Albania

Highlights

- **Economic growth is slowing down.** Strong domestic demand and an expanding hospitality sector led the 8.5 per cent expansion in 2021, but the pace of growth slowed in the first half of 2022 as output grew 4.2 per cent year on year.
- **Most public services have been digitalised.** Continuous progress in this area since 2013 means that nearly all public services in Albania where an in-person meeting is not essential are now offered solely online, despite pervasive cyber security problems.
- **The national energy and climate plan (NECP) has been adopted.** Albania was the first Western Balkans country to adopt the framework, which includes accelerating the development of non-hydro renewables and energy efficiency measures to reduce greenhouse gas emissions.

Key priorities for 2023

- **Fiscal reform would create more policy space and improve longer-term sustainability.** The medium-term fiscal strategy should mobilise revenue and create space for targeted social protection measures by broadening the tax base, boosting tax compliance and reducing the cash economy. In terms of sustainability, it should account for fiscal risks stemming from public-private partnerships and guarantees for public companies.
- **Diversification of renewable energy should lead to greater energy security.** In light of energy security concerns, developing the sizeable pipeline of solar and wind projects should be accelerated.
- **The business environment should be further improved.** Key measures that should be given priority include simplifying the tax system and streamlining procedures, enhancing support for micro, small and medium-sized enterprises and incentives to formalise activities, ensuring the security of e-government services and increasing the effectiveness of the public-private dialogue.

TABLE Main macroeconomic indicators %

	2018	2019	2020	2021	2022 proj.
GDP growth	4.0	2.1	-3.5	8.5	3.0
Inflation (average)	2.0	1.4	1.6	2.0	6.2
Government balance/GDP	-1.3	-1.9	-6.7	-4.5	-4.1
Current account balance/GDP	-6.7	-7.9	-8.7	-7.7	-8.6
Net FDI/GDP [neg. sign = inflows]	-8.0	-7.5	-6.7	-6.4	-6.5
External debt/GDP	65.1	60.0	64.4	63.1	n.a.
Gross reserves/GDP	26.5	24.4	29.7	32.1	n.a.
Credit to private sector/GDP	33.0	34.1	38.0	36.0	n.a.

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Macroeconomic developments and policy response

Economic expansion is slowing. The economy recovered by a strong 8.5 per cent in 2021 on the back of a major rebound of the sizeable tourism sector and heightened domestic demand. The expansion continued into the first quarter of 2022 as output grew by 6.5 per cent but slowed in the second quarter to 2.2 per cent as export and private investment growth were muted, though household consumption remained robust. Strong credit growth to residents, at 14 per cent year on year in August 2022, and steady inflows of remittances supported a 9 per cent annual increase of household consumption in the first half of the year. In spite of continually high credit growth to private companies, investment contracted by 7 per cent year on year in the second quarter given last year's strong expansion, with construction activity falling accordingly. As manufacturing output slowed and industrial activity contracted year on year in the second quarter, exports of goods continued to grow annually in real terms at a more moderate pace of 15 per cent compared with 44 per cent in the first quarter. In the first eight months of 2022 foreign tourist arrivals were up by 29 per cent annually and by 16 per cent compared with pre-pandemic levels while domestic trade posted double-digit growth in the first half of the year.

Inflation is rising but the exchange rate remains stable. Driven by globally higher prices of imported food and oil, annual inflation reached 8.1 per cent in September 2022. Though subdued by regional standards, this level of inflation is the highest in the last 20 years and weighs heavily on households for whom essentials such as food and utilities account for as much as 42 per cent and 10 per cent of consumption expenditure, respectively. Surging electricity prices in international markets did not affect Albanian consumers until October 2022, despite the country's frequent reliance on imports to supplement fluctuating domestic production from hydro sources, as the public sector absorbed the rising costs. The current account deficit narrowed in the first half of 2022, as robust goods and services export growth offset the rise in imports, supporting the relative stability of the exchange rate.

