions. Business-related laws and implementing legislation/decrees are not always duly communicated and announced to relevant stakeholders, with many 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 newly established centralised website for consultation procedures should make the consultation process more accessible and inclusive. Effective communication on this new tool is therefore crucial as well as the introduction of a mechanism to ensure inter-institutional coordination for effective use of the platform by line ministries and reinforced monitoring and evaluation of the consultation process to better measure the level of engagement of stakeholders. 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 96th out of 180 countries in the 2021 corruption perception index compiled by Transparency International, thus continuing the negative trend of deteriorating rankings compared to 87th in 2018, 91st in 2019 and 94th in 2020. Fair competition continues to be negatively affected by the large informal economy. The operational independence of the commission for state-aid and competition remains to be substantiated by a consistent and transparent track record, whereas the transparency of the work of the commission for protection of competition remains to be strengthened and decisions should be systematically published.

Some measures were taken to fight the informal economy. The entry into force of the Law on fiscalisation has initiated the introduction of the e-fiscalisation system, which allows for real-time tracking of the issuance of fiscal receipts, thereby enabling the Tax Administration to better monitor and counter tax evasion. Taxpayers fully adopted the e-fiscalisation system by 1 May 2022. The Law on e-invoicing, adopted in April 2021, entered into force on the 1 January 2022 and envisages a phased introduction of electronic invoicing, achieving full enforcement by 1 January 2023. The law is expected to reduce operating costs for companies and increase transparency. The single information system for inspections (eInspector), which aims to ensure better coordination among various inspections, standardisation of their work, and better availability of data, has continued to function with 44 inspectorates using the system. Further improvements in anti-money laundering/combating the financing of terrorism are ongoing.

State influence on product markets

State presence in the economy remains large amid persistent governance weaknesses. The government started implementation of the 2021-2027 strategy on state ownership and management of state-owned enterprises (SOEs) which aims at more sustainable and efficient management of SOEs. The strategy is incorporated as a reform measure in the ERP 2022-2024. A unified public database of companies in (partial) state ownership has been established, covering 314 entities. Classification of the companies according to certain criteria and decisions on ownership are expected as further steps of the strategy implementation. Governance of state-owned enterprises however 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, which is particularly pertinent in the energy sector. *Srbijagas* has received around EUR 500 million in budget loans in late 2021 and early 2022, while EPS is estimated to have suffered losses of up to EUR 400 million from October 2021 to March 2022. In December 2021, the CEO of EPS resigned following a power supply crisis. Overall, SOEs still account for around a sixth of value added and formal employment in Serbia. The share of administered prices remained broadly unchanged, at around 20% of the consumer basket. In view of strongly rising food and energy prices, the government has introduced a series of temporary price caps for basic food and fuel prices since the end of 2021/early 2022, which have regularly been prolonged or adjusted throughout the first half of 2022. Despite a solid legal framework on public procurement and state aid control, consistent implementation of these policies remains weak. Although reported state aid has decreased from 0.8% of GDP in 2019 to 0.6% in 2020, the latter provisional figure excludes COVID-19-related state-aid of around 3.3% of GDP and the track record of enforcing state aid rules is still uneven, while transparency is also lacking.

Privatisation and restructuring

Privatisation of SOEs recorded some progress while the restructuring of key utility companies is advancing slowly. Six companies were privatised in the course of 2021, including the petrochemical company *Petrohemija*, bringing the number of SOEs yet to be addressed through either bankruptcy or privatisation down from 68 to 62. The implementation of the strategy for banks with state ownership continued. The state remains in control of key entities in the insurance sector. The implementation of Serbia's action plan on gas unbundling adopted in May 2021 is progressively delayed. While some steps of the action plan were implemented regarding the unbundling of *Srbijagas* as planned, the certification of *Transportgas Srbija* as well as opening of the gas market at the wholesale level and third-party access to the gas transmission system are delayed. The decarbonisation of the energy sector remains a big challenge for the government. Serbia is currently working on four strategic documents in parallel: the national integrated energy and climate plan, an energy strategy, a programme for the implementation of the energy strategy and a study diagnostic of just transition.

Functioning of the financial market

Financial stability

Financial stability has been maintained. Supported by crisis-mitigation measures and the economic rebound, macro-prudential indicators remained sound. The banking sector's aggregate capital adequacy (regulatory capital to risk-weighted assets) was at 20.8% at the end of 2021, well above the minimum of 8% set by the central bank. Liquidity remained high at 37.7% (share of liquid assets to total assets) and 49.6% (share of liquid assets to total short-term liabilities) respectively at the end of 2021, also supported by the central bank's liquidity-enhancing measures. The profitability of the banking system improved slightly with an increase in return on assets (1.2% at the end of 2021 vs 1.1% at the end of 2020) and in return on equity (7.8% at the end of 2021, compared to 6.5% at the end of 2020). The non-performing loan (NPL) ratio decreased by 0.5 pps. year-on-year to 3.4% in the first quarter of 2022. The authorities have continued to address legacy NPLs in the portfolio of the Deposit Insurance Agency. The central bank and the government continued to implement their dinarisation strategy to boost the use of the local currency 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 2021 (to 38.3% and 40.3% respectively).

Access to finance

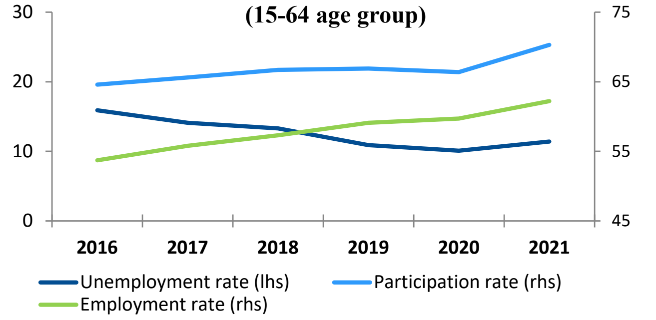
Access to finance was supported by COVID-19 crisis-mitigation measures. Foreign-owned banks continued to dominate the financial system, holding around six sevenths of banking system assets. The continuing consolidation of the banking system via mergers and acquisitions has further reduced the number of banks from 24 at the end of June 2021 to 22 at the end of June 2022. Favourable financing conditions, resulting inter alia from still relatively low interest rates and the government-backed guarantee schemes, have supported growth in lending. Credit activity expanded by 5.1%, 9.9%, 13.9% and 15.8%

for corporate loans and 9.2%, 10.8%, 10.7% and 9.8% for households y-o-y in September 2021, December 2021, March 2022 and June 2022, respectively. Credit growth was mostly due to liquidity and working capital loans and housing loans 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. The new Law on digital assets creating a regulatory framework for the use of cryptocurrencies and digital tokens in Serbia became effective at the end of June 2021.

Functioning of the labour market

The labour market has recovered from the impact of the COVID-19 pandemic, but structural problems remain. Strong economic growth in the years before the pandemic was reflected in continuously improving labour market indicators. Thus, prior to the COVID-19 crisis, activity and employment rates increased steadily, while the unemployment rate decreased. As an increased number of discouraged workers left the labour force in the early phases of the pandemic, the rate of unemployment decreased further in 2020 to 10. 5% (15-64), despite a simultaneous decrease in the employment rate to 59.7% (15-64). In 2021, the economic recovery started to unwind these impacts with the annual unemployment rate recording a slight increase to 11.4% as the pace of return of discouraged workers to the labour market initially exceeded the growth of employment. The activity rate increased by 3.9 pps. to 70.3% in 2021 while the employment rate grew by 2.5 pps. to 62.2%. Youth unemployment (15-24) decreased by 1.2 pps. to 26.4% in 2021. The share of informal employment, almost two-thirds of which was in agriculture, fell to 13.2% of total employment in 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 weigh on the functioning of the labour market. Based on the strategy on economic migration for 2021-2027, that aims at fostering circular migration by retaining workers and encouraging the diaspora to return to the country, an action plan for the period 2021-2023 was adopted in September 2021 followed in November 2021 by a decision to establish a working group for the implementation and monitoring of the strategy and action plan. The strategy is also incorporated as a reform measure in the ERP 2022-2024.

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



Source: EUROSTAT and Statistical Office (SORS)

Real wages have increased. Real wages rose by 5.2% in 2021 as average nominal wage increases by 9.4% were considerably impacted by rising inflation. The authorities have continued to gradually reduce the overall tax wedge by rising the non-taxable part of salaries from RSD 18 300 to RSD 19 300 as of 2022. 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 rose the minimum hourly wage by 9.4% in 2022. Around one in six registered employees receives the minimum wage.

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

Serbia is **moderately prepared** and has made **some progress** in coping 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. Small and medium-sized enterprises still face a number of challenges, including an uneven playing field as compared to large companies and foreign investors. Last years' recommendations have been partially implemented.

In the coming year, Serbia should in particular:

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

→ ensure a harmonised cost-benefit based approach for prioritising and monitoring all public infrastructure investment regardless of the source of financing, and apply to all projects the principles of competition, equal treatment, non-discrimination and transparency in public procurement and state aid procedures in line with the EU acquis;

→ 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; accelerate the implementation of the action plan on gas unbundling and decrease its energy dependence on Russia, in line with the REpowerEU communication

Education and innovation

Despite some progress, skills mismatches in Serbia remain high. Public spending on education stood at around 3.5% of GDP in 2020, below the EU average of 4.7%. Pre-primary school enrolment (age 3 to 5.5 years) remained around 64% in the 2020/2021 school year, while the compulsory preparatory pre-school programme and primary education is almost universal. The rate of primary graduates entering upper secondary education stood at 99.5% in 2020, while the share of early school leavers was 5.6% in 2020. Higher education attainment in the population aged 25-34 (ISCED levels 5-8) stood at 32.6% in 2020. The authorities are gradually updating both the general and vocational pre-university curricula to make them more relevant to labour market needs, at the same time consolidating the national qualification framework (NQF) set-up. The adoption of new qualification standards and/or modernisation thereof has continued at slow pace and should accelerate, with more focus on higher education. Efforts have been made to expose students to work-based learning under both upper secondary and higher vocational education and training (VET). As participation rates in life-long learning are traditionally low (4.8% in 2021), the offer of formal and informal learning would usefully be further diversified and promoted among both working and non-working adult population.

Research and development (R&D) spending remains low at around 0.9% of GDP. Government funding was stable at around 0.4% of GDP, providing close to half of the total R&D financing in 2020. 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 a strategy for the development of start-up ecosystems (2021-2025) in December 2021 to create a national strategic framework to increase the number and quality of domestic start-ups.

Physical capital and quality of infrastructure

Investment has continued increasing, with significant emphasis on road and rail infrastructure, but infrastructure gaps remain. Public investment continued its upward trend while private investment rebounded strongly in 2021 after a crisis-induced decrease in 2020. The economy is attracting significant foreign direct investment (FDI), well above the region's average as a percentage of GDP. FDI inflows reached EUR 3.6 billion in 2021 and surpassed their pre-pandemic record from 2019 in absolute terms. FDI expressed as percentage of GDP grew from 6.5% in 2020 to 7.2% in 2021. Outward investments of Serbian companies abroad remained very modest at EUR 238 million. The share of total investment in the economy has reached 22.5% of GDP in 2021, up from 17.1% in 2016. However, physical infrastructure needs further upgrading and expansion. A continued high level of public investments is planned in 2022, particularly in roads and railways but also environmental investments. However, increased costs due to global developments might impact the implementation of planned projects.

The institutional framework for public investment is weak. The 'user pays' principle is not sufficiently applied when it comes to maintaining existing infrastructure and implementing new infrastructure investment plans. The 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 projects of 'special importance' to be exempted from public procurement rules. Public procurement rules are not always fully complied with, as also evidenced by an increasing number of exemptions and irregularities, and they are not always fully compatible with EU standards (particularly in the case of intergovernmental agreements).

The energy sector remains largely inefficient and highly polluting; the regulatory reform progresses slowly. Serbia started to adopt and implement implementing legislation for its new energy laws adopted in April 2021. Serbia should finalise work to start implementing its new market based auction scheme to support production of energy from renewable sources. A growing share of renewables should help to decarbonise the sector and attract new investments. The economy is increasingly negatively impacted by an inefficient energy sector based on low quality lignite, resulting in higher energy volume imports for protracted periods at a moment of highly increased international energy prices. Electricity tariffs for households are regulated significantly below market prices and have not allowed for the necessary investment in infrastructure even before the surge of wholesale market prices since the second half of 2021. Serbia's dependence on its single gas supplier Gazprom and Russian majority control of Serbia's gas infrastructure and oil industry continued. Full implementation of the action plan for the restructuring of state-owned enterprise *Srbijagas* is still pending. The Balkan stream gas pipeline was finished but the regulatory regime has yet to be brought in line with EU legislation. Works on the EU-supported gas interconnector between Serbia and Bulgaria started in January 2022.

Digitalisation remains one of the government's top priorities. In line with the 2020-2022 e-government development programme and related action plan, 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 as well as fostering the use of open data. The e-government national portal was upgraded with various new services, serving as a one-stop shop for e-government services and as a central point of access for business and citizens alike. Digitalisation of government services is further upgraded with adoption of the 2020-2025 artificial intelligence strategy and its implementing action plan for 2020-2022, as well as with the setting up of a Research and Development Institute for Artificial Intelligence and the 'Smart Serbia platform' for secure collection and processing of data from various public sources. Progress has been made on public access to institutional data thanks to the national open data portal (making data available from 109 public institutions so far). The robust growth of the information and communication sector continued, with exports of ICT services in 2021 valued at EUR 1 857 million, an increase by close to 30% from 2020.

