ALBANIA

Highlights

- **The economy has started to recover in 2021.** After a 3.3 per cent contraction in 2020, gross domestic product (GDP) rose by 17.9 per cent year-on-year in the second quarter of 2021, driven by a recovery in domestic and external demand.
- **A new law on climate change has been adopted.** The law is an important step towards a comprehensive legal and inter-institutional framework for climate action at the national level.
- **A large-scale overhaul of the railway network has started.** In early 2021 the contract to upgrade the railway linking the capital, Tirana, with the country's largest port, Durres, was signed.

Key priorities for 2022

- **Fiscal reforms need to be strengthened to ensure sustainability of long-term public debt.** The authorities should maintain targeted support for those affected by the Covid-19 pandemic but also adopt an appropriate medium-term revenue strategy, improve public investment management and enhance the management of fiscal risks stemming from public-private partnerships, state-owned enterprises and government guarantees.
- **The business environment needs to be improved so that more private-sector companies can reach their potential.** Simplifying the tax system and procedures, strengthening the public administration capacity and fighting corruption would help reduce informality and level the playing field for businesses.
- **Financial stability should be monitored carefully.** The financial sector has remained liquid and stable throughout the Covid-19 pandemic but attention needs to be paid to the progress of restructured loans to detect any potential vulnerabilities early.

Main macroeconomic indicators %

	2017	2018	2019	2020	2021 proj.
GDP growth	3.8	4.0	2.1	-3.3	8.0
Inflation (average)	2.0	2.0	1.4	1.6	1.9
Government balance/GDP	-1.4	-1.3	-2.0	-6.9	-6.7
Current account balance/GDP	-7.5	-6.7	-7.9	-8.9	-8.6
Net FDI/GDP [neg. sign = inflows]	-8.6	-8.0	-7.5	-6.9	-6.7
External debt/GDP	68.8	65.1	60.0	66.0	n.a.
Gross reserves/GDP	25.9	26.5	24.4	30.3	n.a.
Credit to private sector/GDP	34.8	33.0	34.4	38.9	n.a.

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Covid-19: macroeconomic implications

The economy has started to recover. GDP contracted by 3.3 per cent in 2020, mostly on the back of lower exports – especially of services, which make up nearly 75 per cent of all exports and primarily consist of tourism receipts – and a drop in household consumption. The GDP contraction was smaller than expected, mainly because of accommodative fiscal policies and an uptick in construction and real estate sector activities (especially in the second half of 2020), linked to rebuilding activities following the November 2019 earthquake. GDP rose by 5.5 per cent year-on-year in the first quarter of 2021 and by 17.9 per cent in the second quarter, driven by strong investment growth, higher consumption and a healthy export recovery in the second quarter. Exports of goods increased by more than 30 per cent year-on-year in nominal terms in the first nine months of 2021, largely on the back of construction materials, metals, mineral products and textiles and footwear. The tourism sector also seems to be recovering. After the government lifted all Covid-19 pandemic restrictions for foreigners entering the country, the number of tourists in June, July and August 2021 almost reached levels seen in the same months in 2019. This recovery was largely due to more tourists from neighbouring Kosovo and North Macedonia.

Public debt remains high. General government debt increased sharply in 2020 by around 10 percentage points, reaching 77.6 per cent of GDP at the end of the year. A further increase is likely, as in June 2021 the government announced plans to place another Eurobond by the end of the year.

GDP should exceed its 2019 level by the end of 2021. A rebound is under way in 2021, with GDP expected to grow by 8.0 per cent, as household consumption demand and the tourism sector are recovering well. The planned large public investment programme, including continued reconstruction activities after the 2019 earthquake, should also boost domestic demand. Goods exports are also picking up strongly. The economy is expected to grow further at 3.7 per cent in 2022. These forecasts assume that there will be no resurgence of the Covid-19 pandemic; downside risks include the possibility of further tourism disruptions during the post-pandemic phase.

Policy response to Covid-19

A new guarantee fund is to be established. After two sovereign guarantee funds in 2020, in June 2021 the government announced plans to launch a third one. The €100 million fund is to issue loan guarantees to companies whose operations were negatively affected by the containment measures, primarily companies in tourism and manufacturing. The guarantees should be equally divided between the two sectors.

The total budget for Covid-19-related expenditures in 2021 is 1.0 per cent of GDP. The budget targets extra spending on healthcare, including higher wages for healthcare workers, along with increased social assistance and unemployment benefits. In January 2021 the Bank of Albania (BoA) extended the suspension of dividend distribution by banks until the end of 2021. In February 2021 the BoA and the European Central Bank (ECB) agreed to prolong the duration of the repurchase agreement (repo) line set in mid-2020 until March 2022. The BoA can borrow up to €400 million from the ECB in exchange for adequate euro-denominated collateral.

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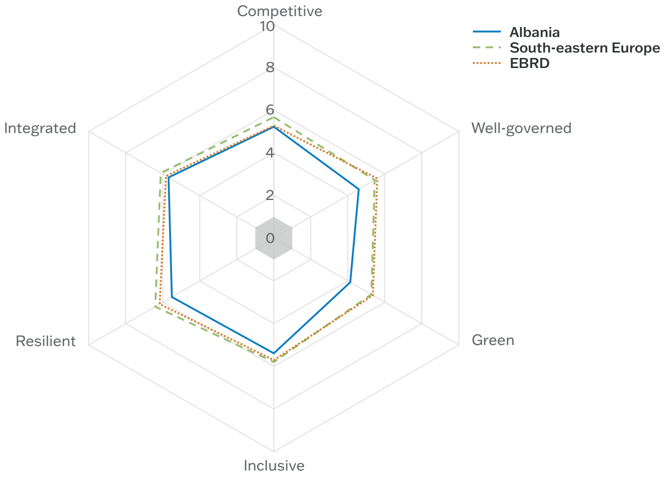
Assessment of transition qualities (1-10)



Structural reform developments

No decision has been made on the opening of European Union (EU) accession negotiations. Despite the green light in March 2020 and the fact that Albania subsequently met the conditions set by the European Council for organising the first intergovernmental conference (IGC), no consensus on the IGC (the formal start of negotiations) has been possible in 2021. In June 2021 the Council concluded that this issue ought to be addressed during Slovenia's presidency of the EU in the second half of 2021.

The government is developing a strategy to promote business and investment. In July 2021 a new Business and Investment Development Strategy 2021-27 and the associated action plan were adopted following public consultations held in June. The strategy aims to improve access to finance for businesses, introduce a financial scheme for human capital development and attract foreign investors while retaining existing ones. Also, new tax legislation entered into force in 2021. Taxpayers with an annual income of less than ALL 14 million (€115,000) now pay zero corporate income tax (versus 5 per cent previously). The same applies for local taxes for taxpayers with an annual turnover of less than ALL 8 million (€65,000), while the threshold for the application of value added tax (VAT) has been increased fivefold, to ALL 10 million (€80,000). In addition, a new fiscal reform was introduced to mandate online reporting of all issued invoices and receipts for all businesses, thus aiming to reduce informality and increase fiscal revenues.

The country has adopted the Law on Climate Change. The law, approved in December 2020, envisions, among other measures, submitting the country's Nationally Determined Contribution on reducing greenhouse gas emissions to the United Nations Framework Convention on Climate Change, and creating a comprehensive legal and inter-institutional framework for climate action at national level. In addition, it provides the legal basis for the country to adopt the National Energy and Climate Plan for the period 2021-30.

The construction of the third-largest solar park in the country is advancing. In March 2021 French company Voltalia won the tender to build and operate the 100 MW Spitalle solar park in Durres.

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The authorities are set to increase the number of international airports in the country to support tourism development. In April 2021 Albania opened its second international airport in Kukes in the north east of the country. The airport was built in 2006 but was not made operational until now. Progress has also been made in the past year towards building further airports. In November 2020 the government reopened a tender for the construction of a new airport in Vlora, in the south of the country. Four months later, a 35-year concession for operating Vlora Airport was approved. And in August 2021 a €37 million tender was announced for the construction of a fourth airport, in the southern city of Saranda.

A large-scale overhaul of the railway network in Albania has started. In February 2021 the first contract for upgrading works was signed, supported by the European Bank for Reconstruction and Development (EBRD) and the EU. Under the contract, more than 34 km of the existing railway between Tirana and the country's largest port (Durres) will be upgraded. In addition, a new 5 km rail track connecting Tirana city with Tirana International Airport will be constructed.

The banking sector remains well capitalised and liquid but non-performing loans (NPLs) are still relatively high. At the end of March 2021 the capital adequacy ratio stood at 18.1 per cent and one-third of banks' assets were liquid. The NPL ratio has slightly declined over the past year but, at 7.8 per cent at the end of May 2021, it remains the highest in the Western Balkans and could start rising again if the economy fails to recover as predicted.

BOSNIA AND HERZEGOVINA

Highlights

- **Economic recovery has started in 2021.** After a gross domestic product (GDP) contraction of 3.2 per cent in 2020, the first half of 2021 was marked by positive signs for the economy, including strong growth in manufacturing output, exports and tourist overnight stays.
- **Work on transitioning away from coal has started but concerns remain about environmental sustainability.** One of the three state-owned power utilities in the country has agreed with the miners' union on a restructuring plan, but the country is in breach of environmental standards of the Large Combustion Plant Directive (LCPD).
- **Loan repayment moratoria and other Covid-19 response measures were extended.** Due to the worsening epidemiological situation in early 2021, the loan repayment moratoria were prolonged until June 2021 and other special measures for banking sector clients up to the end of December 2021.