Policy measures are shielding the economy from rising prices. Following nearly two years of record low policy rates, the national bank tightened monetary policy four times in the first 10 months of 2022, raising the policy rate from 0.5 per cent in March to 2.25 per cent in October. In light of the start of the war on Ukraine and mounting energy security concerns, the government adopted the Social Resistance Package in March 2022. This includes measures such as pension indexation, subsidies for vulnerable groups, temporary tax relief on income (for all) and oil (for farmers), a slight increase in the minimum wage and a heightened energy price shield for firms. As another €100 million was pledged for inflation relief measures, further amendments in pension indexation, an increase in the electricity price for large consumers, and an increase in the minimum wage were approved in September 2022, alongside public sector wage indexation and the scaling up of social transfers. The fiscal deficit in 2022 was revised downwards in September, given better than expected fiscal performance in the first eight months of the year, and is projected at 4.1 per cent of gross domestic product (GDP), with public debt expected to decline in 2022.

Growth is expected to moderate further as downside risks increase. Economic growth is projected at 3.0 per cent in both 2022 and 2023. Key risks to the near-term outlook include rising inflation and tightened financing conditions, which dampen household consumption and investment. On the positive side, initial figures point to a strong tourism season which should boost external and fiscal accounts ahead of the challenging heating season and lead growth in the third quarter of the year.

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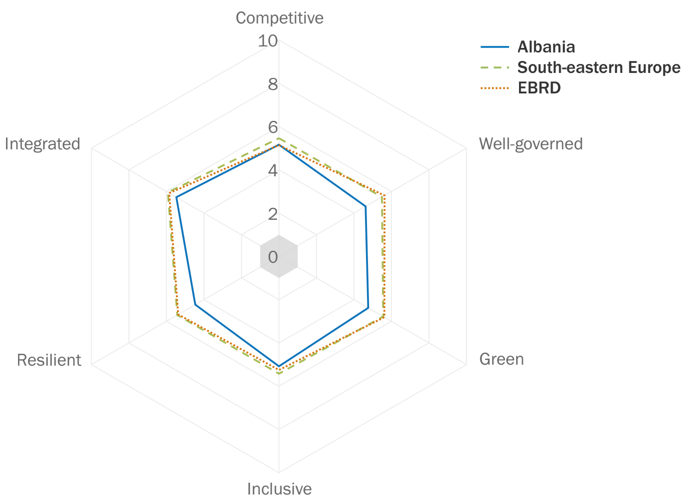
CHART Assessment of transition qualities (1-10)



Structural reform developments

European Union (EU) accession negotiations have begun. The long-awaited formal opening of the EU accession negotiations, the first intergovernmental conference, took place on 19 July 2022. It was followed by the inaugural launch by the European Commission of the screening process.

Nearly all public services are now available online. According to the authorities, 95 per cent of services delivered by the public administration are to be provided solely online from May 2022, with in-person service windows set to be shut down, in a bid to reduce corruption and improve service quality and transparency. The now all-encompassing e-Albania portal has been active since 2013, with public services continually added to the platform in parallel to simplifying processes through deregulation reform. However, digitalisation has not been smooth sailing for the country, as security breaches in December 2021 and April 2022 exposed the personal and income data of over a fifth of Albanians. The government was additionally forced to briefly shut down the online provision of services in July 2022 due to a cyber attack. Some 91 per cent of Albanian households have access to the internet, the highest rate in the Western Balkans.

Albania has adopted the National Energy and Climate Plan (NECP). Adopted in December 2021, the plan represents the framework governing Albania's energy transition efforts until 2030 and will be continually updated. The Albanian energy sector is unique in the Western Balkans due to its near complete dependence on hydropower for electricity generation, giving the country the opportunity to focus its decarbonisation efforts on other emission-intensive sectors such as industry. While domestic energy production is largely green, consumption is frequently supplemented by imported fossil fuels. The plan's targets for the period considered include reducing greenhouse gas emissions by nearly a fifth, cutting energy consumption, and increasing the share of renewables in final energy demand to over a half.