Sectoral and enterprise structure

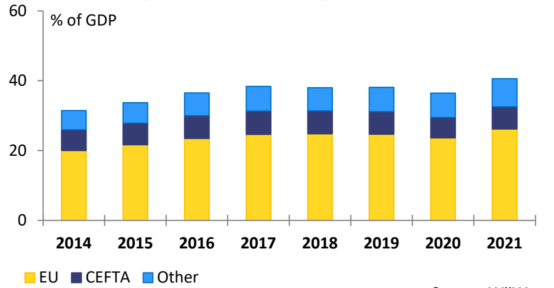
Construction and some services have increased their weight in the economy. Services dominate the economy, providing more than 60% of total value added. Sectors like transportation, retail trade, and information and communication – the last increasingly geared towards exports – benefited from strong growth before the COVID-19 crisis. Reflecting a new investment cycle, the construction sector increased its share in GDP from 3.0% in 2013 to 5.4% of GDP in 2020, strongly supported by capital investments in infrastructure. The weight of the agricultural sector has broadly stabilised at around 6% of GDP since 2017 after a downward trend over the preceding few years in line with the growing shares of manufacturing and services. The share of agriculture in total employment continued to fall steadily from about 20% in 2014 to around 17% in 2017 and further to around 15% in 2021, 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 Serbian economy. They provided close to 60% of total employment and turnover in the economy, and around 60% of the value added in 2020 Statistical Office of the Republic of Serbia, 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 about 64% of total corporate loans in March 2022. Their cost of borrowing has declined recently, but is still disproportionately higher than that of large companies. SMEs still face a number of challenges, including an unpredictable business environment and lack of non-bank financing. SMEs often face an uneven playing field: large enterprises and foreign investors often have direct lines of communication with 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.

Economic integration with the EU and price competitiveness

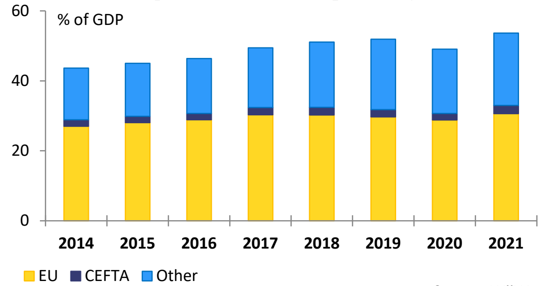
Economic integration with the EU remained high. The EU remains Serbia's biggest trading and investment partner, accounting for 60.3% of its total trade and for 47.8% of foreign direct investment inflows in 2021. Total bilateral trade between the EU and Serbia increased significantly by 23.6% year-on-year from EUR 24.5 billion in 2020 to EUR 30.3 billion in 2021. Imports to Serbia from the EU grew at the same pace as exports to the EU, with the EU registering a surplus of EUR 2.4 billion in 2021. After the EU, Serbia's main trade partners in 2021 were China (8.9% of total trade), Russia (4.7%) and Bosnia and Herzegovina (4.7%). Trade with the signatories of the Central European Free Trade Agreement (CEFTA) represented 15.8% of total exports and 4.4% of total imports in 2021. Notwithstanding ongoing remedy efforts via online health and customs clearance, transit facilitation through international cooperation agreements and the regional green corridor (EU, CEFTA, Western Balkans and Türkiye), there are still significant bottlenecks at border crossing points with neighbouring EU countries; these hamper further trade with the EU and transport facilitation with the EU. Trade openness, after a steady increase from 92% of GDP in 2014 to 111.5% in 2019, decreased to 103.9% in 2020 due to the crisis, before rebounding strongly to 115.6% in 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 rate remained broadly stable in 2021 and the first half of 2022 as some appreciation pressures in the summer of 2021 and some depreciation pressures at the beginning of Russia's war of aggression against Ukraine in the first quarter of 2022 were successfully neutralised by the central bank. The CPI-based real effective exchange rate (REER) depreciated by 9% over the period 2014-2016 before appreciating by 10% over the period 2017-2021. Serbia's cost competitiveness improved in the period

2014-2016 with the unit labour cost (ULC) based REER depreciating by a cumulative 8% and then deteriorated in the period 2017-2021 with the REER appreciating by a cumulative 31% (of which 8% in 2020 and 4% in 2021). The latest IMF external sustainability assessment considered the exchange rate broadly consistent with fundamentals.

5. TÜRKIYE

5.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

The Turkish economy is **well advanced**, but made **no progress** over the reporting period. Serious concerns persist over the continued proper functioning of Türkiye's market economy as there has been backsliding on important elements, such as the conduct of monetary policy and the institutional and regulatory environment.

The economy recovered strongly from the COVID-19-crisis, growing by 11.4% in 2021 and more than 7% in the first half of 2022, despite the fallout of Russia's invasion of Ukraine. The overly loose monetary policy and lack of policy credibility have weakened the lira and drove the official inflation to a two-decade high of more than 80%. Higher prices for imported commodities widened external imbalances, which remain a major vulnerability in a situation of increased uncertainty and low level of international reserves. Budget execution outperformed plans but government debt increased and fiscal policy has come increasingly under pressure, burdened by unsuccessful attempts to curb rising inflation and underpin the domestic currency.

The institutional and regulatory environment remains fragile, particularly as regards the predictability, transparency, and implementation of regulations. Some important steps were taken in order to improve the resolution of commercial disputes. Despite its gradual decline, the informal sector still accounts for a significant share of the economic activity. State intervention in price-setting mechanisms persists. The provision of State aid lacks proper implementation rules, enforcement and transparency. The banking sector remained largely stable and capital adequacy above the regulatory requirements. Non-performing loans decreased and profitability improved, but dollarisation and financial stability risks increased. The labour market recovered from the pandemic, but deep-seated structural challenges, such as a huge gender gap, a high share of youth unemployment, and wide regional disparities remain.

The Commission's recommendations from 2021 were not fully implemented and remain valid. In order to improve the functioning of the market economy, Türkiye should in particular:

→ tighten monetary policy and restore the functional independence of the central bank in order to reduce inflation and inflation expectations;

→ rebalance the policy mix and use some of the available fiscal space in 2022 to cushion the impact of adverse shocks through targeted support to vulnerable households and firms;

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

→ incentivise the labour market participation of women and improve the transition of young people into the labour market.

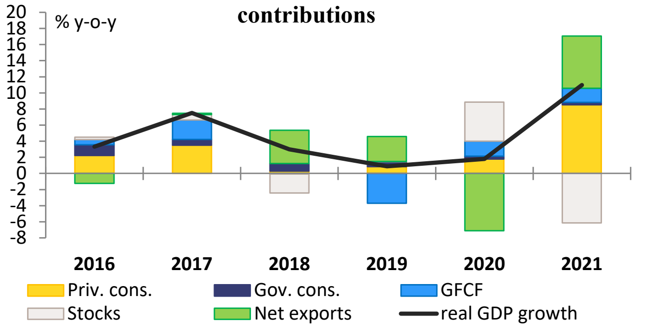
Economic governance

An overly loose monetary policy has fuelled record-high inflation and strained economic fundamentals. Since September 2021, monetary policy took a turn towards a much more expansionary stance, triggering a steep depreciation of the lira and significant increase in inflation and inflation expectations. Attempts to strengthen the lira and curb the rising inflation with the help of other policy instruments have been largely unsuccessful, exposing economic policy inconsistencies. Fiscal policy, in particular, has come increasingly under pressure. The frequent changes in the management team of the central bank and in the statistical institute have undermined policy credibility further and are a cause of serious concern. The policy guidance set out in the conclusions from the Economic and Financial Dialogue of July 2021 has been partially implemented.

Macroeconomic stability

The Turkish economy recovered strongly from the crisis and continued to grow in the first half of 2022 despite multiple challenges. Economic growth reached 11.4% in 2021, supported by base effects and a rebound of both domestic and external demand, bringing the average growth in the last 5 years at close to 5%. Despite growing inflationary pressures, a recovering labour market and deeply negative real interest rates sustained buoyant household consumption, which grew particularly strongly in the first half of 2022 and returned above trend for the first time since the 2018 currency crisis. Net exports had a sizeable positive contribution to growth as the strong export performance continued unabated, while imports were suppressed by the depreciation of the lira. Investment contracted in the second half of 2021, remaining below its level 5 years earlier, while stocks accumulated in the COVID-19 crisis continued to unwind fast. Although decelerating in early 2022, the growth momentum remained buoyant despite the fallout of Russia's invasion of Ukraine. However, heightened volatility and uncertainty took a toll on economic sentiment and sapped the otherwise very strong manufacturing activity. Türkiye's relatively strong performance in the crisis strengthened its real convergence, with per capita GDP in purchasing power standards reaching 64% of the EU average, although remaining below its 2015 high of 68%.

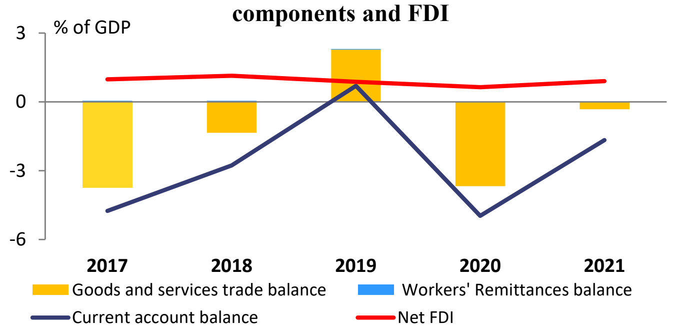
Graph 5.1: **Türkiye - Real GDP growth and contributions**



Source: WiiW

The large negative terms-of-trade shock increased external imbalances, which remain a major vulnerability in a situation of higher uncertainty and weak buffers. The narrowing of the current account deficit to 1.7% of GDP in 2021, close to the average in the last 5 years, turned out to be short-lived as strong increases in international commodity prices, for energy in particular, reversed this trend at the end of the year. The rise to record high levels in the exports of goods, the recovery in service exports, and suppressed import volumes could not offset these price effects. External vulnerabilities are exacerbated by the reliance on short-term external finance and the very high sovereign risk premium. The five-year credit default swap started increasing, from an already high level, since the central bank changed its monetary policy in September 2021 and went further above 900 bps in July 2022, reflecting the tightening of global financial conditions, Türkiye's weakened policy credibility and economic exposure to the fall-out from the war in Ukraine. The low level of gross official foreign exchange reserves and the higher share of non-core foreign currencies in it adds to external vulnerabilities. The external debt ratio declined somewhat to 55% of GDP in 2021 as the economy recovered, largely unchanged in the last 5 years, but remains very sensitive to the depreciation of the lira. The banking sector, in particular, has so far had no difficulty rolling over its short-term external debt while the non-financial sector has a positive short-term net foreign exchange position, which are important factors attenuating external vulnerability.

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



Source: IMF and Central Bank of Türkiye

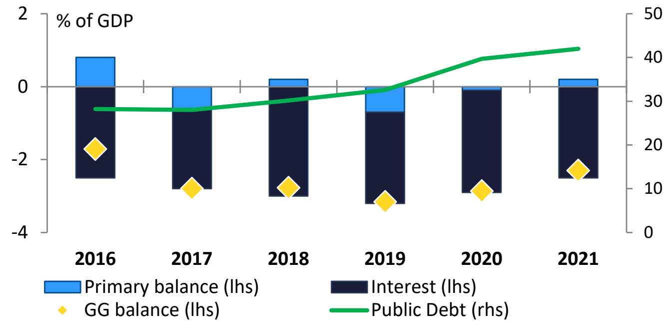
Table 5.1: **Türkiye - Key economic figures**	**2013-18** average	**2019**	**2020**	**2021**
GDP per capita (% of EU-27 in PPS)[1)]	65	59	61	64
Real GDP growth	5.6	0.8	1.9	11.4
Economic activity rate of the population aged 15+ (%), total	51.1	52.9	49.1	51.4
female	*31.5*	*34.3*	*30.8*	*32.9*
male	*71.2*	*71.9*	*67.8*	*70.3*
Unemployment rate of the population aged 15+ (%), total	10.3	13.7	13.1	12.0
female	*12.8*	*16.4*	*14.8*	*14.7*
male	*9.2*	*12.4*	*12.4*	*10.7*
Employment of the population aged 15+ (annual growth %)	3.2	-2.3	-4.8	7.9
Nominal wages (annual growth %)	13.9	26.2	18.0	19.3
Consumer price index (annual growth %)	9.9	15.2	12.3	19.6
Exchange rate against EUR	3.60	6.35	8.03	10.45
Current account balance (% of GDP)	-4.0	0.7	-5.0	-1.7
Net foreign direct investment, FDI (% of GDP)	1.1	0.9	0.6	0.9
General government balance (% of GDP)[1)]	-1.5	-3.2	-2.9	-2.3
General government debt (% of GDP)	28.8	32.6	39.7	42[2)]

Notes:
1) Eurostat
2) State government
Source: national sources

The overly loose monetary policy and lack of policy credibility have weakened the lira and drove inflation to a two-decade high. In the last quarter of 2021, the central bank lowered its key policy rate by 500 bps. to 14%, and further to 13% in August 2022, despite high and growing inflation. Real interest rates turned deeply negative, triggering a strong depreciation of the lira and market instability. The lira's slide was temporarily arrested by sizeable central bank interventions and the introduction of a special scheme protecting the foreign exchange value of lira time deposits. However, the local currency depreciated further since the start of Russia's war against Ukraine and consumer inflation reached 80.2% y/y in August. Food and energy prices increased markedly, affected by global trends as well, despite the authorities' administrative and tax policy efforts to soften their surge. Inflationary pressures firmed up and became more generalised, with producer prices rising 144% y/y in August. Monetary policy has become increasingly inefficient as market interest rates have largely decoupled from the central bank policy rate, providing fertile ground for continued volatility.