Key priorities for 2022

- **To support post-Covid-19 recovery, public capital expenditure should be boosted and strategic planning for large capital investments introduced.** The authorities currently lack a comprehensive investment strategy, and implementation of public investment projects is often slowed by weak internal capacity, lack of financing and political disagreements.
- **Reforms of state-owned enterprises (SOEs) should be stepped up.** The country still has a large and inefficient SOE sector. Establishing a clear ownership rationale, key performance indicators and an effective governance system should improve the performance of the sector, with positive spill-over effects to the private sector and whole economy.
- **Financial stability should be closely monitored and supervisory activities properly coordinated.** Although banking supervision agencies have worked together during the Covid-19 pandemic, there is no centralised macro-prudential framework in the country. In addition, some obstacles to an effective non-performing loan (NPL) resolution (for example, facilitation of out-of-court restructurings or tax treatment of NPL sales to specialised companies) remain.

Main macroeconomic indicators %

	2017	2018	2019	2020	2021 proj.
GDP growth	3.2	3.7	2.8	-3.2	4.5
Inflation (average)	1.2	1.4	0.6	-1.6	1.8
Government balance/GDP	1.8	1.7	1.4	-4.1	-3.3
Current account balance/GDP	-4.8	-3.3	-2.8	-3.8	-3.9
Net FDI/GDP [neg. sign = inflows]	-2.3	-2.9	-1.5	-1.7	-2.2
External debt/GDP	72.0	64.4	64.3	69.5	n.a.
Gross reserves/GDP	33.6	34.8	35.7	40.5	n.a.
Credit to private sector/GDP	58.3	57.5	58.0	58.9	n.a.

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Covid-19: macroeconomic implications

After a recession in 2020, economic activity has been recovering in 2021. The economy contracted by 3.2 per cent in 2020 on the back of falling exports, consumption and investment. The tourism sector was severely affected; foreign tourist arrivals decreased by 84 per cent in 2020. Trade, transport and accommodation and food services recorded a combined decline of more than 10 per cent. The crisis also hit the manufacturing sector, where production of base metals, motor vehicles and other transport equipment fell by around 25 per cent and the production of furniture, clothes and beverages by around 15 per cent. Because of the Covid-19 pandemic, remittances from the country's large diaspora also shrank by 16 per cent, negatively affecting consumption. The recovery started in the first quarter of 2021, with GDP growing by 1.5 per cent year-on-year on the back of growth in private consumption and exports. Growth accelerated in the second quarter as the economy expanded by 11.6 per cent year-on-year, with strong expansion across all expenditure categories. Manufacturing output started expanding from March, averaging nearly 9 per cent year-on-year until September, and goods exports increased sharply in the first nine months (33.1 per cent year-on-year in nominal terms). The tourism sector is also doing significantly better, with a 112 per cent increase in overnight stays of foreign tourists in the first eight months of 2021 versus a year earlier. Still, the number of overnight stays is around 55 per cent of that in the same period in 2019.

Bosnia and Herzegovina did not secure a programme with the International Monetary Fund (IMF). The talks between the country's authorities and the IMF on a three-year Extended Fund Facility worth €750 million ended in failure in December 2020, due to disagreement over which reforms should be included in the programme. Discussions about a new programme may restart later in 2021.

Public debt has increased moderately. As a result of the entity governments requiring more financing to respond to the Covid-19 crisis, public debt rose by around 4 percentage points over the past year, to 36.7 per cent of GDP at the end of 2020. In April 2021 Republika Srpska placed a five-year Eurobond worth €300 million on international financial markets (London Stock Exchange). The Republika Srpska government planned to use the proceeds to finance the budget and repay debts. Disbursement of the European Commission (EC)'s macro-financial assistance, approved in May 2020, has progressed very slowly. The disbursement of the first instalment (€125 million) is awaiting the country's ratification of the memorandum of understanding, which was signed in January 2021. IMF special drawing rights of approximately €300 million were allocated at the end of August 2021.

Moderate growth is expected in the short term. GDP is forecast to grow by 4.5 per cent in 2021 on the back of the ongoing recovery in exports and resumption of consumption, followed by 3.0 per cent growth in 2022. Downside risks include a potentially slower recovery in the main eurozone export markets, a possible prolonged impact of the Covid-19 pandemic on tourism and the persistent unwillingness of the authorities to undertake structural reforms and increase investor confidence.

Policy response to Covid-19

The accommodating fiscal policy is continuing in 2021. Fiscal measures related to the Covid-19 response in 2020 amounted to 2.5 per cent of GDP in 2020 and are projected at around 1.8 per cent of GDP in 2021. These primarily include support for firms but also households, as well as extra spending on the health sector. In 2020 the entity governments established guarantee funds to support on-lending by commercial banks. The Federation of Bosnia and Herzegovina fund (backed by government funding of around €50 million) has no expiration date. The Republika Srpska fund (backed by government funding of around €25 million) is set to expire by the end of December 2021, but may be extended.

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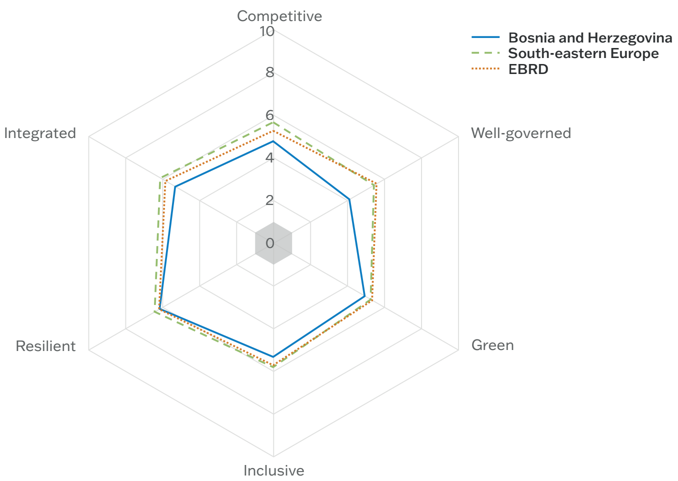
Loan repayment moratoria and other measures adopted at the onset of the Covid-19 pandemic have been extended. In March 2021 the application of the loan repayment moratoria, initially set to expire at the end of 2020, was extended by six months by the banking agencies of Republika Srpska and the Federation of Bosnia and Herzegovina, to June 2021. Other special measures, such as a grace period for repaying loan principal and a longer maturity for annuity loan repayments, were extended until the end of December 2021.

Assessment of transition qualities (1-10)



Structural reform developments

There has been limited progress in the European Union (EU) approximation process over the past year. The country submitted an EU membership application in February 2016. In May 2019 the European Commission issued its Opinion on the application, which was subsequently endorsed by the Council. The Opinion identified 14 key priorities for the country to fulfil in order to be recommended for the status of EU candidate country. In its most recent report of October 2020, the European Commission recognised that some steps have been taken to address the key priorities from the Opinion amid the Covid-19 pandemic. However, the report also states that the country is at an early stage in its level of preparedness and ability to take on the obligations of EU membership and needs to significantly step up the process to align with the EU *acquis* and implement and enforce related legislation.

Problems with energy efficiency and pollution have led to infringement procedures. Bosnia and Herzegovina is in breach of environmental standards of the LCPD. As a signatory of the Energy Community Treaty, the country is subject to the LCPD, which sets emission limits for sulphur dioxide, nitrogen oxides and dust (particulate matter) for plants with a rated thermal input equal to or above 50 MW. However, with the energy sector heavily dependent on coal, the country keeps exceeding agreed limits. Consequently, the Energy Community Secretariat launched an infringement case in March 2021. This comes on top of an existing infringement process regarding the planned Tuzla 7 thermal power plant (450 MW), the construction of which remains uncertain.

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A credible commitment to decarbonisation is still missing. While work on a National Energy and Climate Plan (NECP) is ongoing, both entities currently lack a credible and firm commitment to decarbonisation, in particular to the transition away from coal-fired power. All three state-owned electricity generators have strengthened their plans for new renewable energy sources, envisaging large investments in wind, solar and new hydropower plants. Other investments in gas interconnections for heating purposes are planned. However, some of these planned projects are already marked by controversy and it remains to be seen whether the SOEs have the financial capacity to implement these significant investments. And with the authorities' lack of firm commitment to a credible NECP and regulatory framework to enable bankable private sector investments, these renewable energy investments are placed in doubt.

Work on a transition away from coal has started in the FBiH entity. EPBiH, one of the three state-owned power utilities in the country, has initiated a reorganisation of the coal mines to make them economically sustainable. In May 2021 the government of the Federation of Bosnia and Herzegovina, EPBiH and the miners' union agreed on restructuring, which will see the number of employees in the mines fall by 2,000 to 5,200 by 2023. This plan also envisages new investments and efforts to reskill employees. Discussions on a Just Transition Roadmap have started at the state and entity levels. Renewable energy capacity has also expanded, with the wind farm Podvelezje (48 MW of installed capacity) starting operations in March 2021. In addition, in July 2021 the EPBiH announced plans to build solar power plants on former open-pit coal mines. It also launched a public call for municipalities, individuals and legal entities to express interest in selling or leasing out land for constructing photovoltaic power plants.