The constitution was amended to allow the vetting of the judiciary to continue. The vetting process has been a cornerstone of judicial reform in Albania, initiated in 2016 and extended for another two years via a constitutional amendment in February 2022. Judicial reform was one of the key conditions set by the EU for the beginning of accession talks. Though judged by the European Commission as effective in fighting deep-rooted corruption in the judiciary, the vetting process has taken longer than expected and resulted in a backlog of cases for courts due to a high number of the judiciary leaving their posts. Out of over half of the vetting files processed so far, some 60 per cent have resulted in dismissals or terminations due to resignations or retirement age being reached.

The second and final tranche of the EU's macro-financial assistance (MFA) was disbursed. The tranche, equal in size to the first one and amounting to €90 million, was disbursed in November 2021 as Albania had fulfilled the policy conditions agreed with the EU, including measures to strengthen public finance and financial sector resilience, improve governance and enhance social protection.

Bosnia and Herzegovina

Highlights

- **The country is enjoying a better-than-expected post-pandemic recovery.** Following robust GDP growth of 7.5 per cent in 2021, the country continued to post strong growth rates in demand-driven service sectors and manufacturing in the first half of 2022.
- **The long-awaited public enterprise (PE) reform is slowly advancing.** The authorities have taken steps towards establishing PE oversight units in the two General Secretariats. Once active, the units will oversee the companies' financial performance.
- **The legislative framework to stimulate investment in renewables is gradually advancing, although the decarbonisation vision remains undeveloped.** The new legislation will replace state-determined feed-in tariffs with competitive bidding procedures for investments in clean energy.

Key priorities for 2023

- **The authorities should speed up initiatives to support the private sector and protect vulnerable groups.** Key short-term priorities in the current difficult global environment include targeted social support measures for vulnerable households, adopting a country-wide framework for e-signatures, and accelerating the digitalisation of public services.
- **A plan for green transition needs to be formed.** Setting up a vision for a decarbonisation pathway is crucial for Bosnia and Herzegovina, particularly given the large projected impact of the European Union (EU)'s forthcoming carbon border adjustment mechanism on the country's exports. The legislative package governing renewables should be finalised as soon as possible to leverage investor interest.
- **Reform of state-owned enterprises (SOEs) should progress.** Key steps required include operationalisation of SOE oversight units, implementation of systemic monitoring of fiscal risk stemming from state guarantees, and the creation of a country-wide SOE registry. The rationale for state ownership should be outlined in a State Ownership Policy document.

TABLE Main macroeconomic indicators %

	2018	2019	2020	2021	2022 proj.
GDP growth	3.7	2.8	-3.1	7.5	3.0
Inflation (average)	1.4	0.6	-1.1	2.0	10.5
Government balance/GDP	1.7	1.4	-4.7	0.7	0.5
Current account balance/GDP	-3.3	-2.6	-3.3	-2.4	-4.3
Net FDI/GDP [neg. sign = inflows]	-2.9	-2.1	-1.8	-2.3	-1.6
External debt/GDP	64.4	64.3	69.5	58.9	n.a.
Gross reserves/GDP	34.8	35.7	40.5	42.3	n.a.
Credit to private sector/GDP	57.5	58.0	58.5	54.0	n.a.