The budget balance was lower than targeted but fiscal policy has come increasingly under pressure by the rising inflation. Since the beginning of the pandemic, budget execution has consistently over-performed. At around 2.8% of GDP in 2021, the central government deficit was significantly below the revised 2021 target and the 2020 deficit (both at 3.5%). The general government deficit declined further from 2.8% in 2020 to 2.3% of GDP in 2021. Total revenue fell 1.5 pps. to 28.2% of GDP due to the changed GDP structure towards less revenue-rich net exports. Total expenditure declined by 2.0 pps. as reduced pandemic-related budget support and high inflation supressed compensation of employees and current transfers. Interest payments remained elevated at 2.6% of GDP, reflecting the strong depreciation of the lira, while capital expenditure increased slightly, although remaining far below its historic average. In an attempt to cover some of the surging energy costs, budget lending and transfers, mainly to the state energy company BOTAŞ, shot up at the end of 2021, and continued apace in 2022. The 2022 budget targets a budget deficit of TRY 278.4 billion (3.5% of GDP); although the headline target seems achievable, it is based on unrealistic macroeconomic assumptions and was already outdated at the time of its adoption. The budget did not take into account a number of measures with significant budgetary impact both on the revenue and the expenditure side, trying to address the rising energy costs, limit the general price surge, and support the value of the lira. A budget revision was proposed in June, increasing significantly revenue estimates and expenditure plans, while preserving the deficit target, and the medium-term macroeconomic framework was updated in early September. Debt vulnerabilities and fiscal risks increased. The much weaker lira pushed government debt up to 42% of GDP in 2021, despite the relatively small budget deficit and debt management efforts. Debt composition worsened with a higher share of foreign-currency-denominated bonds. Fiscal policy has also become more opaque as the new measures to support the holding of lira deposits have brought not only direct costs to the budget, but also potentially significant contingent liabilities depending on exchange rate dynamics.

Graph 5.3: **Türkiye - Fiscal developments**



Source: National sources

The macroeconomic policy mix has largely focused on the pursuit of growth but undermined financial and economic stability. The policy mix has underpinned a robust economic recovery in 2021 and in the first half of 2022, but an overly loose monetary stance led to very high inflation, weakened the lira and worsened country risks. Attempts by fiscal policy to remedy some of these negative consequences came at an increased budgetary cost, higher government debt, and rising fiscal risks. In addition, institutional weaknesses and low policy credibility continue undermining the effectiveness of the policy mix.

Functioning of product markets

Business environment

Türkiye's institutional and regulatory environment remains fragile, although some actions were taken to improve dispute settlement. Starting a business is still relatively cumbersome, while market exit has also remained costly and time-consuming, with a low recovery rate. The number of newly established businesses increased by 8.3% in 2021. In parallel, the number of liquidated companies increased significantly by 22.5% while the number of closed ones by 5.6%. Türkiye has taken some positive steps by facilitating the setting-up of specialised courts, ratifying the Singapore Convention for international commercial disputes, bringing changes in the concordat regime and providing online access to court decisions. The authorities also introduced new modalities for the financial restructuring regime. Even though alternative dispute resolution mechanisms have been promoted, commercial judicial processes are slow, and a large backlog of commercial court cases remains. Türkiye still lacks a systematic consultation mechanism with business organisations and social partners during the preparation of new legislation.

Türkiye is at an early stage of applying the EU *acquis* and European standards in the area of judiciary. Major issues identified in previous reports, in particular the systemic lack of independence of the judiciary and systemic violations of human rights, remained unaddressed (see Chapter 23) and serious backsliding continued in the reporting period. Intellectual property right enforcement remains very weak. According to Europol, Türkiye is the second largest source country of pirated products affecting the EU single market and of counterfeit products seized at the EU's external borders (See Chapter 7). The acquisition and management of companies under the trusteeship of the Savings Deposits Insurance Fund (SDIF) remains non-transparent. Moreover, the number of companies managed under the trusteeship of SDIF is still high. As of the end of June 2022, the management of 677 companies based in 36 provinces across Türkiye with a total asset value of TRY 97.2 billion (1.0% of GDP) and with a total of 32 699 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 and well above the OECD average. The share of unregistered employment fell to 25.8%, while in the non-agricultural sector it was 16.5% in the first quarter of 2022. The government pursued its efforts to implement the Action Plan and Strategy for the fight against the informal economy (2019-2021). With this action plan, the Revenue Administration aimed most of all to increase the level of voluntary compliance, strengthen audit capacity, review and regulate the legislation, enhance interagency data sharing and increase awareness. However, the plan lacks performance indicators to track its implementation progress.

State influence on product markets

The state expanded its intervention in the price-setting mechanism of key sectors. More than a quarter of the consumer basket is composed of goods whose prices are set or heavily influenced by public authorities (including through price limits and tax rate adjustments). Since July 2021, the annual increase in residential rent was limited to 25%. The authorities have continued using a sliding scale system to curb the inflationary pressures coming from oil prices. Furthermore, from the beginning of 2022, the Energy Market Regulatory Authority has implemented an electricity tariff system based on the level of consumption (block tariffs). It has been also authorised to set up a tariff for vulnerable consumers before the gradual lifting of some subsidies. Meanwhile, the regulators have continued carrying out intensive price audits to investigate alleged unfair pricing and stockpiling practices. The start of the implementation of a 2% accommodation tax has been put on hold until 2023 on the grounds of the impacts of the COVID-19 outbreak and the deterioration of the economic situation. As part of the efforts to fight against inflation, in early 2022, the VAT was also reduced for almost all food products from 18% to 1% and for hygiene products from 18% to 8%. The delivery of the COVID-19 vaccines is still subject to a 1% VAT until 31 December 2022.

State aid transparency and control remained weak. Legislation to implement the State aid law has not been adopted. However, the legislative framework was amended by a presidential decree establishing a Directorate General for State Aids responsible for evaluating State aid proposals and recommending proposals, change, or cancellation of new State aid schemes. Türkiye has not formally set up a comprehensive State aid inventory or adopted an action plan to align all State aid schemes with the EU *acquis*. The current structure of State aid control is considered neither independent nor operational (see Chapter 8). As of September 2022, the committed investment amount for the supported 45 projects reached TRY 335 billion (2.7% of GDP). The amount of investment incentive has doubled with a single project (worth TRY 145.2 billion) aiming to support the drilling activities in the Black Sea. However, as it is the case for the general incentive scheme, Türkiye failed to publish data concerning the actual support granted to these projects. Small and medium enterprises (SMEs) benefit from numerous support measures and initiatives, for which there is however a lack of systematic monitoring. The SME Development Organisation of Türkiye (KOSGEB) conducted evaluations on five support programmes under its mandate and published them on its website.

Privatisation and restructuring

The sovereign wealth fund expanded further its presence in the economy, while the scope of privatisation remained limited. The privatisation receipts increased marginally to USD 413 million in 2021. The Privatisation Administration has targeted the privatisation of electricity generation plants, ports and real assets in 2022. The Turkish Wealth Fund (TWF) holds shares in major companies in the financial (including large-scale state-owned banks and Borsa Istanbul, consolidated public insurance companies), telecommunications, petrochemicals, real estate, mining, agriculture, and transport sectors. In March 2022, the TWF increased its share to 61.68% of Turk Telekom and thus became its majority stakeholder and the largest player on the telecom market (See Chapter 8). In an effort to strengthen public banks and ensure economic and financial stability, TWF has increased the core capital of public banks. The TWF continues to be exempted from various taxes, charges and rules related to (publicly held) corporations' transactions, merger and acquisition, unlawful exercise of control, and shareholders' rights. TWF total assets increased to TRY 2.2 trillion (44% of GDP) at the end of 2020, up from TRY 1.5 billion (35% of GDP) in 2019.

Functioning of the financial market

Financial stability

The banking sector remained largely stable, although facing some legacy issues and rising financial stability risks. The banking sector remained well capitalised. Since September 2021, the regulatory capital adequacy ratio increased by 0.7 pps. to 18.0% and core capital by 1 pp. to 14% in July 2022. Capital adequacy of state-owned banks improved following a large capital injection (TRY 51.5 billion) by the Türkiye Wealth Fund in early 2022, but it has deteriorated markedly since April and remained well below the average for the banking system. Some prudential measures have remained relaxed to protect capital adequacy ratios, such as the use of a 252-business day rolling average FX rate and the suspension of mark-to-market accounting rules. The non-performing loans ratio declined further to 2.4% in July (1.7% in state-owned banks) and loan-loss provisioning went up to 82.5% for the banking system (88.3% in state-owned banks). At around 10%, however, the share of stage 2 loans under close monitoring remained elevated. Bank profitability improved and the average return on assets reached 2.0% and the return on equity 25.2% in July, but they remained markedly lower in state-owned banks and negative in real terms. Deposit dollarisation increased further, peaking at 67.1% at the end of 2021, before subsiding to 54.9% in August. However, the underlying dollarisation remained higher if FX-protected deposits, representing another 16% of all deposits, are taken into account. This new financial instrument presents particular challenges and risks not only to the government budget, but to financial stability as well in case of a sudden shift back to foreign exchange-denominated deposits.

Access to finance

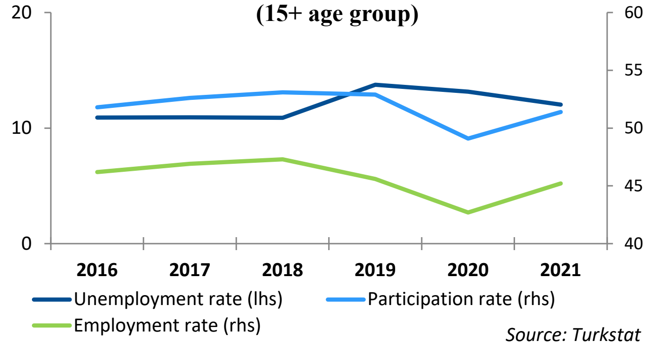
Prudential policies have shifted to tame credit growth. Most of the financial stability and credit stimulus measures, adopted in the context of the pandemic, were lifted in 2021 and credit growth decelerated strongly as a result. Lending remained subdued in early 2022, declining in real terms mostly in the households segment due to the very high inflation rate. However, loans to non-financial companies accelerated strongly, prompting the central bank to introduce macro-prudential measures to tame its growth and direct it to uses and sectors deemed more beneficial to economic and financial stability. Consumer loans were curtailed and a 10% reserve requirement that was later increased to 20%, was imposed on the banks' and financial companies' lira-denominated commercial loans extended since April 2022, with a penalty for banks with a loan growth since the beginning of the year above 20% by end-May. Loans to SMEs, export, investment, tradesmen, agriculture, and some other categories were exempted from this rule. As part of their 'liraisation' efforts, in June the authorities introduced new revenue-indexed bonds and restricted access to lira-denominated loans to companies with significant FX cash assets (including gold and FX deposits). Total credit stood at 62% of GDP in June, declining somewhat since the beginning of the year. Total bank assets increased from 121% of GDP in 2020 to 127% in 2021, while the share of foreign-owned banks in total banking sector assets increased from 25.1% to 25.9%. After being stable throughout most of 2021, the USD and lira interest rate spreads between commercial loans and deposits have increased markedly since the end of November.

Functioning of the labour market

The labour market has recovered from the pandemic but deep-seated structural challenges remain. The strong economic growth lifted the labour market and the number of jobs reached new heights in 2022. The activity and employment rates increased markedly, to pre-crisis levels. Job creation was particularly strong in services and industry, extending its gains in early 2022, while the sector of agriculture shed jobs. The number and share of workers without social security registration declined further to their lowest level on record in early 2022. Unemployment declined from its peak and the headline unemployment rate went down to single digits in June for the first time since 2018. The labour market slack, however, remains structurally high, as evident by the elevated composite measure of labour underutilisation at nearly 20%, which takes into account time-related underemployment and potential labour force. Despite the economic rebound, the gap between male and female employment remained significant, with female activity and employment rates less than half of male. In June, almost a quarter of all young people (15-24 years) were not in employment, education or training and the youth unemployment rate remained very high, although falling below 20% in the second quarter of the year.

Regional labour market disparities have declined but are still significant, with the unemployment rate across different regions ranging from 5.8% to 29.8% in 2021. The wage policy was procyclical as the minimum wage nearly doubled in 2022, after two hikes – of around 50% in the beginning of the year and another one of close to 30% in early July.