Banking sector NPLs are down but still relatively high. The capital adequacy ratio of the banking sector stood at 18.9 per cent at the end of March 2021, well above the regulatory minimum of 12.0 per cent. At the same time, the NPL ratio of the banking sector was at 6.0 per cent, down from 6.6 per cent a year ago but with the potential to increase once loan repayment moratoria and special measures have been lifted. During the Covid-19 pandemic, the two entity banking supervisory agencies have worked closely together to implement support measures such as debt moratoria.

BULGARIA

Highlights

- **The economic recovery has been modest so far.** Gross domestic product (GDP) expanded by 3.4 per cent in the first half of 2021, while quarter-on-quarter growth remained negative.
- **The policy response to Covid-19 has been extended with more permanent measures in 2021.** While regional peers continued conditional support measures for employment and company liquidity, the authorities in Bulgaria have also focused on increased resources for pensions and public wages.
- **Reforms in the energy sector continue, with an enhanced focus on renewables.** Liberalisation of the electricity market will be accompanied by the introduction of market-based support for small renewable projects, while administrative barriers to renewables are being removed.

Key priorities for 2022

- **Efficiently implementing incoming European Union (EU) funds will be critical.** As of mid-October 2021, Bulgaria has submitted its Recovery and Resilience Facility (RRF) plan and is now awaiting assessment by the European Commission. Bulgaria has requested a total of €6.6 billion in grants under the RRF. Political stability would help the country prepare for the next EU budget and adequately direct the allocation of EU funds towards key objectives.
- **Further efforts are needed to improve governance and the rule of law.** Areas that require attention include the anti-money laundering framework, the non-banking financial sector, state-owned enterprises and the insolvency framework, all of which would help the country achieve its target of adopting the euro in January 2024.
- **Moves towards decarbonisation should be stepped up.** Energy sector reforms have lagged those of Bulgaria's peers but the authorities have been considering coal phase-out dates. New opportunities for firms are opening up with the liberalisation of the market and high electricity and gas prices are creating incentives for decarbonisation.

Main macroeconomic indicators %

	2017	2018	2019	2020	2021 proj.
GDP growth	2.8	2.7	4.0	-4.4	4.2
Inflation (average)	1.2	2.6	2.5	1.2	2.1
Government balance/GDP	0.8	0.1	-1.0	-2.9	-3.7
Current account balance/GDP	3.3	0.9	1.9	-0.3	0.5
Net FDI/GDP [neg. sign = inflows]	-2.5	-1.3	-2.0	-3.5	-2.7
External debt/GDP	71.8	66.1	61.3	64.6	n.a.
Gross reserves/GDP	45.0	44.6	40.4	50.3	n.a.
Credit to private sector/GDP	49.5	49.8	48.9	51.3	n.a.

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Covid-19: macroeconomic implications

The economy remains below the pre-pandemic level. After plunging in the second quarter of 2020 (and by 4.4 per cent in the full year 2020), GDP closed some of the gap in the third quarter of 2020. Net exports, private consumption and inventories were the main headwinds to growth in 2020, while investment and government spending held up relatively well. In 2021 the economy failed to expand, as in the first two quarters quarterly GDP growth declined by 0.1 and 0.3 per cent, respectively. Private consumption has been the main driver of growth in 2021, as investments had a sluggish performance, while export growth in the second quarter did not compensate the accelerated growth of imports supported by domestic demand.

Pressure on government spending has increased. At the end of July 2021 the budget recorded a 0.6 per cent of GDP surplus for the year to date, lower than the surplus recorded in 2020 and in previous years. Expenditures rose significantly in this period, by 21.4 per cent, on the back of increased social spending and personnel costs. The 2021 budget originally targeted a deficit of 3.9 per cent of GDP, but the current caretaker government has drafted a revision proposing a cash-based deficit of 3.6 per cent of GDP. The revision shifts resources to allow the government to deal with another Covid-19 infection wave in autumn 2021, cover the upcoming pension increase and continue supporting the private sector.

Inflation has picked up in 2021. After falling to a low of -0.6 per cent in January 2021, inflation increased to 3.7 per cent year-on-year by August 2021, largely due to higher fuel, gas and electricity prices. The wholesale electricity price on the local exchange reached record highs in August 2021, mainly due to the increase in demand and a more expensive carbon price, prompting some companies to stop production.

The growth outlook remains favourable but downside risks are strong. We forecast the economy to expand by 4.2 per cent in 2021 on the back of the expansionary fiscal policy, which is supporting consumption. The main downside risks are a prolonged political stalemate, which could affect the budget execution and EU funds absorption, and the low vaccination rate. The authorities are already preparing for another wave of infections, which could lead to new containment measures. In 2022 the economy should grow by 4.4 per cent, with EU funds expected to support investment.

Policy response to Covid-19

The policy response in 2021 was mostly concentrated on long-lasting policy changes. In 2020 the authorities deployed a Covid-19 crisis-response package of about 3 per cent of GDP, centred on the 60/40 scheme covering wages, a decreased value added tax (VAT) rate in the hospitality sector until the end of 2021 and liquidity support through the Bulgarian Development Bank. In 2021 the government extended the 60/40 scheme to help preserve jobs. A pension bonus of about €25 was introduced in autumn 2020, with parliament voting for an increase to €60 from October 2021 until the end of the year. Resources were also shifted towards more permanent increases in spending, such as a 10 per cent increase in public wages and a hike of 12.5 per cent in pensions starting December 2021, on top of an indexation of 5 per cent approved in July 2021.

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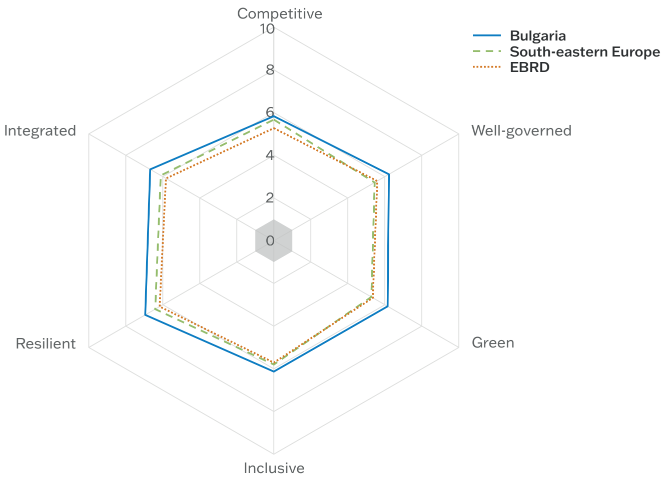
Assessment of transition qualities (1-10)



Structural reform developments

The competition law was updated as a step towards full alignment with EU regulations. The amendments to the law came into force at the end of February 2021, transposing the EU directives on European Competition Network Plus (ECN+) and Unfair Trading Practices (UTP). Among the main changes are: introducing a significant impediment of effective competition test in antitrust proceedings; repealing the concept of stronger bargaining power (a rather unclear procedure introduced by Bulgaria in 2015 but not in other EU member states); and stricter deadlines for solving cases by the Commission for Protection of Competition. Other updates this year include measures to address bid rigging and the introduction of a pre-notification contact in merger proceedings.

Digitalising the judiciary has accelerated. Due to the outbreak of the Covid-19 pandemic and the need to respect containment measures, the judicial process has been allowed to operate digitally. In July 2020 parliament amended the Civil Procedure Code to introduce online court hearings, including administrative and criminal cases.

The Energy Act was amended to include support for small renewables and remove indirect administrative barriers. The premium model for renewable projects with a capacity between 0.5 MW and 1 MW was proposed in an amendment to the Energy Act in November 2020. The introduction of small renewable projects comes after premiums replaced the feed-in tariffs for projects over 1 MW in 2019 and over 4 MW in 2018. This will support further liberalisation of the energy market and provide stronger incentives to deploy renewable sources. In addition, new renewable projects will not be required to pay a contribution of 5 per cent of future income to the Security of Electricity Supply fund, set up to stabilise the electricity market.

Competition watchdog CPC approved Eurohold's acquisition of the assets of Bulgarian power company CEZ. After a years-long process and the initial CPC ruling against the acquisition in 2019, the process was finalised in early 2021. The European Bank for Reconstruction and Development (EBRD) agreed on a €60 million loan to Eurohold to support the €335 million acquisition and modernisation of the acquired assets, as well as digitalisation and improved governance.

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A new gas interconnection project was launched to link Bulgaria with Serbia. The project, which was announced in 2018 with construction expected to start by the end of 2021, is in line with the government's plans to ensure energy security and diversify sources. The €85 million connector will be operated by Bulgartransgaz, which, given its regional importance, has received financing from the EU and the European Investment Bank (EIB). This complements another interconnector between the two countries, which became operational in 2021 and is part of the TurkStream pipeline. A notable regulatory change is the introduction of licensing for wholesale natural gas traders.

The Waste Management Act was updated to include more ambitious recycling targets. The amendments, which will come into force at the start of 2022, cover increased recycling targets for packaging waste along with a phased schedule within which to reach them. The aim is to recycle 70 per cent of packaged waste by 2030. Moreover, all entities producing packaged waste are now obliged to adhere to the law, while commercial sites need to ensure they have adequate facilities to collect and separate this type of waste.