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Macroeconomic developments and policy response

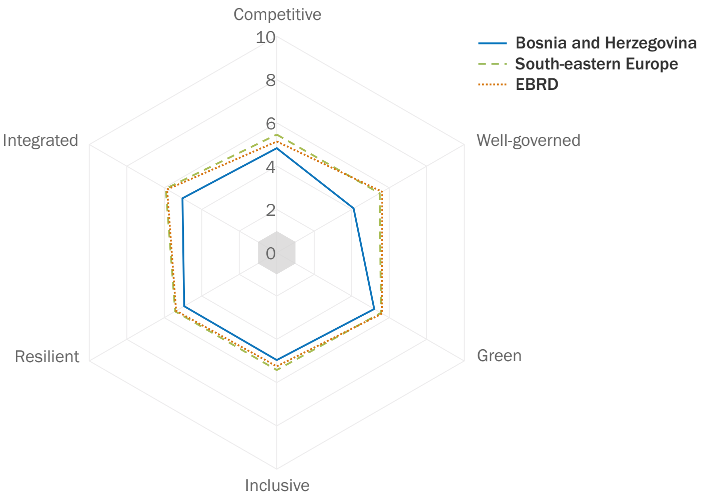
Robust economic growth continued into the first quarter of 2022. The economy expanded by 7.5 per cent in 2021, driven by very strong external demand and recovering domestic consumption, although investment remained weak. The first half of 2022 was marked by a continued expansion of GDP by 5.9 per cent year on year. Growth was led by investment, which rose by 24 per cent year on year, albeit partly driven by the base effect and a likely increase in inventories, and private consumption which grew by 3.5 per cent in real terms. Services led the expansion on the production side, as the fastest-growing sectors were trade, transport and hospitality, as well as information and communication services, followed closely by manufacturing. Exports continued to post strong growth rates in annual terms (30 per cent in the first half of the year), although their contribution was outstripped by imports rising to meet both producer and consumer demand. In line with the increased trade deficit in goods and elevated energy prices, the current account deficit doubled on an annual basis.

Inflation surged to unprecedented levels. The annual inflation rate has been rising since mid-2021 and reached a record-breaking 16.8 per cent in August 2022. While nearly all divisions of the consumer basket have registered price increases, the highest were food and transport, in line with globally rising food commodity and oil prices and the high proportion of household consumption going towards food. Unlike most countries in Europe, electricity has not been as significant a cause of inflationary pressures in Bosnia and Herzegovina as it continues to come from domestic coal-based production at below-market prices.

The authorities have implemented fiscal policy measures in an effort to shield the economy from rising prices. One-off increases in state aid for different categories were implemented and higher-than-planned pension hikes approved in the second quarter of 2022. While the Republika Srpska (RS) entity hiked electricity prices for firms at the beginning of 2022 but kept them well below market levels, the Federation of Bosnia and Herzegovina (FBiH) adopted in December 2021 an amendment to the Law on Electricity to enable a 20 per cent limit on electricity price increases for firms. Both entities have kept prices for households capped. A country-wide 90-day ban on log, firewood and pellet exports used for heating was adopted in June 2022 to curb price increases.

Growth is expected to moderate. GDP growth is forecast at 3.0 per cent in 2022 and 2.3 per cent in 2023 as risks tilt towards the downside. The economic impact of the war on Ukraine is expected to be reflected in a further rise in prices, thus eroding disposable income, a slowdown in the eurozone, Bosnia and Herzegovina's main export market, and increased geopolitical uncertainty. While political challenges associated with the elections in October 2022 complicate the short-term outlook, the economy's resilience demonstrated in recent years and a robust growth performance in the first half of the year bode well for short-term prospects.

CHART Assessment of transition qualities (1-10)



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Structural reform developments

The European Commission has issued a conditional recommendation for EU candidate status. In 2019 the European Commission issued the Opinion on Bosnia and Herzegovina's application for EU membership, identifying 14 key priorities for the country to implement to become an EU candidate country. These priorities – a roadmap for a comprehensive EU reform agenda – lie in the areas of democracy and functionality of institutions, rule of law, fundamental rights and public administration reform. Although progress in implementation has been slow thus far, in June 2022 the European Council expressed its readiness to grant the status of candidate country pending the European Commission's assessment of the progress in implementation of the 14 key priorities. In October 2022 the European Commission recommended that Bosnia and Herzegovina be granted candidate status by the European Council, on the understanding that steps were taken in eight concrete areas of reform.