Graph 5.4: **Türkiye - Labour market trends (15+ age group)**



Source: Turkstat

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

Türkiye has a **good level of preparation** and made **limited progress** in achieving the capacity to cope with the competitive pressure and market forces within the EU. Despite some progress in improving vocational training, the mismatch between the education system and labour market needs persists. Expenditure on research and development continued to increase at a very slow pace and remained well below the government's target. Investment activity weakened in the second half of 2021. Progress continued with regard to the diversification of energy supplies and increasing the share of energy generated from renewable sources. The extension of local content requirement practices in the renewable energy generation sector raises concerns. Türkiye removed some of the additional custom duties; however, extensive deviations from its obligations under the EU-Turkey Customs Union hinder bilateral trade.

The Commission's recommendations from 2021 were not fully implemented and remain valid. In order to improve competitiveness and support long-term growth, Türkiye should in particular:

→ continue increasing enrolment in education (especially for pre-education), improve vocational education and training and better adapt education and training to labour market needs;

→ deepen natural gas market reform and revise the natural gas market law to ensure compatibility with the EU's Third Energy Package;

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

Education and innovation

Türkiye has made some progress towards improving vocational education. Total expenditure on education stood at 5.4% of GDP in 2020, representing a real increase of 4.5% year-on-year. Government spending was around three quarters of it or 4.0% of GDP in 2020, decreasing by 0.4 pps. from 2019. The highest increase in education expenditure per student was observed in tertiary education. In the 2020-2021 school year, net enrolment rates decreased for primary (first 4 years) and for lower secondary education (second 4 years), whereas it has increased for upper secondary (final 4 years) and tertiary education. The COVID-19 pandemic had a negative impact on pre-school attendance (See Chapter 26). Türkiye continues to score poorly in educational attainment in the Gender Gap Index calculated by the World Economic Forum, ranking 101st of 156 countries in 2021. The proportion of students in vocational and technical secondary education fell further to 27.4% in 2021 (from 35.9% 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 13.7%, up from 10.1% five years ago. There is a persistent mismatch between the requirements of the labour market and the skills acquired in the education system. With the adoption of the National Youth Employment Strategy and Action Plan, Türkiye is increasing its efforts to improve vocational training and to reduce the NEET rate to 20% by end of 2023.

Investment on research and development (R&D) continues to increase, but Türkiye still lags in the EU innovation scoreboard. R&D expenditure increased gradually from 0.8% of GDP in 2013 to around 1.1% in 2020, although remaining below the government's target of 1.8% by 2023 and EU average of 2.3%. With the largest share in R&D expenditures (65%), the private sector continues to be the main driver behind the R&D in Türkiye, although there remains scope for strengthening its cooperation with research institutions. Türkiye adopted its first National Artificial Intelligence Strategy (2021-2025) in August 2021, showing its growing interest to shift towards innovation-driven economy. In the Global Innovation Index 2021, Türkiye's overall score has improved significantly over a year, ranking in the 41st place among 132 countries. However, according to the EU innovation scoreboard, Türkiye's innovation performance relative to the EU declined markedly from 74% in 2020 to 55% in 2021. While the number of domestic patent applications increased by 2.9% in 2021 as compared to 2020, Türkiye's total international patent applications decreased further by 13.1% in the same period. The implementation of Türkiye's action plan to boost the national research and innovation capacity contributed positively to Türkiye's performance in Horizon 2020. In October 2021, the European Commission and Türkiye signed the association agreement for Horizon Europe for the period 2021-2027.

Physical capital and quality of infrastructure

Despite continued weakness of construction, investment rebounded somewhat. Investment activity was strong in the first half of 2021 but has been rather subdued since then. Total investment accounted for 28.1% of GDP in 2021, close to the historic average. The share of construction in total investment fell further to 43% in 2021 – the lowest in more than a decade. The government announced a series of new loan schemes in May 2022, to revive the real estate sector. The share of investment in machinery and equipment, on the other hand, reached new highs, increasing further to 46% in 2021. Public investment had been broadly stable for years at close to 4% of GDP but fell sharply below 3% since 2019.

Although diversification of energy supplies improved and the use of renewables increased, competition and pricing mechanism issues in the energy sector persist. Limited progress was made on natural gas market reforms, as the unbundling of the state-owned gas company BOTAŞ was once again suspended. As a result, BOTAŞ remained vertically integrated comprising gas trade, pipeline and LNG infrastructure and retained its dominant market position, thus hindering a transparent, cost-reflective, and non-discriminatory pricing. Türkiye continued to be a reliable transit country ensuring the smooth operation of the Trans Anatolian Pipeline (TANAP), which as part of the Southern Gas Corridor (SGC) transmits natural gas from Azerbaijan to Europe by connecting to the Trans Adriatic Pipeline (TAP). As regards renewable energy, Türkiye pursued its efforts to maximise the use of domestic and renewable sources and raised the share of renewable energy in the country's installed power mix to 53% at the end of 2021. Private investments kept driving the growth in renewable installations, on the back of a preferential feed-in-tariff extended until 2030. The local content requirement practices in Türkiye continue to raise concerns as they contradict WTO and the EU-Turkey Customs Union rules and affect the EU's and other international companies' competitiveness on the Turkish energy market.

The COVID-19 pandemic has been an important accelerator of the digital transformation of the Turkish economy. Although its share in GDP remains low at 2.8 % in 2021, the sector of information and communication grew significantly over the last two years, by 14.5% and 21.8% respectively in 2020 and 2021. The number of broadband internet subscribers reached 88.2 million in 2021, up from 82.4 million in 2020 and 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 90.7% in 2020 (88.3% in 2019) to 92.0% in 2021. Over the same period, internet usage by individuals aged 16-74 also increased from 79.0% in 2020 (75.3% in 2019) to 82.6% in 2021. The share of individuals using e-government services reached 58.9% in 2021. The number of 4.5G subscribers increased to 80.2 million in 2021, of which 61.9 million were active users. The digitalisation in business has also accelerated, with 14% of the enterprises having started or increased their e-sales during the COVID-19 pandemic.

Sectoral and enterprise structure

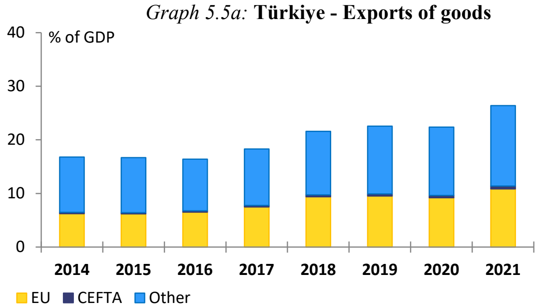
The services sector continued to dominate the economy, having recovered significantly with the lift of pandemic-related restrictions as of the second quarter of 2021. Services sector activities increased by double-digits in 2021, with the accommodation, entertainment, and information and communication sectors recording the fastest pace of growth. Financial and insurance activities contracted as credit activity decelerated. Services accounted for 55.3% of employment in 2021, down by 0.6 pps. from their 2020 level. Previously one of the main sectors driving economic growth, the construction sector has slowed down since 2018, with a share of GDP falling to 5.1% in 2021. However, the construction sector' share in total employment increased slightly to 6.2%, up by 0.4 pps. from its 2020 level. Although its share of GDP decreased from 6.7% in 2020 to 5.5% in 2021, agriculture continues to be an important sector, employing 17.2% of the workforce (down by 0.5 pps. from its 2020 level).

Small and medium-sized enterprises (SMEs) are the backbone of the economy. SMEs employ around three quarters of Türkiye's workforce and generate more than half of the economy's total value added. Türkiye continued to implement various economic support schemes, mostly targeting SMEs. The SME Development Organisation KOSGEB provides support to companies on R&D, innovation, product development, internationalisation, entrepreneurship and for investments in high technology and strategic products. In addition, there are SMEs support schemes implemented by the Scientific and Technological Research Council of Türkiye (TÜBİTAK) as well.

Economic integration with the EU and price competitiveness

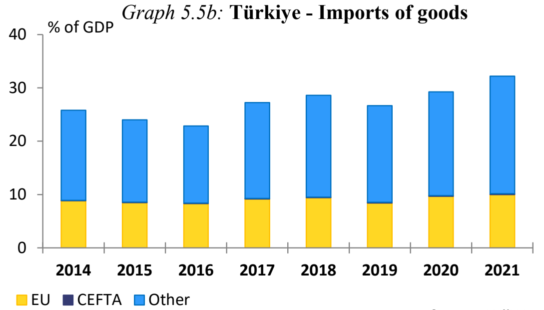
Economic integration with the EU declined, although remaining high. Türkiye is the EU's sixth largest trading partner, while the EU is by far Türkiye's largest trading partner. The share of the EU in Turkish exports was broadly unchanged at 41.3% in 2021, while the share of Turkish imports originating in the EU-27 decreased from 33.4% to 31.5%. The EU's share of foreign direct investment (FDI) inflows in Türkiye fell from 52% in 2020 to 34% in 2021, but rebounded again in the first half of 2022.

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



Source: WiiW

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



Source: WiiW

The EU's share in the overall stock of FDI declined from around 60% 5 years ago to around 50% in 2020 and 2021. Trade openness increased markedly in 2021, surpassing 70% of GDP for the first time and was up 10 pps. over the previous year, as the growth of exports of goods continued unabated and the exports of services rebounded.

Türkiye removed some of the additional duties imposed on a large number of products of non-EU origin and in free circulation within the EU-Turkey Customs Union. Yet, a large number of additional duties remain in force, in contradiction with the rules of the EU-Turkey Customs Union. Non-tariff barriers such as import surveillance and excessive customs checks continued to hinder trade flows. Following the WTO appeal ruling, Türkiye now must remove its inconsistent localisation and prioritisation measures in the pharmaceutical sector.

6. BOSNIA AND HERZEGOVINA

6.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Bosnia and Herzegovina is at an **early stage** of establishing a functioning market economy and there was **backsliding** in some areas. Higher foreign demand and government support measures helped the economy to rebound in 2021. This also benefitted the labour market, though unemployment remains high and structural problems persist. The financial sector remained stable and credit growth picked up. The fallout from Russia's war against Ukraine has been limited so far. In line with global trends, inflation accelerated significantly. The business environment is negatively affected by the country's fragmented internal market and a large informal economy. The rule of law and the functioning of the internal market has been further weakened by the long-standing political crisis and the blockage of state-level institutions which has also harmed the quality of economic governance. 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 very 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;

→ 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 government spending; furthermore, improve the efficiency of tax collection by ensuring an effective exchange of taxpayer information between the country's tax authorities, and in particular clarify the constitutional competence for establishing a central (i.e. country-wide) registry of bank accounts of private individuals, in line with the EU acquis;

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

Economic governance

Economic governance continued to suffer from poor cooperation between the entities and at the state level. Country-wide economic governance stalled in part due to the refusal of political parties based in the *Republika Srpska* entity to participate in decision-making at the state level. This also affected the preparation of the 2022-2024 Economic Reform Programme, an important element for the country's participation in the Economic and Financial Dialogue with the EU which supports the alignment of the country's economic governance with EU procedures. The failure to adopt a state-level budget in 2021 and the severe delay in the adoption of the 2022 budget disrupted the functioning of state-level institutions and economic policymaking.

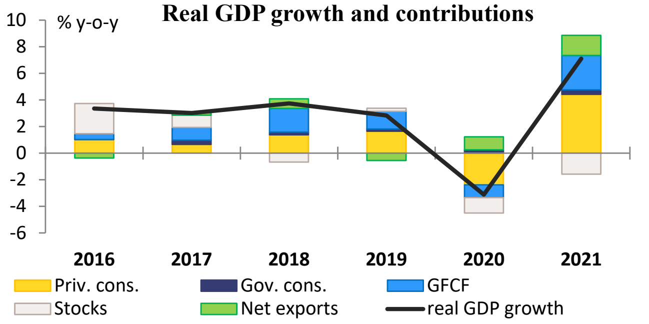
The country's response to the COVID-19 pandemic suffered from a lack of transparency and coordination among key stakeholders. Measures were primarily focused on the regional or local level and were not well-targeted to protect the most vulnerable parts of the population.

The implementation of the policy guidance jointly adopted at the Economic and Financial Dialogue with the EU in July 2021 has been limited. Due to the blockage of state level decision-making, the Economic Reform Programme (ERP) was submitted with a substantial delay and suffered from a lack of internal consistency and a fragmented policy approach. The country failed to implement agreed policy conditions which would have allowed the EU to disburse the second and final tranche of its COVID-19 related macro-financial assistance (MFA) package. As a result, the disbursement of EUR 125 million had to be cancelled.

Macroeconomic stability

Economic growth appears to have slowed after a strong post-pandemic recovery, with year-on-year output growth of 5.5% in the first quarter of 2022, after 7.5% growth in 2021 and a contraction of 3.2% in 2020. Exports and private consumption were the main growth drivers, benefitting from strong external demand but also solid growth of disposable income, as a result of increased COVID-19-related transfers. Substantial assistance from international institutions such as the IMF, the World Bank and the EU, amounting to more than 3% of GDP, helped to finance those additional transfers. Strong private consumption also translated into relatively strong growth in imports. Due to the low volume of trade with Ukraine and Russia, the direct economic impact of the Russia's invasion of Ukraine has remained limited so far. However, there is a risk of negative second round effects through indirect trade links and prices. The recovery of investment remained muted, reflecting lingering uncertainty related to COVID-19, but also continued political disputes and the resulting stalemate in the political decision-making process. Import growth remained rather high, reflecting strong private consumption and export-related imports. Per-capita income (in purchasing power parities) has remained at around one third of the EU-27 average.