Amendments to the law on protection from domestic violence are currently under way. The changes aim to address the gaps and weaknesses of the current law, such as the lack of effective protection of victims, poor coordination between relevant institutions and insufficient data collection. Domestic violence remains a serious issue in Bulgarian society and the number of cases has increased since the outbreak of the Covid-19 pandemic.

KOSOVO

Highlights

- **Growth has started to recover in 2021.** After the 5.3 per cent contraction in 2020, the economy expanded by 16.3 per cent year-on-year in the second quarter of 2021 on the back of growth in domestic demand and exports.
- **A new economic recovery package has been adopted.** The package, worth €420 million, includes support to employment, manufacturing, families and the public sector, as well as investment in infrastructure and the environment.
- **The much-needed green agenda is gradually advancing.** Since the end of 2020 Kosovo's transmission system operator (TSO) KOSTT has signed three important agreements on new renewable energy projects (wind and solar).

Key priorities for 2022

- **Further improvements in the business environment and public governance are needed.** The private sector would benefit from the government cutting red tape, reforming business inspections and fighting corruption. Strengthening fiscal management and the governance of state-owned enterprises (SOEs) would also help to increase the economy's resilience to future shocks.
- **More progress towards a green transformation of the energy sector is critical.** Further efforts are needed in implementing the auctions systems in renewables, introducing a competitive market-based system to award new licences and exploring the potential of gas as a transition fuel instead of the old lignite power plants, which should be decommissioned.
- **Financial stability should be monitored carefully.** The financial sector withstood the recession well but non-performing loans (NPLs) could rise with the phasing out of regulatory measures and government support.

Main macroeconomic indicators %

	2017	2018	2019	2020	2021 proj.
GDP growth	4.8	3.4	4.8	-5.3	7.7
Inflation (average)	1.5	1.1	2.7	0.2	3.1
Government balance/GDP	-1.4	-2.8	-2.9	-7.8	-4.8
Current account balance/GDP	-5.7	-7.8	-5.8	-6.7	-7.9
Net FDI/GDP [neg. sign = inflows]	-3.3	-3.4	-2.7	-4.2	-1.2
External debt/GDP	32.9	30.5	31.2	37.2	n.a.
Gross reserves/GDP	10.8	11.5	12.2	13.3	n.a.
Credit to private sector/GDP	38.9	41.1	42.8	47.8	n.a.

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Covid-19: macroeconomic implications

Gross domestic product (GDP) is recovering well in 2021. The economy experienced a recession of 5.3 per cent in 2020. While exports of services fell fairly sharply (by 40 per cent), investments contracted by a milder 7.1 per cent and household consumption recorded growth of 2.5 per cent, supported by remittance inflows. Manufacturing also recorded growth, reflected in a surprising growth in exports of goods of 21.7 per cent, but output from the trade, transport and construction sectors fell strongly. In the first quarter of 2021 GDP grew by 5.6 per cent year-on-year and by 16.3 per cent year-on-year in the second quarter on the back of a strong rise in consumption, investment and exports. Both exports of goods and services recorded a robust nominal growth in the first half of the year (each by around 60 per cent year-on-year).

Prices are trending up. Following a mild deflation in the second half of 2020 and early 2021, the year-on-year inflation rate picked up relatively strongly thereafter, rising from 0.2 per cent in January 2021 to 4.9 per cent in September 2021. The uptick in prices came primarily on the back of growth in prices of transport (oil), telecommunication services, alcoholic beverages and tobacco.

Economic activity could reach its 2019 level in 2021, subject to upside risks being realised. According to our latest forecasts, GDP should expand by 7.7 per cent in 2021, mainly driven by the recovery in investment and travel and tourism activities related to the country's large diaspora. In 2022 GDP growth is expected to pick up further to 4.5 per cent. Risks to the projection seem to be more on the upside in 2021, given the positive developments in the first half of the year and reopening of the borders. Still, the pace at which diaspora visits and the economy as a whole recover will depend on how the Covid-19 pandemic develops, both locally and globally. Stronger economic growth would be helped by improving public investment management and accelerating the hitherto slow implementation of key infrastructure projects.

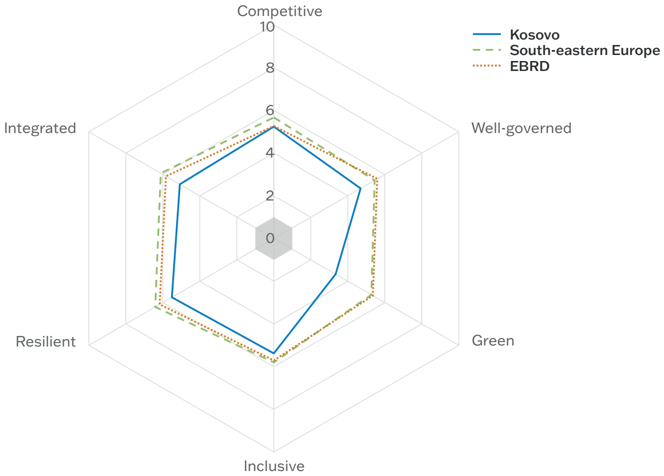
Policy response to Covid-19

The Law on Economic Recovery has been adopted. The law, approved in December 2020, included an additional stimulus for businesses affected by the Covid-19 crisis, proposals to subsidise wages to employees who lost their jobs and the removal of value added tax (VAT) on all raw materials. Since the fiscal implications of the law were not fully covered by the 2021 budget, a revised budget was prepared in July 2021, following the adoption of the new government's programme 2021-25. The economic recovery package amounted to €420 million, with €190 million envisaged to come from the budget and the rest from borrowing.

The country has issued treasury bonds for the diaspora. In July 2021 the Ministry of Finance issued a public call to resident and non-resident physical persons to buy three-year and five-year diaspora bonds (carrying an annual interest rate of 1.2 per cent and 2.2 per cent, respectively), which are part of the economic recovery package. The first sale, in the amount of €10.4 million, was completed in August 2021.

CONTINUES

Assessment of transition qualities (1-10)



Structural reform developments

There has been little progress in the European Union (EU) approximation process over the past year. Kosovo signed the Stabilisation and Association Agreement with the EU in October 2015, which formally entered into force in 2016. While the European Commission (EC) has repeatedly stressed that Kosovo shares the European perspective of the Western Balkans, the question of its integration into the EU remains contentious due to the fact that five EU member states do not recognise Kosovo bilaterally. Although the Commission confirmed that Kosovo fulfilled outstanding visa liberalisation benchmarks, the decision on visa liberalisation is pending in the European Parliament and the Council, and citizens of Kosovo remain unable to travel to the Schengen area without a visa.

The TSO KOSTT has started operating as part of the energy bloc with Albania. The connection agreement between KOSTT and TSOs from continental Europe entered into force in December 2020, marking the start of operations of KOSTT as a control area within the joint control block with OST, the Albanian TSO. A year earlier, KOSTT and OST signed an agreement to set up a common energy market consisting of Kosovo and Albania. In addition, the new 400 kV line between Kosovo and Albania has been put into operation, contributing to further cross-border exchanges.

A draft law on the Commercial Court has been prepared. The Commercial Court is being set up to increase the effectiveness of trade dispute resolution. Until now, many businesses have had to file claims in two departments of the Pristina Basic Court (the Economic Department and the Administrative Department). However, their unclear mandates and jurisdictions result in delays and sometimes inconsistent decisions by the two departments. The Commercial Court would be the sole body in charge of resolving trade disputes involving foreign businesses and other investors. The draft law was prepared in March 2021 and adopted by the Kosovo Assembly's legislation committee in July 2021.

The central bank of Kosovo (CBK) has developed a national strategy for retail payments. The National Retail Payments Strategy 2021-26 was prepared and published in July 2021. The strategy stipulates that the CBK should finalise transposing the relevant EU Directives, continuously review the legal and regulatory framework of the country's retail payments market and encourage the use of innovative payment services and instruments. To ensure progress of the strategy's implementation, increasing the adult account ownership ratio and the number of cashless payments per capita are set as objectives.

CONTINUES

The financial system has remained stable throughout the Covid-19 pandemic. Banks withstood the recession well, relying on previously high levels of liquidity and capital. In June 2021 the capital adequacy ratio in the banking sector averaged 17.3 per cent, while the liquidity ratio (showing the coverage of short-term liabilities by liquid assets) was 36.7 per cent. The quality of bank assets has also remained good, with the NPL ratio at 2.5 per cent in June 2021. However, asset quality requires continued vigilance as regulatory forbearance measures are being lifted.

MONTENEGRO

Highlights

- **The economy is recovering from a deep recession in 2020.** Gross domestic product (GDP) fell by more than 15 per cent in 2020 but data from the second quarter of 2021 show a strong recovery in foreign tourist overnight stays, retail sales and manufacturing output.
- **Progress has been made on the country's digital agenda.** The electronic monitoring of fiscal cash registers has begun and a new electronic platform is enabling the rapid establishment of new companies.
- **The country has announced a date for phasing out coal.** Montenegro has joined the Powering Past Coal Alliance and has committed to ending power generation from coal by 2035.