Incremental progress has been made on PE reform. The PE sector is large and poorly documented in Bosnia and Herzegovina, with around 550 PEs that account for upwards of 10 per cent of all employment, many of which are low productivity loss-makers. While PE reform is a long-standing issue, the authorities in both entities have recently affirmed a commitment to reform. Both entities took steps towards establishing central oversight units for PEs in 2022, although full regulatory frameworks have not yet been adopted. A reform plan for SOEs has been in place in the RS since mid-2021, while the FBiH is continually updating a registry of SOEs, albeit with incomplete financial reporting.

Supervisory and regulatory banking sector standards have received equivalence status to the EU. The prudence of Bosnia and Herzegovina's supervisory and regulatory requirements was affirmed by a European Banking Authority assessment of equivalence to those of the EU, published in November 2021. Nonetheless, the financial safety net is incomplete due to the weak bank resolution framework in the absence of an effective country-wide financial stability fund which could provide liquidity on an exceptional basis when required to ensure stability. The need for an effective lender of last resort was illustrated when, in February 2022 following Russia's invasion of Ukraine, the EU imposed sanctions on Russian-owned Sberbank, which resulted in significant deposit withdrawals. A prompt sale of the bank in both entities helped to ensure stability of the sector.

The lifetime of two highly polluting coal-powered thermal power plants was extended. The country's three oldest power generation units (Tuzla 3, Tuzla 4 and Kakanj 5) "opted out" of the EU's Large Combustion Plant Directive (LCPD) in 2016, meaning that they are allowed to operate for a total of 20,000 hours between 2018 and 2023, after which they need to either close or comply with limits under the new Industrial Emissions Directive. Against the backdrop of a global energy price increase, in March 2022 the parliament of FBiH cancelled the opt-out regime for Tuzla 4 and Kakanj 5, and decided to extend their operations to 2028. The Energy Community Secretariat, which opened a case against the country in February 2022 for failing to meet the emissions ceiling set in its National Emission Reduction Plan (NERP), has stated that this was a clear breach of the country's obligations. Financing for a new Tuzla 7 power plant came into question in July, when the State Aid Council ruled that the guarantee from FBiH constitutes as illegal state aid, aligning its decision with European state aid enforcement standards.

The legislative groundwork for renewable energy development is slowly advancing. The new Law on Renewable Energy Sources entered into force in the RS in March 2022, setting out competitive bidding procedures as determinants of incentives for larger renewable capacities. The law introduces two new concepts: prosumer – a customer that builds and connects to a renewable-source power plant for self-consumption; and Renewable Energy Community – a legal entity entitled to produce, consume, store and trade electricity from renewable sources between members of the Community and access all energy markets. A similar piece of legislation, the draft Law on the Use of Renewable Energy Sources and Efficient Cogeneration, was adopted by the government of FBiH and is set to go through the entity's parliament. The draft law similarly adopts the two concepts, but establishes that both feed-in tariffs for small plants and feed-in premiums for large plants are to be determined through auctions.

The Law on Public Procurement was amended. The adoption of the amendment in August 2022, following years of parliamentary procedure, aligns public procurement legislation further with the EU's and is an important step in fighting corruption and organised crime.

Bulgaria

Highlights

- **Economic growth is decelerating and inflation has risen sharply amid spillovers from the war on Ukraine.** Although growth was robust in the first half of 2022, inflation reached almost 19 per cent in September because of high food and energy prices, and a slowdown in gross domestic product (GDP) growth took hold in the third quarter.
- **The implementation of the Recovery and Resilience Plan (RRP) has commenced.** Following approval in April 2022, the government formally requested the first disbursement in early September 2022, contingent on the completion of 22 targets and milestones in digital transformation, innovation and education, green transition and justice.
- **The government has focused on social support in its policy response to the current crisis.** The key measure in response to elevated inflation has been an increase in wages and pensions, as pensioners are among the most vulnerable to price increases. State subsidies for company electricity and gas bills is the primary support measure to mitigate the effects of the energy crisis.