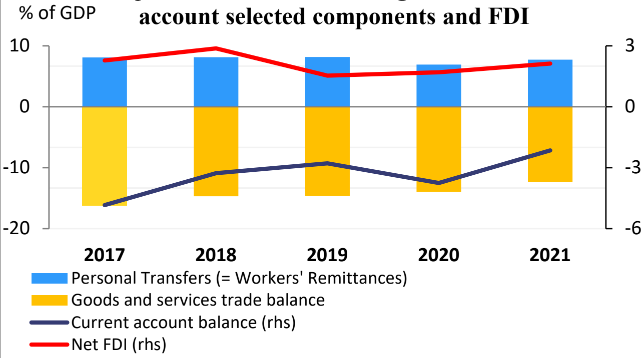
Graph 6.1: **Bosnia and Herzegovina - Real GDP growth and contributions**



Source: WiiW

The current account deficit deteriorated slightly in the first quarter, reaching 4.4% of the quarter's GDP, after 2.1% in 2021, mainly due to higher spending on imports. Workers' remittances, which constitute an important source of disposable income, recovered in 2021 and the first quarter of 2022 to pre-pandemic levels. Net foreign direct investment recovered too, increasing from 1.7% of GDP in 2020 to around 2% in 2021 and the first quarter of 2022, mainly consisting of reinvested earnings. Official foreign exchange reserves dropped to about 8.4 months of imports, largely reflecting high import growth. However, thanks to the strong inflow of foreign currency in 2021 in the form of emergency assistance, the foreign exchange import coverage is still rather high. At the same time import-intensive investment remained weak. Short-term debt accounts for only 0.1% of foreign exchange reserves, reflecting the country's strong reliance on longer-term financing through international financial institutions, such as the IMF, the World Bank, the EU (MFA) and the EIB. 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 2021, the coverage stood at 71%, similar to 2020.

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



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

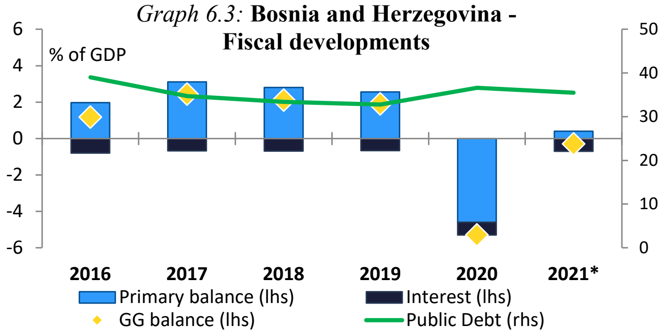
Table 6.1: **Bosnia and Herzegovina - Key economic figures**	**2013-18** average	**2019**	**2020**	**2021**
GDP per capita (% of EU-27 in PPS)[1)]	31	32	33	33
Real GDP growth	2.8	2.8	-3.2	7.1
Economic activity rate of the population aged 15-64 (%), total	54.2	55.5	58.2	59.1
female	*42.1*	*44.4*	*46.1*	*46.7*
male	*66.1*	*66.4*	*70.4*	*71.4*
Unemployment rate of the population aged 15-64 (%), total	25.0	16.4	16.2	17.5
female	*28.0*	*19.7*	*19.0*	*22.2*
male	*23.1*	*14.2*	*14.4*	*14.5*
Employment of total population (annual growth %)*	2.8	2.5	-1.2	0.9
Nominal wages (annual growth %)	0.9	4.3	4.0	4.4
Consumer price index (annual growth %)	-0.1	0.6	-1.1	2.0
Exchange rate against EUR	1.96	1.96	1.96	1.96
Current account balance (% of GDP)	-5.1	-2.8	-3.8	-2.1
Net foreign direct investment, FDI (% of GDP)	2.2	1.5	1.7	2.1
General government balance (% of GDP)	0.5	1.9	-5.3	-0.3
General government debt (% of GDP)	37.8	32.8	36.6	35.5

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

Monetary policy has continued to be anchored by the currency board arrangement. This monetary regime has served the economy well so far. The resilience of the currency board during the pandemic demonstrates the public confidence and trust it enjoys, which makes it an important pillar of macroeconomic stability. However, it also implies that the burden of adjustment to external shocks must be accommodated by other policy areas, in particular fiscal policy to manage demand, and structural reforms to improve the functioning of markets. Headline inflation has been accelerating since autumn 2021, reaching 15.8% year-on-year in June 2022. This brought the average inflation rate to 11.4% in the first half of 2022, compared to 0.1% the year before. About half of this increase in headline inflation is due to increases in food prices, which account for about one third of the basket used to compute the consumer price index. No data on core inflation has been published so far. Domestic political tensions have continued to prevent the appointment of a new board of the central bank, including the governor, whose mandate expired in August 2021.

During the second half of 2021 and the first half of 2022, public finances benefitted from strong revenue growth, increasingly driven by accelerating inflation. This additional revenue was used for increasing COVID-19-related spending as well as higher spending on social benefits, such as pensions, and on public wages, while reported public investment spending declined slightly. Once the inflation-related increase in revenues subsides, financing the additional permanent spending could pose a challenge. Overall, the general government registered a deficit of 0.3% of GDP in 2021, compared to 5.3% of GDP in 2020. During 2020 and 2021, COVID-19-related public

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



Source: National sources

spending is estimated to have amounted to some 2½-3½% of GDP, facilitated by the emergency assistance received from international institutions and the EU. However, the size of the policy response was limited by administrative bottlenecks and political stalemates, delaying the decision process and the implementation of spending decisions. Budget proposals for 2022 are characterised by significantly higher spending, likely related to the general elections on 2 October 2022, as well as measures to compensate public employees and pensioners for the rapid increase in inflation. The public debt ratio rose only moderately, from 33% of GDP in 2019 to some 37% in 2020 and it declined to 35.5% in the first quarter of 2022. Despite strong growth in revenue from indirect taxes, the overall cooperation and information exchange among the various fiscal authorities has remained limited, which facilitates tax avoidance. Calls by the *Republika Srpska* entity to dismantle the state-level Indirect Taxation Authority pose a threat to the revenue collection system. Furthermore, public finances are burdened by contingent liabilities, in particular in the area of public enterprises. There is a significant degree of non-alignment with EU public sector accounting standards, which strongly impedes the assessment of the country's actual fiscal position. As a result, both the deficit and debt ratio could be significantly higher than reported. Fiscal rules are established only at entity level and there is no independent fiscal institution to monitor and enforce compliance with countrywide fiscal rules.

Overall, the country's economic performance remains below its potential, as macroeconomic policymaking was hindered by political stalemates, a strong short-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 continues to be insufficiently geared towards growth-enhancing measures. As 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, this policy tool is not adequately used to steer the country towards stronger growth and faster convergence with EU income levels. The effectiveness of fiscal policy with respect to enhancing the country's growth potential is severely limited by the 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. With respect to the COVID-19 crisis, the measures taken by the fiscal authorities and the central bank helped to stabilise the economy but failed to pay particular attention to lower income groups.

Functioning of product markets

Business environment

There was no significant progress in reducing barriers to market entry and exit while the institutional and regulatory environment for the functioning of the country's internal market has further deteriorated. 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 2021 is available concerning the number of registered companies. Contract enforcement, in particular settling commercial disputes, remains difficult; there is a substantial backlog in court cases. It remains difficult to establish 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. Furthermore, during last year, key institutions, such as the central bank and the Constitutional Court, were affected by delays in key appointments and in adopting the state budgets for 2021 and 2022. Plans to set up a separate High Judicial and Prosecutorial Council in the *Republika Srpska* entity risk further fragmentation of the country's legal institutions and their independence as well as the integrity of the country's single economic space. Overall, the country's business environment is still hampered by numerous and lengthy administrative procedures, political interference, corruption and diverging rules in different parts of the country, complicating the operation of companies and creating additional costs. Furthermore, risks for a further fragmentation of the country's judiciary have increased while the functioning of the country's constitutional court has been impeded by delays in appointing open positions.

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

State influence on product markets

State influence on the economy has further increased during the pandemic. Already before the COVID-19 crisis, the oversized public administration as well as poorly performing state-owned enterprises (SOEs) already had a significant impact on the economy, in particular in terms of employment. During the pandemic, the role of government measures gained further prominence. The amount of contingent liabilities has increased as a result of mitigation measures, such as providing loan guarantees, which were extended during 2021. Many public companies rely on state support or accumulate payment arrears 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 basis of overly complex procedures. This facilitates corruption and leads to a preference for domestic suppliers which is incompatible with the EU *acquis* (*see also chapter 5 – public procurement*). There is still a wide range of administrated prices, and during the pandemic and more recently in response to rapidly increasing energy prices, prices of certain products, such as hygiene products, have been regulated.

Officially recorded state aid is relatively low, at some 1¼ of GDP in 2019, according to the latest available data. However, significant indirect state support continues to undermine the level playing field. In 2021, as part of the COVID-19 crisis support package, many companies benefitted from discretionary state assistance. Available data on provided assistance is incomplete. Nevertheless, the level of state aid appears to have been significant during the last year. State aid control is still hindered by only partial legal alignment with European standards and the lack of consistent enforcement of state aid rules throughout the country. The competences of the State Aid Council continue to be limited. This leaves room for unfair distortions of competition in the country.

Privatisation and restructuring

Progress with privatisation and restructuring has remained very limited. Publicly owned enterprises still play an important role in certain sectors, such as mining, but are often badly managed, leading to a significant burden on public finances. Despite some preparatory works at entity level, actual steps to restructure or to dissolve public enterprises have 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 financial market's institutional and regulatory set-up remained fragmented, which impedes 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 coordinating the local regulatory and supervisory agencies. During the last year, the central bank's governing board was only operating on a technical mandate, as due to the blockage of state-level institutions, the appointment of a new governing board and of the governor were delayed. This had a negative impact on the full functioning of the central bank.

The banking sector has remained stable during the COVID-19 crisis. The quality of loan portfolios remained solid, despite expiring policy support. The share of non-performing loans (NPLs) in total loans declined further in 2021 and reached 5.2% in the second quarter of 2022, compared to 5.7% a year before. There was limited progress on removing remaining obstacles to an effective and swift resolution of NPLs, including in the areas of out-of-court restructuring and the securitisation and sale of NPLs. Bank profitability started to improve after the fall during the pandemic. The return-on-equity ratio was at some 10.4% during 2021 and rose slightly to 11.1% in the first half of 2022, while the return on average assets stood at about 1.4% during that period. The banking system's overall capital adequacy ratio recovered during the second half of 2021, and remained at 19.4% in the first half of 2022, compared to 19% a year before. However, there are big differences among the country's 22 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. Like elsewhere in the Western Balkans, the degree of euroisation is rather high: 36% of deposits and 45% of loans of commercial banks were denominated in euro in 2021, although the share of euro denominated loans has been on a gradually declining trend in recent years. During the COVID-19 crisis, the central bank has reassured households and corporations on the stability of the country's financial sector and supported debt payment moratoria, suggested by the country's two banking agencies, as well as the suspension of dividend payments and stricter rules on remuneration. Furthermore, the governments of the two entities supported lending by providing temporary guarantees to private sector loans. The volume of those guarantees amounts to about 0.5% of GDP. In early 2022, the entities' banking agencies took over the Russian-owned Sberbank subsidiaries, as the announcement of sanctions on certain Russian-owned financial institutions had led to a bank run on those subsidiaries, endangering their viability.