Key priorities for 2022

- **The government needs to step up fiscal consolidation once Covid-19 concerns recede.** To ensure fiscal sustainability, it is important not only to improve public investment management and tax collection, but also to adopt a comprehensive medium-term public debt management strategy and establish a fiscal council to strengthen the oversight of fiscal policy. Public investment projects should be assessed carefully and prioritised based on a cost-benefit analysis.
- **State-owned enterprise (SOE) governance should be enhanced.** Montenegro has a relatively large SOE sector and some important companies are run inefficiently. Adopting a government policy or law that defines the overall objectives of state ownership and its effective implementation would be desirable.
- **A "just transition" for the planned phase-out of coal should be ensured.** To mitigate the negative social and economic impacts of closing coal-fired power plants in the affected regions, it is important to work out in advance a strategy to address associated labour and regional development issues.

Main macroeconomic indicators %

	2017	2018	2019	2020	2021 proj.
GDP growth	4.7	5.1	4.1	-15.3	12.3
Inflation (average)	2.4	2.6	0.4	-0.3	2.0
Government balance/GDP	-6.8	-6.2	-1.8	-10.9	-5.0
Current account balance/GDP	-16.1	-17.0	-14.3	-26.0	-21.0
Net FDI/GDP [neg. sign = inflows]	-11.3	-6.9	-6.2	-11.2	-9.1
External debt/GDP	161.0	163.7	169.0	224.1	n.a.
Gross reserves/GDP	19.7	22.3	27.6	41.5	n.a.
Credit to private sector/GDP	48.9	49.6	49.0	59.9	n.a.

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Covid-19: macroeconomic implications

After a major recession in 2020, the economy started to recover in the first half of 2021. In Montenegro, around one-fifth of GDP normally comes from tourism. Due to the Covid-19 pandemic and strict border policies, foreign tourist arrivals declined by 86 per cent in 2020. Consequently, GDP contracted sharply, by 15.3 per cent. The contraction came primarily on the back of falling services exports (mainly tourism-related) but investment and consumption also declined strongly. Although GDP fell again in the first quarter of 2021 on a year-on-year basis, it recovered strongly in the second quarter. In this quarter, retail sales picked up significantly (by almost 20 per cent year-on-year) and manufacturing output by 13 per cent year-on-year, while the number of foreign tourist overnight stays in July and August was around 85 per cent of the 2019 level.

Prices are trending up. The economy entered deflation in the second quarter of 2020, with the inflation rate averaging -0.2 per cent for the year as a whole. However, price growth became positive in the first nine months of 2021 (1.8 per cent year-on-year) on the back of higher transport (oil) and food and beverage prices.

Public debt reached a record high in 2020. The strong economic contraction and increased government expenditures to mitigate the negative effects of the Covid-19 pandemic resulted in public debt exceeding 100 per cent of GDP at the end of 2020. In light of the deteriorating fiscal and external positions, ratings agency Standard & Poor's downgraded Montenegro's sovereign ratings in March 2021 by one notch, to B. In July 2021 the government managed to hedge the Chinese Exim Bank loan for the Bar-Boljare highway through a swap deal which eliminated future exchange rate volatility risk and reduced the interest rate.

The short-term rebound is expected to continue. In 2021 GDP is forecast to increase by 12.3 per cent. A more relaxed border policy this year has boosted the tourism sector, while last year's positive base effect will contribute additionally to the relatively high growth rate. In 2022 a further recovery is expected, with the economy projected to expand by 5.7 per cent. Downside risks to the forecast are a possible weaker-than-expected recovery in tourism due to a prolonged impact of the Covid-19 pandemic, as well as limited fiscal space to accommodate further spending should such needs arise.

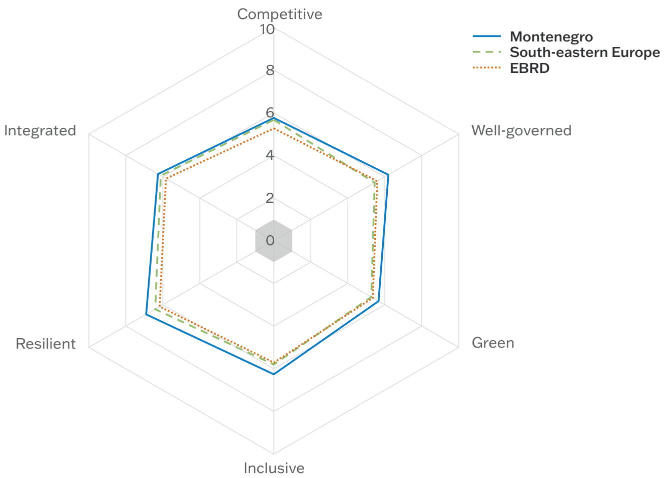
Policy response to Covid-19

The government has adopted two more aid packages in 2021. The first package of measures, adopted in January 2021, included providing wage subsidies for businesses severely affected by the Covid-19 pandemic, as well as one-off assistance to the unemployed, pensioners and social welfare beneficiaries. Additional measures were also taken to support tourism and agriculture. The latest package, approved in April 2021, included credit support for the economy (aimed at providing the economy with at least €110 million of new loans in 2021) and support for tourism and the vulnerable.

The moratorium on loan repayments has been extended. In 2021 the Central Bank of Montenegro extended the right of loan beneficiaries to use the moratorium. Those who were given the right to a moratorium on loan repayment until 31 August 2021 included businesses performing activities threatened by the Covid-19 pandemic, providing accommodation and food services or preparing the tourist season, as well as those whose total revenue in 2020 was at least 50 per cent lower than in 2019. The moratorium was also extended until the end of 2021 for the repayment of loans granted to private persons who lost their job after 31 March 2020 or whose net salaries had not been paid to them for more than three months before submitting the application.

CONTINUES

Assessment of transition qualities (1-10)



Structural reform developments

There is a renewed focus on closing European Union (EU) accession negotiating chapters. Having opened the last remaining chapter of the EU accession negotiating framework in 2020, the focus has now shifted to closing chapters. Only three chapters were provisionally closed since the opening of accession negotiations in June 2012 and there has been no progress on this over the past year. According to the European Council, further progress on negotiations will depend on meeting the interim benchmarks set out in the rule-of-law chapters (chapters 23 and 24) of the EU *acquis*.

The country has a new state-owned national carrier, while the future of the former one is unclear. In December 2020 the government announced the decision to shut down the troubled state-owned Montenegro Airlines and replace it with a new national carrier. Earlier, the company had received financial support from the government worth €43 million, which the Agency for Protection of Competition did not consider to be in line with state aid rules. In February 2021 a new state-owned national carrier, Air Montenegro, was established and it started operations in June. The future of the former national carrier, which is undergoing bankruptcy proceedings, remains unclear as it has restored some business operations and reopened sales offices in the country.

A new state-owned company has been established to supervise the management of other SOEs. In August 2021 the government decided to establish a company – Montenegro Works – whose task will be to oversee and analyse the financial performance of SOEs and to ensure that reforms to increase their efficiency are properly implemented. The company will provide strategic guidance to the government on establishing appropriate policies for managing SOEs. The effectiveness of the new company remains to be seen.

An infringement procedure has been launched against Montenegro over the thermal power plant (TPP) Pljevlja. In April 2021 the Secretariat of the Energy Community (the EU energy watchdog) initiated an infringement procedure against Montenegro for continuing to operate its only TPP after the opt-out period under the Large Combustion Plants Directives had expired. The authorities are planning an ecological reconstruction of TPP Pljevlja.

The country has set the date for the coal phase-out. In June 2021 Montenegro joined the Powering Past Coal Alliance, promoting the coal phase-out and the transition to clean energy. The country has announced it will end power generation from coal by 2035. Plans on how to meet this goal remain to be developed.

CONTINUES

Feed-in tariffs have been abolished for renewables. In July 2021 the government announced that it would no longer provide incentives for renewable energy as the country had met its target of a 33 per cent share of renewable energy in final energy consumption (in 2018 and 2019 the share was 39.8 and 38.7 per cent, respectively). In recent years Montenegro has made progress on creating a relevant legislative framework for developing renewable energy and decarbonisation, including legislation to limit greenhouse gas emissions, as well as introducing an emissions trading scheme for large industrial emitters.

Electronic monitoring of fiscal cash registers (e-fiscalisation) has started. Application of the Law on Fiscalisation in the Trade in Goods and Services, which entered into force in mid-2019, began on 1 January 2021, although full application was delayed until 1 June 2021. Together with more efficient inspections, e-fiscalisation should contribute to reducing the grey economy and increasing tax revenues.

Electronic registration of new companies has been enabled. In July 2021 the eFirma platform was launched, making it possible to establish a new company electronically. This has significantly shortened the time required for registration and reduced costs, as there are fewer required procedures and documents. The process to set up a company now takes just three days.

NORTH MACEDONIA

Highlights

- **Economic growth is picking up.** As a result of the Covid-19 pandemic, gross domestic product (GDP) fell by 4.5 per cent in 2020, with industry, trade, transport and tourism being particularly affected. Manufacturing, exports and retail trade picked up relatively strongly in the first six months of 2021.
- **Plans have advanced for the closure of coal-fired power plants.** The country is preparing to shut down all coal-fired thermal power plants by the end of 2027, as set out in the National Energy and Climate Plan (NECP), currently under public consultation.
- **Support for economic inclusion of the Roma population has been increased.** A new €2 million fund has been set up to support Roma businesses and address unemployment in this community.