Key priorities for 2023

- **RRP implementation should be prioritised.** The country's political crisis meant that European Commission approval of a revised RRP worth €5.7 billion in grants occurred only in April 2022, and Bulgaria missed the pre-financing step. The ongoing crisis risks further delays, but political forces should commit to its implementation, as demonstrated so far.
- **Meeting the euro adoption criteria is important for investor confidence.** Bulgaria failed to meet the convergence criteria on the inflation measure in the summer 2022 assessment, and the earliest date for euro adoption is now 2024. Progress in this area would help counteract perceptions of political instability and would boost confidence in the economy.
- **Anti-corruption and judicial reforms should be stepped up.** In its latest *Rule of Law Report*, the European Commission flags, among other issues, Bulgaria's slow progress on tackling high-level cases of corruption, while the National Strategy for Prevention and Countering Corruption continues to be implemented.

TABLE Main macroeconomic indicators %

	2018	2019	2020	2021	2022 proj.
GDP growth	2.7	4.0	-4.0	7.6	3.0
Inflation (average)	2.6	2.5	1.2	2.8	12.4
Government balance/GDP	1.7	2.1	-3.8	-3.9	-3.3
Current account balance/GDP	0.9	1.9	0.0	-0.5	-0.9
Net FDI/GDP [neg. sign = inflows]	-1.3	-2.0	-4.5	-1.4	-1.0
External debt/GDP	66.1	61.3	63.8	58.4	n.a.
Gross reserves/GDP	44.6	40.4	50.1	48.7	n.a.
Credit to private sector/GDP	49.8	48.9	51.0	47.9	n.a.

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Macroeconomic developments and policy response

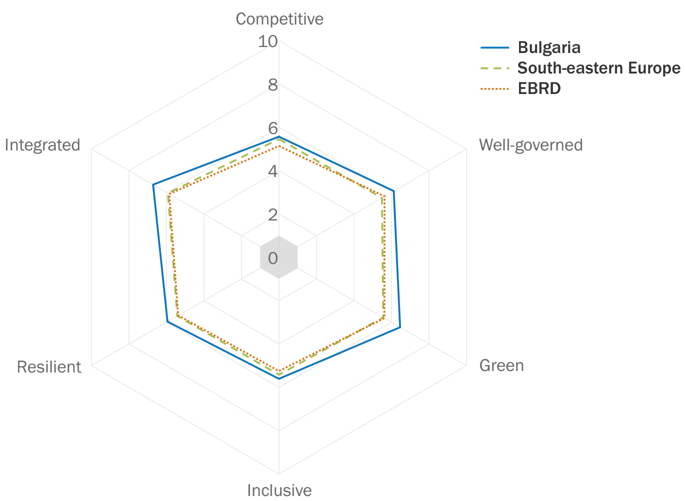
The robust growth seen in the first half of 2022 is slowing. GDP expanded 7.6 per cent in 2021, driven by strong private consumption. This, in turn, was underpinned by fiscal support and wage growth, though investment declined by 8.3 per cent. In the first half of 2022 GDP grew by 4.1 per cent year on year on the back of slowing private consumption, but increased public spending and accumulating inventories. However, preliminary figures show a further decline in investment of 9.6 per cent year on year in the first half of 2022. Although Bulgaria has stronger supply-chain links with Ukraine and Russia than most regional peers, the industrial sector has remained quite resilient so far, growing 18.6 per cent on the year in the first half of 2022. Despite decelerating amid high inflation, household spending is being supported by public spending and growing retail credit, which has accelerated in recent months amid deep negative real rates.