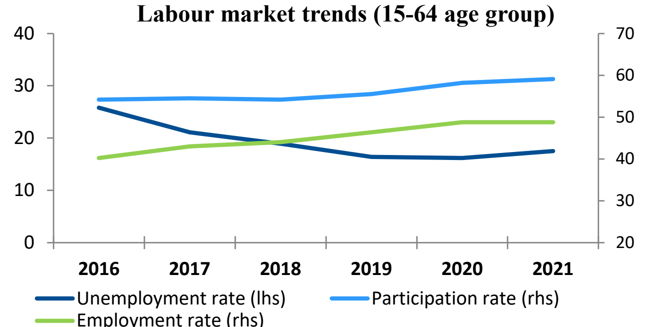
Access to finance

Credit growth picked up but access to finance often remains challenging. Annual loan growth averaged 1.7% in 2021, with nearly 3% growth in the second half of 2021. This recovery was mainly driven by household loans, which account for some 30% of the total credit stock. Bank deposit growth accelerated markedly, from 5.6% in 2020 to 10.1% in 2021. Interest rate spreads for consumer loans have declined, dropping during the last 5 years from above 6 percentage points to around 3 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 declined from 54.5% of total debt at the end of 2021, which is higher than at the beginning of the year, and also markedly above the country's five-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 17.5% of GDP in May 2022. 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

Economic recovery and government support measures have benefited the labour market, but structural problems persist. The number of registered employed was some 3.2% (26 500 persons) higher in the first half of 2022 than a year before, while the number of unemployed declined by 7.3% (29 600 persons), leading to a drop in the administrative unemployment rate to 30.8%, compared to 33.2% the year before. However, due to the strong decline in registered unemployed, the registered labour force shrank by about 0.3%, or some 3 100 people. Due to the high share of informal employment, in particular in the trade and tourism industry, administrative data provides only a partial picture of the country's labour market dynamics. Although due to methodological changes, the comparability of labour force survey data over time is limited, their findings largely support the picture of decelerating employment growth and strong declines in unemployment. However, the overall labour force continued to decline, partly as a result of a persistent brain drain, with a high share of qualified and mobile workers leaving for job opportunities abroad. This has a negative impact on the country's competitiveness as well as its growth potential in the medium-term. Reflecting structural problems as well as the COVID-19 shock, youth unemployment (age group of 15-24 years) is particularly high, at around 36% in June 2022. While in the pre-pandemic period employment opportunities have been created in tourism and manufacturing, high unemployment has persisted for years due to challenges associated with skills mismatch and an insufficient increase in job creation as a result of weak investment in the capital stock. 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 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 evaluated sufficiently rigorously. 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 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, which contributes to high wage growth. Labour mobility within the country remained low. Many companies suffer from a lack of qualified labour, which is further exacerbated by high emigration. In combination with accelerating domestic price pressures, this scarcity of qualified labour has contributed to relatively high nominal wage growth (4.4% in 2021 and 9.4% in the first half of 2022. This translated into an increase in real wages by some 2% in 2021, but accelerating inflation brought this increase to a halt. Public sector wages are relatively high compared to other sectors, in particular when taking into account the sector's productivity, which to some extent crowds out qualified labour in the private sector.

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

Bosnia and Herzegovina has made **no progress**, and remains at an **early stage** in terms of capacity to cope with competitive pressure and market forces in the EU. There have been no significant improvements in the overall quality level of education, while measures to improve the transport and energy infrastructure were impeded by political disputes. However, some structural adjustment took place, responding to strong external demand and the constraints imposed by COVID-19. The implementation of last year's recommendations has been very limited.

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. Improved management of public investment and an accelerated implementation of those investment projects that have been subject to a clear positive cost-benefit assessment are of particular importance in this respect.

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

Education and innovation

Investment in education remains inadequate, highly fragmented and poorly coordinated, leading to varied standards within the country. Public spending on education accounted for some 4% of GDP in 2020. When adding private spending and support by 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 (36.3% in June 2022 according to the LFS), twice the country's overall unemployment rate**.** The insufficient coordination leads to a lack of common standards for various levels of education, as well as in differences in the quality of teachers' training and performance evaluation. Teaching curricula continue to be outdated and are still not sufficiently aligned with the country's needs. The country participated for the first time in the 2018 PISA study. Results indicate that the students' performance ranks well below the OECD average, which is a clear impediment for the country's competitiveness and growth potential. Unfortunately, Bosnia and Herzegovina refrained from participating in the follow-up study. The country's illiteracy rate continues to be around 3%, largely as a result of a relatively high rate among women.

Spending on research and innovation is limited and impeded by the low degree of cooperation and coordination among the various levels of government, leading to 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 limited, while brain drain continues, most notably in the health, medical, and IT sectors with no systematic measures having been introduced so far to address the issue.

Physical capital and quality of infrastructure(around 200 words recommended

Investment in the country's capital stock remained impeded by continued political uncertainties. Gross capital formation recovered only partially as it grew by 4.4% in 2021 after a drop of nearly 13% in 2020. This has led to a further decline in the share of gross capital formation to 23% of GDP in 2021, compared to 24.5% in 2019, the last year before the COVID-19 pandemic. Public investment remained low, reflecting a focus on COVID-19-related current spending, while private investment was also negatively affected by the continued uncertainty related to COVID-19 and political uncertainty. Inflows of foreign direct investment (FDI) recovered from a low level to its 5-year pre-COVID average of 2.1% of GDP, after 1.7% of GDP in 2020. A large share of those FDI inflows continue to be 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 brain drain. Overall, the insufficient momentum in investment and negligence of environmental standards continues to hamper improvement in the country's growth potential.

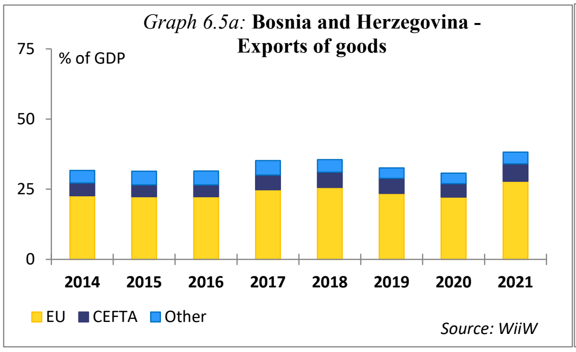
Investment in transport and energy infrastructure was delayed as a result of a strong focus of public spending on COVID-19 related measures, but also due to political stalemates on country and entity level including the absence of a state-level budget in 2021 and the delayed 2022 budget. Political disputes blocked necessary steps for updating the regulation of the energy and transport markets, while the country's spending focus was towards measures to support the economy in response to COVID-19. 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 inadequate. Furthermore, investment into improving environmental standards, in particular the air pollution, has been neglected.

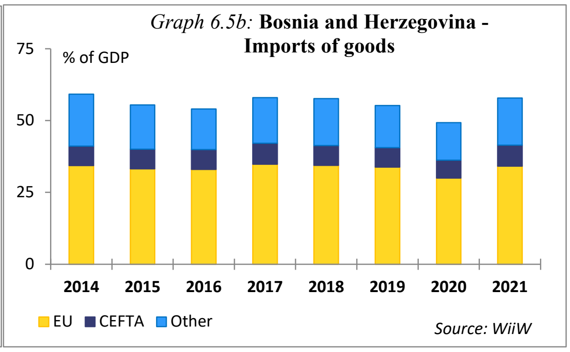
Sectoral and enterprise structure

Structural change has continued during the last year, with a continued shift towards trade and transport. In the first quarter of 2022, the share of value added in the trade, transport and tourism sectors rose to 21.7% of GDP, compared to 19.7% of GDP a year before, while due to below-average growth the share of the public sector declined by nearly one percentage point, from 17.9% in the first quarter of 2021 to 17% in the first quarter of 2022. During the last years, the company structure registered some increase in the share of micro companies (0-9 employees), and medium-sized companies employing between 50-249 employees. However, the majority of new companies were often trading companies with lower value added. Some 93% of all companies are in the group of small and micro businesses, i.e. those with less than 50 employees.

Economic integration with the EU and price competitiveness

Trade and investment integration with the EU remained high but overall trade is below its potential. In response to the strong export decline during the beginning of the COVID-19 crisis, exports rose by 40% year-on-year in the first half of 2022, mainly as result of strong demand from the EU (Germany, Italy, Croatia), but also from CEFTA countries such as Serbia. During the five years before the pandemic, trade slightly shifted towards the neighbouring region, reflecting stronger exports to countries such as Serbia and Croatia. Exports to the EU-27 as a share of total merchandise exports rose from some 72% in 2021 and rose to 74% in the first quarter of 2022. Exports to CEFTA countries increased their share in total exports, reaching 16.7% in 2021 and 18.7% in the first half of 2021. The country's openness to trade (exports and imports as a percent of GDP) recovered in 2022 from the sharp drop in in the first quarter of 2021, reaching 89% of GDP, compared to 69% the year before. Even before the pandemic, the country's openness to trade was relatively low, in particular in view of its relatively small economy. The export structure is not very diversified and relies mainly on basic metals, furniture, and textiles. 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 has deteriorated somewhat. After a long period of gradual improvements during 2016-2021 by some 4%, the country's real effective exchange rate started to appreciate in December 2021 and was 4.4% higher in April than a year before, reflecting a rising positive inflation differential with the country's trade partners. In nominal effective terms, the currency appreciated by 1.2% during that period, 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 is at an **early stage** and has made **some progress** in developing a functioning market economy.

The loosening of COVID-19-related mobility restrictions and the resumption of travel and related financial inflows by the diaspora led to a very strong economic rebound in 2021, which moderated in the first quarter of 2022. Notwithstanding the resilience the economy has demonstrated during the pandemic, long-standing structural challenges, such as a widespread informal economy, a high prevalence of corruption and the overall weak rule of law, continue to hinder the private sector. While the fiscal rule was suspended for three years in 2020, the economic recovery resulted in a strong increase in tax revenue and a low public deficit in 2021. Driven by surging commodity prices, inflation increased substantially. Inflationary pressures were reinforced by the fallout of Russia's war against Ukraine. Higher prices for imported commodities widened external imbalances. The financial sector remained stable and lending continued to expand. The business environment saw low improvement. The economic recovery created jobs but lack of data hinders a proper assessment of the labour market situation. Last year's recommendations were partly addressed.

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

→ cushion the impact of adverse shocks by well-targeted support measures when needed 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, with a view to improving the cost-efficiency and fairness of the social security schemes, and a review of tax expenditure, quantifying the size of the revenue forgone from all exemptions and reduced rates;

→ 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 as well as the implementation of laws on inspection and electronic identification;

→ implement active labour market measures to support employment, resume publishing of the labour force survey data and continue to implement measures aiming to formalise informal employment.

Economic governance

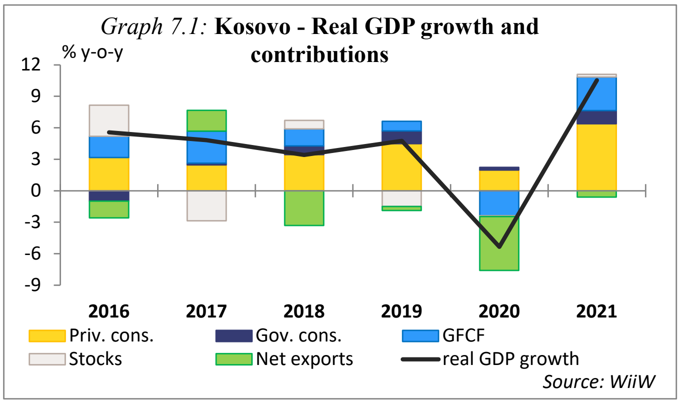
Kosovo's economic policies focused on providing policy support to cushion the impact of the pandemic and of high energy prices for the most affected households and firms, but there was little progress with structural reforms. Pandemic-related support amounted to 3.9% of GDP in 2021, targeting vulnerable households and firms, formal and informal employment, and the health sector. The 2022 budget included a blanket allocation for the economic recovery programme amounting to 2% of GDP, which was mostly reallocated to cover energy subsidies at the beginning of 2022, compensating the increase in electricity tariffs. The disbursement of these subsidies was delayed until August. The 2022 budget was based on overly optimistic assumption for economic growth, despite rising global energy prices since autumn 2021. High import costs, increased electricity consumption and insufficient domestic power generation resulted in an energy crisis with daily energy cuts in winter. In response to the fallout of Russia's war against Ukraine, the government decided to provide a further EUR 150 million in April to support low-income groups. The government finalised an agreement with Serbia as part of the EU-facilitated Dialogue to address electricity billing issues in four municipalities in the north of Kosovo. When fully implemented, this agreement should substantially reduce losses of publicly owned enterprises and government subsidies to the sector *(See also Chapter 15 Energy)*. The government took fiscally prudent positions in opposing further withdrawals from the Kosovo Pension Savings Trust (KPST) and proposing legislation to decouple the level of war veterans' pensions from the minimum wage despite strong political opposition.

The policy guidance, jointly agreed at the July 2021 Economic and Financial Dialogue between the EU and the Western Balkans and Türkiye has been partially implemented. The 2022-2024 Economic Reform Programme focuses on supporting the economic recovery, but is very vague on the initiatives stemming from the government programme.

Macroeconomic stability

Following a very strong rebound in 2021, Kosovo's economic growth moderated in the first quarter of 2022. Before the pandemics, i.e. in 2016-2019, the average rate of GDP growth was well over 4%. Real GDP surged by 10.5% in 2021, on the back of the revival of diaspora travelling, increasing remittances and investment as well as a strong growth in household loans. Further support came from the pandemic-related government measures. Robust growth in 2021 brought Kosovo's economy above the pre-pandemic level in real terms. Economic growth slowed down to 4.8% in the first quarter of 2022, in line with historical trend. Rapidly rising energy and food prices in the first half of 2022 started to erode the disposable income of households. Slowly advancing economic diversification, high import dependency and an unreliable energy supply make Kosovo vulnerable to adverse external shocks. **Kosovo's per capita GDP remains the lowest in the region**. It stood at 26% of the EU average in 2021. Due to a large informal sector and high inactivity rates, especially among women, Kosovo has high income inequalities.