Key priorities for 2022

- **To maintain fiscal sustainability, the fiscal governance framework needs to be improved.** While fiscal policy should remain supportive to growth, it would be important to develop a credible medium-term fiscal strategy. The focus needs to be on enhancing the efficiency of tax collection and improving public investment management.
- **A "just transition" for the planned phase-out of coal should be ensured.** To mitigate the negative social and economic impacts of the closure of coal-fired power plants and related coal mines in the affected regions, it is important to work out in advance a plan to address associated labour and regional development issues.
- **Educational reform should be accelerated to address the persistently high level of youth unemployment.** Ongoing reforms focusing on addressing skills mismatches in the labour market through revamping the vocational education system could help address this problem.

Main macroeconomic indicators %

	2017	2018	2019	2020	2021 proj.
GDP growth	1.1	2.9	3.2	-4.5	4.0
Inflation (average)	1.4	1.5	0.8	1.2	3.1
Government balance/GDP	-2.7	-1.8	-2.0	-8.1	-5.9
Current account balance/GDP	-1.0	-0.1	-3.3	-3.4	-2.1
Net FDI/GDP [neg. sign = inflows]	-1.8	-5.6	-3.2	-1.4	-3.0
External debt/GDP	73.3	73.0	72.7	79.1	n.a.
Gross reserves/GDP	23.2	26.7	29.1	31.1	n.a.
Credit to private sector/GDP	49.9	50.2	51.5	56.2	n.a.

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Covid-19: macroeconomic implications

After a recession in 2020, GDP has started to recover in 2021. In 2020 GDP declined by 4.5 per cent year-on-year, on the back of a double-digit fall in investment and exports and a 5.6 per cent decline in private consumption. These falls were somewhat counter-balanced by a significant (10.1 per cent) increase in government consumption. Industrial output contracted by 10 per cent in 2020, and the trade, transport and accommodation sectors only slightly less. After a negative first quarter, economic developments became more favourable in the second quarter of 2021 with GDP growing by 13.1 per cent year-on-year; domestic trade picked up by a strong 46 per cent year-on-year on the back of pent-up demand, and manufacturing recovered by nearly 20 per cent year-on-year, which was also reflected in strongly growing exports (by 45 per cent year-on-year). Investments rebounded by nearly 40 per cent year-on-year in the same quarter.

The fiscal stance remains expansionary. The general government deficit jumped from 2.0 per cent of GDP in 2019 to 8.1 per cent in 2020. As a consequence, general government and government-guaranteed debt rose to 60 per cent of GDP at the end of 2020, more than 10 percentage points higher than at the end of 2019. The expansionary fiscal stance is continuing in 2021, involving further Covid-19-related support measures such as wage subsidies, investment incentives and liquidity support to firms. In March 2021 the government issued a €700 million seven-year Eurobond. Some of the proceeds (€500 million) were used to repay a Eurobond issued in 2014 and the rest of the proceeds will be used to finance the state budget for 2021.

GDP should exceed its 2019 level in 2022. A partial recovery is expected in 2021, with real GDP growth of 4.0 per cent on the back of the recovery of exports and private consumption, as well as sustained government consumption. The growth momentum is expected to continue in 2022, also at 4.0 per cent, on the back of resuming private investments. However, the projection is subject to significant uncertainty. Both upside and downside risks are present and primarily relate to the speed of recovery of external demand and the government's ability to realise its ambitious infrastructure agenda, given the narrowed fiscal space.

Policy response to Covid-19

The fifth and sixth packages of support measures were approved in April 2021. The fifth package was worth €160 million and consisted of four pillars: (i) direct financial support for companies in the troubled sectors (tourism, transport, hospitality and the events industry) to help preserve jobs; (ii) interest-free loans to the private sector with a grant component to support the liquidity of companies; (iii) a reduction of para-fiscal duties, tax relief measures and tax deferrals to improve the business environment; and (iv) direct financial assistance to citizens. The sixth package of economic support measures was worth €17.8 million and it aimed to financially support around 10,000 companies employing around 60,000 workers in total.

New interest-free loans have been extended to micro, small and medium-sized enterprises (MSMEs) and a guarantee scheme is to be established. In December 2020 the Development Bank of North Macedonia issued a public call for small and medium-sized enterprises (SMEs), sole proprietors and artisans to apply for interest-free loans under a €31 million credit line. In July 2021 the government announced the launch of a guarantee fund that would provide loan guarantees worth up to €500,000 to MSMEs, but also to large companies with export revenues accounting for at least 30 per cent of total revenues.

The central bank temporarily blocked dividend distribution. In February 2021 the central bank prohibited commercial banks from distributing dividend payments to shareholders until the end of 2021. The decision was rescinded in August 2021. In March 2021 the key policy rate was cut by 25 basis points, to 1.25 per cent.

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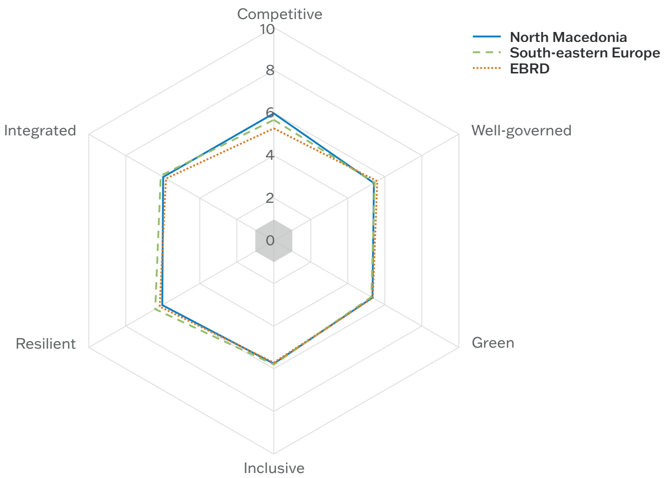
Assessment of transition qualities (1-10)



Structural reform developments

No decision was made about opening European Union (EU) accession negotiations. Despite the green light in March 2020 and the subsequent positive report by the European Commission on the country's progress towards the start of the EU accession negotiations, no decision has been made by the Council in 2021 on the formal start of negotiations because of a dispute with one member country. In June 2021 the European Council concluded that this issue ought to be addressed during Slovenia's presidency of the EU in the second half of 2021.

A review of 377 para-fiscal charges is under way to improve the business environment. Para-fiscal charges create considerable barriers to businesses and could push them to operate in the informal sector. It is planned that these charges will be either eliminated or streamlined, optimised and digitalised to reduce the burden on companies, especially SMEs.

The authorities have developed a plan to close coal-fired power plants, accompanied by large-scale investment in renewables and gas-fired power capacity as a transitional fuel. North Macedonia has become the first country in the Western Balkans to set a concrete plan for the closure of coal-fired power plants, through the country's Energy Development Strategy until 2040 and draft NECP, which was the first in the region to be submitted and reviewed by the Energy Community Secretariat. The NECP, currently under public consultation and expected to be approved by the government in the first half of 2022, sets a date of the end of 2027 for coal-fired power plants to close. At present, coal-based thermal power plants account for around 50 per cent of total electricity production and about a third of total consumption. To replace these, renewables will play a primary role in the transition, with planned investment of about 1,600 MW of solar power plants, 600 MW of wind farms and about 333 MW of hydropower plants. According to the government's Intervention Investment Plan 2021-27, presented in May 2021, the country will invest a total of €3.1 billion in the energy sector, mostly in renewables. In recent years, both the private and state sectors have been investing in large-scale wind, solar and hydropower projects.

Value added tax (VAT) on electricity has been temporarily cut. In July 2021 the VAT Law was amended to lower electricity prices and reduce expenses for households. The VAT rate on electricity was cut to 5 per cent from 18 per cent. The reduced rate will apply for one year, until 30 June 2022. Afterwards, it will be increased to 10 per cent until the end of June 2023 and then, in July 2023, it should return to 18 per cent.

CONTINUES

The government has signed an agreement with Greece for the construction of a gas interconnector. The 123 km-long pipeline will cost €110 million and will have the capacity to transport around 1.5 billion cubic metres of natural gas every year. The final investment decision by the government is expected by the end of 2021.

The government is promoting the economic inclusion of the Roma population. A €2 million development fund was launched in July 2021 to support Roma businesses and address the issue of unemployment in the community. The aim of the initiative is to create more favourable business conditions for Roma entrepreneurs in several ways, by facilitating access to loans, offering coaching, business development services and creating new jobs, formalising Roma employment and harnessing the Roma's demographic dividend.

ROMANIA

Highlights

- **The economy is recovering quickly after the Covid-19 shock.** Gross domestic product (GDP) has been expanding robustly since the last quarter of 2020 and was already above pre-Covid-19 pandemic levels in the first quarter of 2021. Most of the growth was accounted for by rising private consumption, as the authorities eased containment measures.
- **The National Recovery and Resilience Plan (NRRP) includes key structural reforms.** The approved €29 billion plan combines investments with reforms in sustainable infrastructure, education, health and local development. Public administration, pension and fiscal reforms are also envisaged.
- **Covid-19 and political tensions have held back structural reforms.** The centre-right coalition has focused on addressing the Covid-19 pandemic and preparing the NRRP.