Russia's invasion of Ukraine has exacerbated already strong inflationary pressures. Consumer prices rose 18.7 per cent in September 2022, with food prices up 24.9 per cent on the year. Core harmonised inflation, as measured by Eurostat, reached 9.4 per cent the same month, implying relatively strong demand pressures. Higher utilities and food prices, as well as strong demand, are also feeding into services, as prices in restaurants and hotels increased 20.7 per cent year on year in the latest reading. Nominal private-sector wage growth reached 14 per cent in the first half of the year, outstripping the six-month average inflation rate of 13.1 per cent. This raises the risk of prolonged high inflation to some extent, although, in the public sector, average wages increased only 4.9 per cent in the first half of 2022.

Fiscal policy is being used to alleviate the impact of inflation. In June, the forecast fiscal deficit for 2022 was revised to 4.1 per cent of GDP, the same as in 2021. By July, however, the budget had recorded a cumulative surplus of about 1 per cent of GDP. The budget revision includes a package of measures to compensate for inflation, among them a 10 per cent hike in pensions, tax relief for families with children, full compensation of corporate electricity bills at prices above €125/MWh and value added tax (VAT) cuts to 0 per cent for bread and flour and 9 per cent for gas and heating. The government also raised the VAT registration threshold for firms from BGN 50,000 (€26,000) to BGN 100,000 (€51,200). Policy support did not include households, as the retail electricity market in Bulgaria is still regulated.

Inflation pressures, energy security risks and political uncertainty are all weighing on the short-term growth outlook. Although the economy has performed relatively well so far in 2022, the downside risks to growth are rising. A new political crisis could increase uncertainty and delay reforms, while inflation has the potential to rise even further given likely upward adjustments in electricity, heating and gas retail tariffs. Our 2022 GDP growth forecast is 3.0 per cent, while in 2023, we see a growth rate of 1.5 per cent as the overall slowdown in the eurozone affects Bulgarian exports and energy security risks weigh on confidence and economic activity.

CHART Assessment of transition qualities (1-10)



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Structural reform developments

Energy security remains uncertain amid the halting of gas imports from Russia. In April 2022 Gazprom announced that it was shutting down exports to Bulgaria and Poland due to the countries' refusal to pay in Russian roubles. The announcement initially did not affect Bulgaria in a significant way, as gas accounts for the lowest share of gross energy consumption in the region, even though it imported almost entirely from Russia before the war. Moreover, immediately after the announcement, Bulgaria started to import Azerbaijani gas on a long-term contract, as well as liquefied natural gas (LNG), through Greece. Both the short- and long-term tenders for LNG and gas deliveries were launched in September 2022, as the caretaker government was considering all options, including relaunching Russian gas deliveries. The long-term LNG contract covers a 10-year period from 2024, booked through the Alexandroupolis terminal, while the important gas interconnector with Greece started operations from October 2022.