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

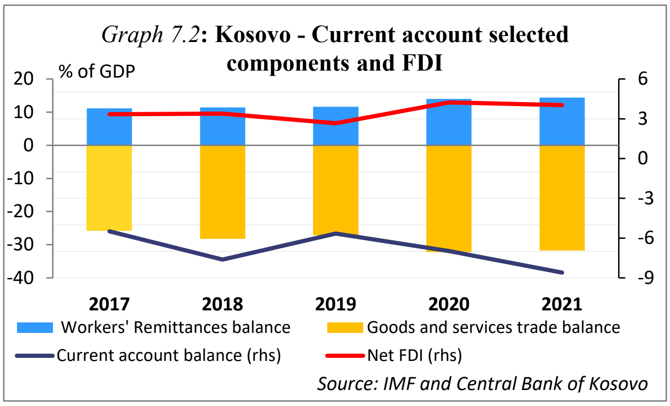


Source: WiiW

Despite a strong tourism season, the current account deficit widened to 8.6% of GDP in 2021. The extraordinary performance of exports, with exports of services and goods expanding by 91% and 51% year-on-year, respectively, was outweighed by the robust growth of imports (42%), resulting in a practically unchanged trade deficit at 31.8% of GDP in 2021. As usual, the most important offsetting factor was remittances which increased by 18% in 2021 and reached 14.4% of GDP. Further unofficial remittances (2.5% of GDP) were reflected by larger errors and omissions in 2021. In the first quarter of 2022, the current account deficit more than doubled due to the deteriorating balance of goods trade.

Net FDI inflows increased by 10% in 2021 and stood at 4% of GDP, covering less than half of the current account deficit. Key drivers were continued investment by the diaspora into the real estate sector and reinvested earnings in the financial sector partly due to the ban on dividend distribution, which was lifted in late 2021. For the first time, Kosovo registered portfolio investment inflows of EUR 10 million in the third quarter of 2021, stemming from the issuance of so-called "diaspora bonds" which are treasury bonds designed for the diaspora, but other than that Kosovo remains absent from international debt markets. In the first quarter of 2022, net FDI inflows stood stable at 4.9% of GDP while official reserve assets amounted to 3 months of imports of goods and services.

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



Source: IMF and Central Bank of Kosovo

Table 7.1: **Kosovo - Key economic figures**	**2013-18** average	**2019**	**2020**	**2021**
GDP per capita (% of EU-27 in PPS)	24	26	25	26
Real GDP growth	4.7	4.8	-5.3	10.5
Economic activity rate of the population aged 15-64 (%), total	40.4	40.5	38.3	39.5
female	*19.6*	*21.1*	*20.8*	*22.7*
male	*60.9*	*59.7*	*56.0*	*56.5*
Unemployment rate of the population aged 15-64 (%), total	31.0	25.7	25.9	25.8
female	*36.5*	*34.4*	*32.3*	*29.7*
male	*25.0*	*22.6*	*23.5*	*24.2*
Employment of the population aged 15-64 (annual growth %)	2.5	5.2	-4.0	1.3
Nominal wages (annual growth %)	2.8	5.3	-2.3	3.9
Consumer price index (annual growth %)	0.7	2.7	0.2	3.3
Exchange rate against EUR*	1.0	1.0	1.0	1.0
Current account balance (% of GDP)	-6.8	-5.7	-7.0	-8.6
Net foreign direct investment, FDI (% of GDP)	3.6	2.7	4.2	4.0
General government balance (% of GDP)	-2.1	-2.9	-7.6	-1.3
General government debt (% of GDP)	13.4	17.6	22.4	21.9

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

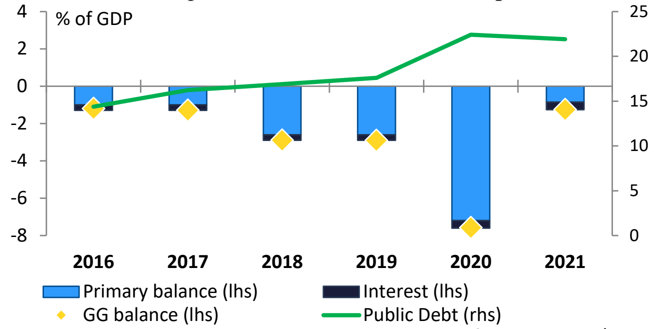
Higher commodity prices and a robust economic recovery led to increasing inflation in 2021. Annual inflation rose over the course of 2021 from 0.6% in the first quarter to 6.7%in December. Upward price pressures continued in 2022, with consumer prices increasing by 14.2% year-on-year in July. The main drivers were rising food and energy prices, which were amplified by Russia's war against Ukraine. Most energy prices are regulated in Kosovo. In response to rising energy prices in late 2021, the Electricity Regulation Office decided to bring in a two-tier tariff structure for household consumers, maintaining electricity prices for households consuming less than 800kWh unchanged and doubling them for households consuming more than 800kW.

The 2021 budgetary outcome improved considerably, due to surging revenue and conservative spending. The headline budget deficit narrowed to 1.3% of GDP, which corresponds to a deficit of 0.6% of GDP under the fiscal rule definition[22]. This outcome would comply with the fiscal rule prescribing a deficit ceiling of 2% of GDP, though the rule has been suspended since 2020. Government deposits recovered to 3.9% of GDP, up from 3.5% in 2020. The fall in the government deficit resulted primarily from an extraordinary increase in government tax revenue, which rose by 29% year-on-year. Higher revenues from indirect taxes were key, but there were also gains in personal income taxes partly due to formalisation measures associated with the COVID-19 recovery package. Tax and non-tax budget revenue exceeded the projections of the revised 2021 budget. By contrast, public spending increased by 2.8% year-on-year, compared to the planned 12.6%. Capital spending reached only 75.8% of the revised budget allocation (although this is still an improvement over previous years), while the execution of current expenditure was roughly in line with the initial plan. The largest increase in current spending was in the category of goods and services (9.6%) driven by the purchase of vaccines. Spending on social transfers and subsidies fell by 2.9% due to the high base in 2020. The 2021 economic support programme amounted to 3.2% of GDP, which compares to a crisis-related stimulus of 4.2% of GDP provided in 2020. In 2022, the government responded to high inflation and in particular to high energy prices, with

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

subsidies for agricultural inputs, wage bonuses, temporary increases in pension benefits and social transfers. The latter involves electricity price subsidies for around 20% of households, aiming to target the poorest households with low energy consumption, but taking no account of disposable income. The government resisted pressure to reduce excise the excise and VAT rates on fuel. In June, the Assembly approved the revised 2022 budget, which targets a headline deficit of 5.3% of GDP instead of initially planned 4.5%. As per the fiscal rule definition, the deficit is projected at 3.8% of GDP as compared to the originally planned 2.9%. The government cash reserve is expected to decline to 3% of GDP, which is below the initial projection of 3.9%.

Graph 7.3: **Kosovo - Fiscal developments**



Source: IMF and MoF

On the back of strong economic and fiscal performance in 2021, the public debt-to-GDP ratio has declined but the investor base for government debt remains narrow. The public debt ratio stood at 21.9% at the end of 2021 and fell to 20.3% of GDP in the first quarter of 2022. These figures do not include the liability stemming from tax-free withdrawals of 10% of pension savings from the Kosovo Pension Saving Trust (KPST), which the government promised to reimburse from 2023.[23] Domestic debt, which is held by a narrow investor base, increased by 15% in nominal terms in 2021. In March 2022, the KPST's share of domestic debt reached 48% as compared to 38% in 2019, while the Central Bank of Kosovo and commercial banks hold a further 19% and 27% of domestic debt respectively. In the absence of a sovereign credit rating and very limited access to international bond markets, foreign financing has been largely provided by international donors. Foreign debt rose by 9.6% in 2021. This includes EU macro-financial assistance (the second and final instalment of EUR 50 million was disbursed in June 2021), World Bank loans (EUR 32.2 million) and Council of Europe Bank lending (EUR 17 million).

Progress with fiscal governance has been mixed. The 2022 budget, as adopted in December 2021, assumed unrealistically high GDP growth (7.8%) and a very large increase (67%) in public investment. While higher public investment is a welcome aim, such a large increase is not supported by the track record of capital spending over the last years, although the budget included additional funds for expropriation of properties to help unlock capital investment. At the same time the absence of a functioning board at the Procurement Review Body since March 2021 has impeded the execution of capital spending. A blanket allocation of 2% of GDP for the economic recovery programme in the 2022 budget undermines fiscal transparency and accountability. To contain social spending, the government adopted an administrative instruction requiring a medium to long-term costing of any pension or social spending initiative before its adoption. Despite this progress, there is no cost estimate for the draft law on salaries for public employees. The revised budget law of 2021 and the budget of 2022 include the assessment of high-risk publicly owned enterprises while excluding others. The full implementation of the agreement reached on 21 June 2022 between Kosovo and Serbia as part of the EU-facilitated Dialogue to address electricity billing issues in four municipalities in the north of Kosovo should eliminate a substantial fiscal risk. As in 2021, the cost of electricity losses reached nearly EUR 42 million. The cost of war veteran pensions continues to breach the 0.7% of GDP legal ceiling.

Supporting the most vulnerable while improving the budget balance in 2021 was appropriate, but stronger contingency planning is needed. The pandemic-related fiscal support, which mainly took the form of subsidies and transfers to vulnerable families, employment and affected businesses was broadly well-targeted and helped to cushion the impact of the shock. However, the economic support programme included in the 2022 budget, does not clearly reflect the priorities set in the government programme. Risks related to upbeat GDP projections and rising energy prices in autumn were not sufficiently

[23] The IMF estimates the liability to KPST at 1.8% of 2020 GDP.

considered in the initial budget. The tax base remains narrow and weakened by tax exemptions and preferential tax rates, while public spending is burdened by category-based specific transfers. .

Functioning of product markets

Business environment

In line with economic recovery in 2021, business creation was more dynamic with higher numbers of registered and terminated firms. The total number of new businesses in 2021 was 10,659, which is 8.7% higher compared to 2020. The number of closed businesses in 2021 was 1,602, an increase of 19% compared to the same period of the previous year (1345). The numbers of firms with female and foreign owners also increased.

Some progress was made in improving the business environment. The Law on Inspections, aiming to reduce the number of parallel and overlapping inspection bodies and streamline the procedures, was approved by the Assembly in December 2021. The draft Law on the Commercial Court, which is critical to improve the efficiency of the justice system, was approved by the Assembly in March 2022. Kosovo started the process of amending the Administrative Burden Reduction Programme, which should deliver a two-year action plan with measurable results. The Kosovo Investment and Enterprise Support Agency (KIESA), whose task is to help businesses and investors, lacks capacity and resources to execute its wide mandate. The lack of a coherent policy for industry development throughout the supply chain, a large informal sector and incomplete implementation of the Law on business organisations undermine the business environment and competitiveness of SMEs.

Despite some success in fighting the informal economy, it still accounts for more than a third of total employment.[24] There was some improvement in voluntary compliance, as the number of registered workers increased due to financial incentives to join formal employment that were, included in the pandemic-related package. The impact of the potential minimum wage increase on informality warrants close monitoring. According to the corruption perceptions index by Transparency International, Kosovo improved its index score in 2021, ranking 87 out of 180 countries, which is 17 positions higher than in 2020.

State influence on product markets

Despite some progress made in 2021, Kosovo's State aid policy framework needs further alignment with EU rules and principles. The current framework lacks a coherent approach to State aid as well as a comprehensive strategy and cost-benefit evaluations for aid and subsidies granted. There is 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. The government has made some progress on enforcement of competition and State aid rules and on training the staff of the State aid department. The State aid Commission had no decision-making quorum since mid-September 2021 and is unable to function formally until the Assembly appoints a new Commission. According to the official data, State aid is estimated at 1.7% of GDP in 2020, with the largest item being agricultural subsidies. In the context of high energy and crop prices due to Russia's war against Ukraine, further subsidies to agriculture were allocated in 2022, aiming to increase self-sufficiency.

Privatisation and restructuring

Kosovo undertook steps to dissolve the privatisation agency and to set up a sovereign wealth fund. At end-2021 the Privatisation Agency of Kosovo (PAK) approved its exit strategy. In early 2022 the government issued a decision forbidding PAK to sell assets under its administration, which are envisaged to be transferred to a sovereign wealth fund. In June 2022, the government adopted a concept document on the sovereign fund. The sovereign fund is expected to take over socially-owned enterprises[25] (SOEs) and assets managed by PAK and some publicly owned enterprises managed by the Ministry of the Economy after improving their financial performance. During the reporting period the PAK continued

[24] IMF 2021 Article 4 consultation.
[25] The ownership of socially-owned enterprises was considered as shared social property in former Yugoslavia.

liquidation procedures of SOEs. The process of dismissal and appointment of new board members of publicly owned enterprises continued. Changes are needed in the rules and procedures on governance and oversight of publicly owned enterprises in order to address issues of poor performance and maladministration. Some improvements were made in reducing overemployment in Kosovo Telecom and adopting a new performance framework for regional water companies.

Functioning of the financial market

Financial stability

Supported by robust economic growth, the financial sector remained stable. In the second half of 2021, as the economic recovery gained pace, the Central Bank of Kosovo gradually lifted the pandemic-related forbearance measures, without a negative impact on bank asset quality so far. The predominantly foreign-owned banking sector accounts for 66% of financial system assets, followed by pension funds, insurance and microfinance institutions with 26.5%, 2.8% and 4%, respectively. The banking sector's return on average equity (RAE) remained high at 19.5% in 2021, as compered to the pre-pandemic level of 18.9% in 2019, and increased further to 22.3% in Q2 2022. The ratio of bank non-performing loans (NPLs) declined from 2.7% in 2020 to 2.1% in 2021 and stayed at this level in the first half of 2022, partially supported by the denominator effect of high credit growth. Although overall the credit risks remain contained, challenges remain in evaluating risks from the rapid credit expansion in the household segment. The ratio of banks' regulatory capital to risk-weighted assets stood above 15% in 2021 and the first half of 2022, comfortably exceeding the regulatory minimum of 12%. Banks continued to be financed by deposits, predominantly from households. The loan-to-deposit ratio increased to 85.2% in June 2022 from 77% in mid-2021. In 2021, profitability recovered for micro-financial institutions after a sharp drop in 2020. The insurance sector's performance remained positive in 2021, with its net profit increasing by 50% on an annual basis.