Key priorities for 2022

- **Judicial reform remains a key priority.** Although some amendments have taken place, further efforts are needed to reform justice laws and step up the fight against corruption, as specified by the latest assessments of the European Union (EU)'s Cooperation and Verification Mechanism, the European Court of Justice of the EU and the Group of States against Corruption (GRECO).
- **Improving administrative capacity to absorb EU funds will be critical.** Almost €100 billion will be available to the country until at least 2027, combining new allocations with leftover funds from the previous EU budget. The key challenge remains the administrative capacity to absorb these funds, considering the modest performance previously in this regard.
- **Fiscal consolidation should advance next year, in line with the commitments under the Excessive Deficit Procedure.** With inflation already running significantly above target and external accounts in deficit, there is a risk that financing conditions will tighten in the short term. The authorities should therefore commit to a more ambitious consolidation plan from 2022.

Main macroeconomic indicators %

	2017	2018	2019	2020	2021 proj.
GDP growth	7.3	4.5	4.1	-3.9	7.2
Inflation (average)	1.3	4.6	3.8	2.6	4.3
Government balance/GDP	-2.6	-2.9	-4.4	-9.4	-6.7
Current account balance/GDP	-3.1	-4.6	-4.9	-5.2	-5.7
Net FDI/GDP [neg. sign = inflows]	-2.6	-2.4	-2.2	-0.9	-1.6
External debt/GDP	52.0	48.8	49.2	58.2	n.a.
Gross reserves/GDP	19.5	16.8	18.0	19.8	n.a.
Credit to private sector/GDP	26.3	25.6	24.6	25.9	n.a.

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Covid-19: macroeconomic implications

The economy is growing rapidly in 2021 after a better-than-expected performance in 2020. GDP declined by 3.9 per cent in 2020, with private consumption and exports being the main headwinds to growth. Strong public investment was a counter-cyclical factor in 2020 and again in 2021, together with recovering private investment. In line with the relaxation of containment measures, private consumption has driven most of the recovery in 2021, mainly on the back of strong demand for durable goods. Export performance was mixed, with some sectors held back by supply constraints in the automotive industry and fluctuating demand in the eurozone, while imports recovered faster. The current account balance reflects this trend, as the trade deficit in goods continued to widen in 2021. The unemployment rate declined from a high of 5.9 per cent in February 2021 to 5.2 per cent in August 2021, but remains above the pre-Covid-19 pandemic level.

The public sector deficit is high but fiscal consolidation is under way. The high structural deficit and Covid-19-related support measures aggravated the government balance significantly to a deficit of 9.8 per cent of GDP in 2020. A budget revision in August 2021 raised expenditure plans, mainly for health and regional transfers, in line with the higher GDP growth and revenue targets, but the deficit target for 2021 is still 7.1 per cent of GDP in cash-based terms. The medium-term fiscal framework envisages a deficit below 3 per cent of GDP by 2024 and public debt is expected to hover below 60 per cent of GDP in the medium term. In April 2021 ratings agency Standard & Poor's upgraded its outlook for Romania from negative to stable, given the lower fiscal risks.

Accommodative monetary policy supported economic recovery and credit growth, while inflation increased. The National Bank of Romania (NBR) reduced the policy rate to a record low of 1.25 per cent in January 2021 to support economic recovery. Inflationary pressures increased in 2021 due to the liberalisation of the electricity market and recovering global energy prices. The inflation rate reached 6.3 per cent in September 2021. The NBR started to wind down liquidity from the market through its deposits facility before hiking the policy rate to 1.5 per cent in October 2021 to counter rising inflation. Nevertheless, credit growth continued accelerating in the first half of 2021, driven by a strong demand from corporates supported by the state credit guarantee schemes.

The economy has strong growth momentum in the medium term. Overall, the economy's current momentum is expected to lead to 7.2 per cent GDP growth in 2021. In 2022 the NRRP should start boosting investments, in particular, which, together with private consumption growth and gradually improving net exports, will translate into projected 4.4 per cent growth. The downside risks to the forecast are related to the evolution of the Covid-19 pandemic amid the slow progress of vaccination, while the twin (fiscal and current account) deficits and high inflation indicate a deepening of macroeconomic imbalances.

Policy response to Covid-19

Policy support in the first half of 2021 amounted to 0.7 per cent of GDP. Support measures worth about 4.5 per cent of GDP in 2020 included tax deferrals, preserving employment through subsidies and facilitating access to finance. In 2021 spending on Covid-19-related support significantly decreased, in line with the drop in requests for employment support. However, demand for state credit guarantees has been robust and the impact on credit growth has been visible, which has led to an extension of the small and medium-sized enterprise (SME) investment programme until the end of 2021. As of the end of May 2021 state credit guarantees totalled €2.6 billion, mostly in investment loans, out of a total of €6.9 billion allocated in 2020 and 2021. The authorities also devised three grant schemes for working capital and investments and a dedicated scheme for the hospitality sector financed by EU funds. By August 2021 about €600 million had been disbursed through the working capital scheme, while the other two schemes encountered problems with budgeting. The hospitality scheme was open to applications until the end of July 2021 and will disburse grants of €500 million to June 2022, covering 20 per cent of the difference between revenue recorded in 2020 and the level of revenue in 2019.

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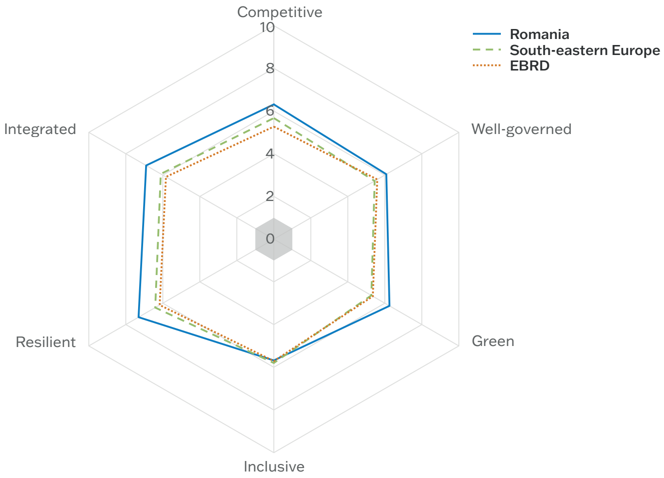
Assessment of transition qualities (1-10)



Structural reform developments

Infrastructure works have accelerated in the past year. A number of large highway projects have advanced rapidly, with the Ministry of Transport fast-tracking the award of contracts on key highway projects that had stalled in the past. The RRF will finance some sections of highway, most notably the A7 highway linking Bucharest with the Moldova region, which is expected to be finalised in 2024.

A new renewables support scheme is in preparation. The scheme, announced in spring 2019, with a memorandum signed in mid-2020, is based on a contracts-for-difference mechanism (CfD) and is being designed as the new procedure for supporting low-carbon electricity generation. It is expected to enter into force by the end of 2022. Moreover, in an amendment to the Energy Law in May 2020, the ban on over-the-counter power purchase agreements (PPAs) was lifted.

A law subsidising the development of offshore wind farms was adopted. The law, adopted by the Senate in November 2020, regulates the subsidies that investors receive when producing electricity, which will differ based on the mechanism for awarding the contract (auction or direct licensing). However, Romania has yet to prepare a maritime spatial plan and a framework law that would enable offshore wind investments, while subsidies following auctions will need to be aligned with the CfD mechanism, which (as noted above) is not yet finalised.

A new law on agricultural land may hold back the development of renewables. The law regulating the sale of agricultural land, adopted in August 2020, heavily constrains the sale of arable land to buyers without pre-emptive rights, especially foreign investors, while imposing an 80 per cent tax on the difference between the sale price and purchase price if the land is sold earlier than eight years after purchase. While the law does not explicitly change the procedure to change the use of the land, the business community has voiced concerns over the impact of the law on developing both onshore renewables and gas infrastructure. Nevertheless, it remains to be seen if the law will have a visible impact on potential investment.

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The government announced plans to list 15 per cent of Hidroelectrica's shares next year. The Ministry of Energy announced that it intends to list a minority package of the most profitable state-owned enterprise (SOE), Hidroelectrica, in the second half of 2022. The process recently started with the company launching a tender for auditing the SOE, a first step in the initial public offering process. For now, a listing is not possible due to the law suspending any privatisation for two years, adopted last year. Hidroelectrica supplies about 30 per cent of electricity in Romania and is seen as a central actor in future investment in offshore wind and solar infrastructure.

Tax incentives have been introduced to firms that improve their equity positions. The low equity of most Romanian firms limits their access to finance. To counter that, a reduction of 2 per cent of the tax due will be granted to companies and to the permanent establishments of non-residents if their equity is positive, while certain increases in equity capital compared with previous years will be rewarded as well. The scheme will be active from 2021 until 2025.

A law regulating 5G networks has been adopted. In June 2021, after several delays, parliament gave the green light to 5G auctions being held in 2021. However, the auctions will depend on (among other things) implementation of the European Electronic Communications Code, which has yet to be adopted by the government. Previously, both public- and private-sector actors had criticised the draft law for its lack of alignment with EU regulations.

SERBIA

Highlights

- **The economy is growing strongly after a mild reduction in 2020.** Gross domestic product (GDP) fell by just 0.9 per cent in 2020, as the economy was propped up by a large fiscal package, and strong growth occurred in the first half of 2021.
- **Serbia has agreed a new non-financial and advisory deal with the International Monetary Fund (IMF).** The 30-month Policy Coordination Instrument (PCI) aims to support structural reforms and economic recovery, while maintaining macroeconomic and financial stability.
- **Progress on the green transition has been made in the past year.** New laws should help to enable large investments in renewable energy sources, as well as promote energy-saving and climate change mitigation measures.

Key priorities for 2022

- **The green transition agenda should be accelerated.** Among other measures, the authorities should step up renewable energy auctions, energy efficiency improvements and environmental infrastructure investment.
- **The governance of state-owned enterprises (SOEs) needs to be strengthened.** SOE governance should be improved in line with the recently approved action plan for state-ownership policy.
- **Fiscal and financial sector risks should be contained after support measures expire.** To preserve fiscal sustainability, it would be prudent to adopt a new fiscal rule, prioritise productive capital investments and moderate the growth of pensions and public wages.

Main macroeconomic indicators %

	2017	2018	2019	2020	2021 proj.
GDP growth	2.1	4.5	4.3	-0.9	6.5
Inflation (average)	3.0	2.0	1.7	1.6	3.0
Government balance/GDP	1.4	0.8	0.0	-7.3	-6.5
Current account balance/GDP	-5.2	-4.8	-6.9	-4.1	-4.1
Net FDI/GDP [neg. sign = inflows]	-6.2	-7.4	-7.7	-6.3	-6.0
External debt/GDP	65.1	62.2	61.4	65.8	n.a.
Gross reserves/GDP	25.4	26.3	29.1	28.8	n.a.
Credit to private sector/GDP	40.3	41.4	42.0	45.8	n.a.

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Covid-19: macroeconomic implications

The economy is recovering in 2021 after a modest drop in output in 2020. The effects of the Covid-19 pandemic on the economy were moderate in 2020. The structure of the economy – a limited reliance on tourism and a relatively high share of basic goods, such as food and some chemicals in manufacturing – combined with large government aid packages and less restrictive lockdown measures for most of the year, contributed to a GDP contraction of just 0.9 per cent. In the first quarter of 2021 GDP grew by 1.8 per cent year-on-year, underpinned by a strong recovery in the construction sector, the growth of industrial output and an increase in trade, transport and tourism activities. The second quarter saw strong growth of 13.7 per cent year-on-year, reflecting the low base of last year due to Covid-19 pandemic-related restrictions.

Inflationary pressures have increased. The year-on-year inflation rate rose from 1.1 per cent in January 2021 to 5.7 per cent in September 2021, which is above the central bank target range (3.0 ± 1.5 per cent). The increase is primarily the result of temporary factors such as rising utilities, oil and primary commodity prices. The exchange rate against the euro has remained stable. The central bank has intervened in the foreign exchange market on both sides, but in the first seven months of 2021 it was a net buyer of euros (€700 million in total).

Public debt has increased due to aid packages for the economy. In July 2021 public debt stood at 55.2 per cent of GDP, around 2 percentage points below the 2020 level, but more than 3 percentage points higher than in 2019. The country placed a 12-year €1 billion Eurobond in February, while in September it issued its first ever 7-year €1 billion green bond at a record low coupon rate of 1.0 per cent, together with a 15-year €750 million Eurobond, the longest maturity Serbia has issued so far. Receipts from the green bond will be used to finance the construction of water and wastewater treatment plants, subway and modern railways, flood protection, biodiversity conservation, pollution control and prevention, waste collection, processing and recycling infrastructure, energy efficiency and renewable energy sources, and other projects from the green agenda.

GDP will exceed its 2019 level in 2021. Continuing expansionary fiscal policy in 2021, together with a planned significant increase in public investment and recovery in domestic and external demand, will result in GDP expanding by a projected 6.5 per cent in 2021. In 2022 a growth rate of 4.3 per cent is forecast, as the economy is expected to return to pre-pandemic growth rates amid a likely fiscal adjustment. Risks to the forecast are balanced. They relate primarily to the pace of recovery of external demand and speed of public infrastructure projects and structural reforms.

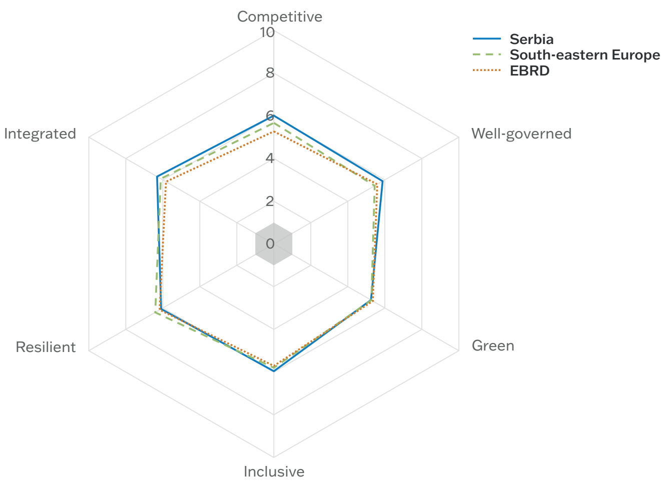
Policy response to Covid-19

A third package of Covid-19-response measures was approved in 2021. The package, worth €2.2 billion (4.3 per cent of GDP), was adopted in February 2021. It included direct support to the private sector, extending the previous guarantee scheme and introducing a new one, and one-off financial assistance for adults and pensioners (€60 and €110, respectively). Direct support to the private sector comprised payments of 50 per cent of the minimum wage to all entrepreneurs and companies for three months and an additional minimum wage for employees in sectors that had been hit the hardest (catering, travel agencies, tourist guides, hotels, rental car agencies and so on). In addition, in June 2021 the state paid one-off "vaccine bonuses" of around €25 to those who had received at least one vaccine dose by the end of May.

CONTINUES

The central bank has introduced new measures. To support dinar liquidity, the National Bank of Serbia (NBS) introduced in November 2020 additional foreign exchange purchase swap auctions and securities purchase repo auctions, both on a weekly basis and with a three-month maturity. In December 2020 the key policy rate was lowered by 25 basis points to another historical low of 1.0 per cent. In February 2021 the NBS and the European Central Bank (ECB) agreed to prolong the duration of the precautionary repo line set in mid-2020 until March 2022. The line enables the NBS to borrow up to €1 billion from the ECB.

Assessment of transition qualities (1-10)



Structural reform developments

European Union (EU) accession negotiations are advancing, albeit slowly. Since the start of negotiations in January 2014, 18 chapters (out of 35) of the EU *acquis* have been opened, of which two are provisionally closed. No new chapters have been opened in the past year. According to the European Commission, the future speed of negotiations will depend on, among other things, the pace of reforms regarding the rule of law as well as progress on normalising relations with Kosovo. In 2021 it was agreed to apply to Serbia the revised enhanced methodology for EU accession negotiations that was previously approved by the Council for candidate countries. This means greater leverage in preventing and addressing possible reversals in the reforms but it also presents an opportunity to accelerate the opening of new negotiation “clusters” containing several chapters.

The IMF has approved the new 30-month PCI with Serbia. Soon after the previous PCI had expired, the authorities launched talks with the IMF on a new one, which was approved in June 2021. The new PCI aims to support structural reforms and economic recovery, while maintaining macroeconomic and financial stability. The main pillars of the programme, which will run until the end of 2023, are: anchoring the fiscal policy framework; strengthening SOE governance; developing capital markets and further increasing dinarisation; improving the provision of social assistance; and transitioning to a green economy.

CONTINUES

The country has made legislative changes that pave the way for the greening of the economy. In March 2021 parliament adopted the Law on Climate Change, which should help establish a system for limiting greenhouse gas emissions. In April 2021 the country adopted four bills in the area of energy and mining (the Law on Energy Efficiency and Rational Energy Use, the Law on Renewable Energy Sources, and amendments to the Law on Mining and Geological Exploration and to the Law on Energy). These legal changes should enable large investments in renewable energy sources such as wind and solar, help achieve energy savings and security of energy supply, and reduce the impact of the energy sector on the environment and climate change. In addition, amendments to the Law on Energy create a legal basis for the adoption of the National Energy and Climate Plan (NECP) for 2021-30. The NECPs are the framework for EU member states to outline their climate and energy goals, policies and measures.

Separation of electricity generation from electricity distribution has taken place. In December 2020 the power utility Elektroprivreda Srbije (EPS) transferred its ownership of distribution system operator EPS Distribucija to the government of Serbia. The transfer of ownership is the final step in unbundling the distribution system from EPS, which began five years ago.

The country has adopted a new state-ownership policy for 2021-27. The policy, adopted in April 2021, should help better monitor and tackle fiscal risks and enhance the efficiency of SOEs. It identifies the rationale and objectives of state ownership and reviews the legal and regulatory framework for corporate governance of SOEs. In June 2021 the government adopted an action plan to implement the strategy for 2021-23.

Ownership changes and acquisitions have been taking place in the banking sector. The banking sector has remained stable, liquid and well-capitalised through the Covid-19 pandemic, with the non-performing loan ratio at 3.7 per cent in May 2021. In late 2020 Slovenia's state-owned commercial bank NLB completed the acquisition of the state-owned Komercijalna Banka, while a US investor sold its majority stake in Opportunity Bank Serbia to a group of investors. In June 2021 state-owned bank Postanska stedionica acquired MTS Banka, one of the smallest banks in the country, previously 100 per cent owned by the state-owned telecommunications company. As of early August 2021 there were 24 banks in the country and additional consolidation is under way.