Access to finance

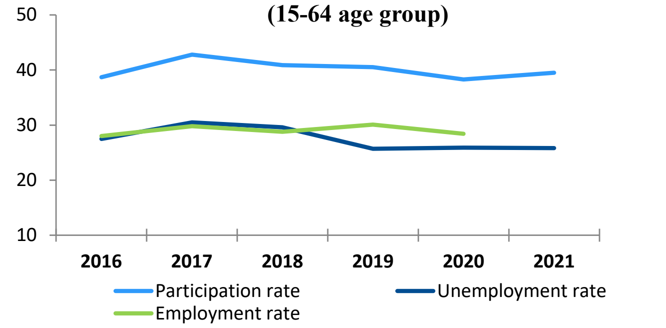
Financial intermediation continues to expand. Credit growth accelerated from 7.1% in 2020 to 15.5% in 2021 and further to over 17% year-on-year in the first half of 2022. Loan growth was facilitated by low interest rates, a continued increase of deposits, improved contract enforcement, and increased 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. In 2021, lending to both firms and households continued to grow on annual basis, by 13.6% and 18.6%, respectively. The amount of credit compared to the size of the economy remained moderate, at around 40%. The lack of easily accessible and affordable credit constitued 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 capital market remains at an early stage of development. A first-ever 'diaspora bond' issuance was made during the summer of 2021 through commercial banks and in collaboration with the Ministry of Finance. This issuance managed to raise EUR 10 million of the EUR 20 million initially offered. Microfinance has gained momentum in recent years, but shortcomings in the legal framework regulating microfinance institutions hinder the industry's long-term growth and sustainability.

Functioning of the labour market

Kosovo has large delays in publishing labour force survey (LFS) data for 2021. The latest available LFS data refer to the second quarter of 2021, i.e. before the recovery came into full swing. The labour force participation ratio stood at 37.7% in line with its long-term trend. Employment rates of men and female were at 44% and 16%, respectively. Unemployment stood at 20.5%. Tax administration data suggest that official employment in the private and public sector increased by 10% in 2021. A number of registered jobseekers dropped by almost a third in 2021 compared to 2020, which might be partially due to financial incentives included in the pandemic-related support measures, but their level still remains 10% higher than in 2019[26].

[26] World Bank 2022 Regular Economic Report.

Despite some formalisation gains, the labour market is hindered by an inadequate system of social assistance, a large gender gap and a lack of job opportunities for young people. In 2021, spending on transfers and subsidies reached nearly 11% of GDP while within this amount expenditure on poverty-targeting social assistance was around 0.5%. Category-based social transfers, e.g. war veteran pension scheme, are costly and undermine the soundness and fairness of the social benefit system while motivating other specific groups to request similarly generous allowances. In September 2021, within the recovery package the government introduced maternity leave for women unemployed for longer than 12 months. By excluding women in shorter spells of unemployment, this could act as a disincentive for women planning motherhood to take on (formal) work. The lack of affordable transport options, child and elderly care facilities constitute long-term challenges, hindering female employment. High reservation wages, partially supported by remittances, and the lack of jobs are considered to be a key factors fuelling the emigration of young people. Further issue relates to skills mismatch, as Kosovo's labour market generates little demand for academic qualifications, more so for hands-on vocational skills.



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

Source: Kosovo Agency of Statistics

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

Kosovo is at an **early stage** and has made **limited progress** in terms of capacity to cope with competitive pressure and market forces in the EU. Insufficient quality of education and skills mismatches lead to a difficult transition from school to the labour market. Some progress was made in improving road infrastructure. The recent energy crisis underlined the urgency of ensuring a reliable and clean energy supply and diversifying energy sources. Kosovo made some progress as regards the digitalisation of the economy. Structural changes are advancing slowly as the economy remains highly reliant on small and very small firms which cannot compete internationally. The export structure remains dominated by base metals with slightly increasing shares of mineral, plastic and textile products. The recommendations from 2021 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, with the view of narrowing the skills mismatch;

→ strengthen energy security and 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

Improving the quality of education and its alignment with labour market needs remain a key challenge. Public spending on education (4.7% of GDP in 2020) and the enrolment of children in early school (36%), primary (100%), lower (91%) and higher (81%) secondary education followed historical trends in the school year 2020/2021. A participation of children in early school education and care (3-5 years) is still far below the EU average of over 80%. Following the pandemic-related disruptions to learning in the previous year, which affected all pupils, but especially the marginalised groups, the government prepared new distance learning solutions for the school year 2021/2022. The new law on textbooks and educational material, aiming to improve the quality of learning material, is pending approval. Learning materials were adapted for the Programme for International Student Assessment (PISA) 2022 test, following Kosovo's lowest ranking in 2018. Kosovo students' scores are the equivalent to five years of schooling behind the OECD average in reading, and a little over four years behind in mathematics. Many graduates remain unemployed as their training does not provide them with the necessary skills required by the labour market. A recent skills mismatch measurement indicates that over 40% of young workers with a tertiary education are employed in jobs below their level of education. To improve training programmes, Kosovo finalised a quantitative analysis on future needs with the support of the Joint Research Centre. Following the expulsion from the European Association for Quality Assurance in Higher Education, Kosovo Accreditation Agency (KAA) has implemented the recommendations, related to institutional and financial independence, and an increase in the number of staff. The Law on KAA has yet to be adopted by the Assembly.

Little progress has been achieved in improving Kosovo's research, development and innovation system. Despite legal provision to allocate 0.7% of GDP for science and innovation, the allocated budget for 2022 was less than 0.1% of GDP, due to the lack of funding. In November 2021 Kosovo appointed members of the Council of Science that should develop scientific research activity. Kosovo has successfully completed negotiation with EU to become a fully associated member of the Horizon Europe programme, but it still needs to improve its performance in accessing grants.

Physical capital and quality of infrastructure

Slow progress in improving road and railway infrastructure delays the implementation of major projects. There was no progress on Route 7 *Peace highway*, despite the increase of EU grant for its implementation. The rehabilitation works for the Railway Route 10 continued at a slow pace, with the first segment expected to be completed by the end of 2022. The related signalling and telecom works have not started yet. Transport system still faces a number of challenges in terms of safety, inadequate maintenance, and weak administrative capacity of regulatory institutions.

Kosovo remains heavily reliant on coal. Over 90% of electricity is produced by two highly unreliable and polluting lignite power plants, which the government plans to upgrade. A partial shutdown of the 'Kosovo B' power plant, together with an unprecedented increase in import prices and high electricity consumption in winter 2021, led to an energy crisis with rotating power outages. Renewable energy sources, account for just over 5% of electricity supply. By the end of 2021, Kosovo registered a total of 249.2 MW of renewable electricity generation, 101 MW small hydropower, 137 MW of wind, 10 MW of solar, and 1.2 MW of biomass. The increase is due to an additional 21 MW of hydropower.

Further options should be explored in order to diversify energy supply. The government is exploring cooperation options with neighbouring countries (Albania and North Macedonia) on joint gas projects. The Assembly adopted the Millennium Challenge Compact and the Program Implementation Agreement between Kosovo and Millennium Challenge Corporation for developing battery storage to provide electricity balancing reserve. To establish a sustainable market in Kosovo and Albania, Kosovo signed two agreements with Albania: the Electricity Markets Cooperation Framework Agreement and a Memorandum of Understanding aiming to recognise each other's electricity and supply licenses *(See also chapter 15 – Energy).*

The digitalisation of the economy is in progress. With 96% of households having access to a broadband internet connection, Kosovo has reduced the infrastructure gap between urban and rural areas. Kosovo is engaged constructively in high-level regional dialogue on digital transformation. Following the implementation of the Regional Agreement of 2019, Kosovo is working on the digital agenda covering the period up to 2030. The policy document should provide a comprehensive framework for the digital transformation, including 5G technologies, digital transformation of businesses and public services. the next step is to focus on further development of broadband and 5G. Kosovo needs to continue to develop the legal framework and necessary infrastructure to stimulate e-commerce and allow for international electronic payments. This lack of relevant infrastructure was exacerbated by the COVID-19, meaning that physical commercial transactions were largely impossible for several months.

Sectoral and enterprise structure

The economic rebound was mainly driven by the sectors, which suffered heavy losses during the pandemic. Most notably, the annual output in the wholesale and retail trade sector rebounded by around 21% in real terms in 2021, as compared to 2020 levels. Construction output, which contracted in 2020 due to the pandemic, increased by 6.6%, while industry expanded by nearly 4%. The service sector continues to dominate the economy, making up around 46% of GDP and providing 65% of total employment. Within the service sector, wholesale and retail trade, real estate, transport and storage are the largest in terms of employment and output. The share of industry sector amounted to some 26% of GDP in 2021, while the contribution of agriculture in GDP stood at around its long-term average of close to 7%.

The enterprise structure of private sector in Kosovo continues to be heavily dominated by micro and small enterprises with difficult access to finance. By the end of 2021, similarly to the previous years, almost 99% of registered enterprises are those employing 1-9 employees and the remaining 1% are enterprises that employ 10-249 employees. Although credit growth has been strong over the past decade, due to bank's stringent loan requirements affecting mostly smaller enterprises, access to finance remains still an impediment to growth. Further obstacles to access to finance relate to a limited access to reliable information in the cadastre, lack of formal dispute processes and limited enforcement of collateral execution. Given the structure and the difficulties in access to finance, the benefit from economies of scale remains limited.

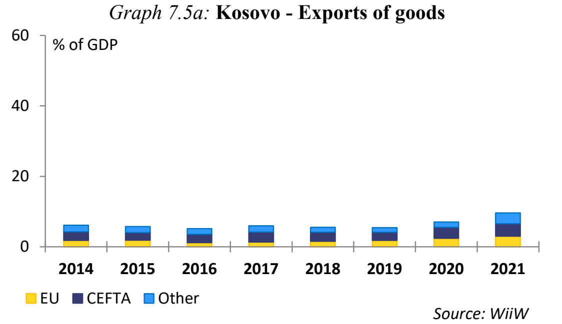
Economic integration with the EU and price competitiveness

The balance of goods trade has deteriorated due to a large increase in imports while exports also increased strongly. The merchandise deficit reached 46.1% of GDP in 2021 as compared to 42% in 2020. The rebound in consumption and investment led to substantial increase in good imports (41%), driven by mineral products and prepared foodstuffs. In 2021, the EU accounted for some 44% of the total imports of goods, CEFTA's share stayed roughly stable at 19%. The surge in goods exports (57%) was mainly driven by base metals[27], which accounts for one third of merchandise exports, followed by mineral, plastic and textile products. The improved performance was partially driven by enhanced support for exporting SMEs through digitalisation of support services and improved export promotion.The share of goods exports to the EU and CEFTA contries declined to 31% and 37% respectively, due to a noticeable increase of textile and furniture exports to the USA. The adoption of the EU standards remains low in Kosovo.

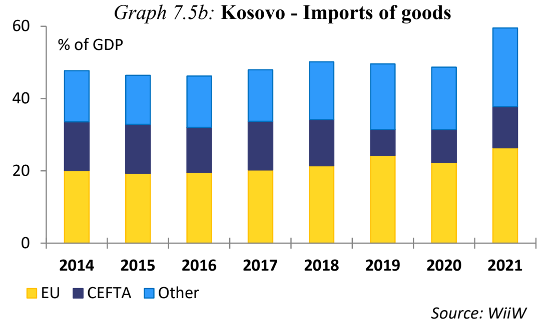
In line with robust performance of trade, the indicator for trade openness improved significantly in 2021. Overall trade openness increased to 101% of GDP in 2021 from 75.6% in the previous year. The improvement took place on both sides. Strong growth of merchandise trade was complemented by a surge in service exports. Following the lift of lockdown and travelling restrictions, exports of services almost doubled in nominal terms in 2021 compared to 2020. In addition to travelling services, currently amounting to 76% of service exports, there are positive developments in exports of IT and communication services.

The EU remains the main investor in Kosovo. Net FDI inflows are estimated to have increased by 20% in 2021, on the back of massive investment of the diaspora into real estate and reinvested earnings in the financial sector due to the ban on dividend distribution. Heavy concentration in these sectors (around 90% of FDI inflows) contribute little to enhance export capacity. The EU share in net FDI stock reached 38% while the shares of Germany and Switzerland (two countries with large diasporas from Kosovo) increased from the previous year to over 15% each.

Graph 7.5a: **Kosovo - Exports of goods**



Graph 7.5b: **Kosovo - Imports of goods**



[27] Although Ferronikeli, the largest exporter of Kosovo, halted its production due to the rise in energy prices in the last quarter of 2021, its exports nevertheless increased in the whole year of 2021.

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