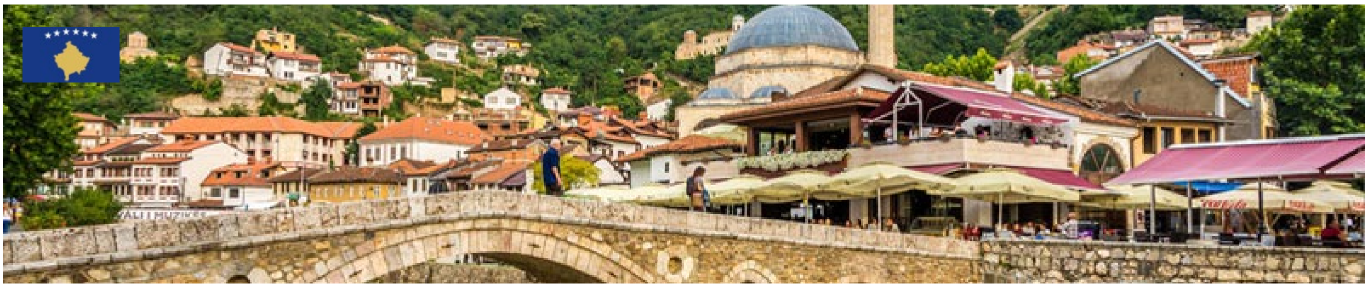
RRP implementation has started after significant delays. Despite the delay in the final approval of the RRP, which was given in April 2022, the authorities are trying to make up for lost time by fast-tracking the next steps. The government has swiftly set up a management and control system for the plan and has been actively meeting targets for the first disbursement request, initially planned for the second quarter of 2022, despite first needing to sign all of the technical agreements with the European Commission. In early August 2022 the Ministry of Finance signed the operational agreements with the Commission. To improve the management of RRP investments, the government reached an agreement on technical support with the European Bank for Reconstruction and Development (EBRD), while it signed agreements with the European Investment Bank and the World Bank for technical support in absorbing 2021-27 programming period funds totalling €11 billion. Parliament needs to adopt important milestones, including those related to judicial reform, by the end of 2022. However, the political uncertainty poses significant implementation risks.

E-governance reforms have progressed, alongside a new ministry focused on digital transformation. Some of the main measures adopted or in the works are: i) the development of an electronic identification tool and regulatory amendments to use the system; ii) the facilitation of online access to documents; iii) the digitalisation of cadastre, procurement and public information; iv) the strengthening of public institutions' cybersecurity; and v) support for ministries on various aspects of digitalisation, including justice, road administration, healthcare, tourism and education.

As part of the RRP, the government launched state-aid schemes for the modernisation of firms. The tender for the €130 million support scheme for technological modernisation was launched in July 2022 and received more than 2,500 proposals for about BGN 634 million (€323 million). The scheme targets small and medium-sized enterprise (SME) investment in new information and communication technologies, with the aim of increasing the overall productivity of Bulgarian SMEs, and has a target of 1,492 completed projects by the end of 2024. A second fund will be focused on equity investments in venture capital, technology transfer and social impact funds. The instrument will be managed by the European Investment Fund. These funds will be complemented by two similar programmes worth €3.57 billion financed by European Union structural funds, which will start in 2023.

The government has adopted a 2030 strategic plan to develop transport infrastructure. The plan includes measures to stimulate sustainable transport and intermodal infrastructure. These include intermodal links in Sofia and Northern Bulgaria and a feasibility study for a terminal in Vidin, as well as railway modernisation to link with ports. In July 2022 the transport ministry signed the decision that, for cost-cutting reasons, the state-owned Bulgarian Railways Holding would merge back into a single entity with its passenger and freight subsidiaries. This goes against the decision in late 2019 to fully separate the passenger and freight companies, but the announced plans include a potential listing of the company in 2024.

The Employment Promotion Act was amended. Parliament adopted the Employment Promotion Act in May 2022, aimed at strengthening the labour-market inclusion of inactive persons, young people not in training or education (NEETs) and those with informal training, who will get their skills validated in vocational training centres. This was a reform milestone for the second disbursement of the Recovery and Resilience Facility, planned for the end of 2022. The Employment Agency will now be tasked with actively interacting with and collecting information on inactive persons. An amendment to the bill ensures that Ukrainian refugees are included in the renewed effort.



Kosovo

Highlights

- **Economic activity is slowing.** Strong demand-side pressures, underpinned by renewed mobility and the large diaspora, resulted in vigorous expansion in 2021. As the scope for recovery narrowed and demand became more muted, growth slowed to 3.2 per cent year on year in the first half of 2022.
- **Regulatory initiatives to improve the business environment have advanced.** Laws on inspection, the protection of competition and the establishment of a commercial court have been approved by the national assembly.
- **Reform is under way to improve the management of state assets.** The government has approved a concept paper on establishing a sovereign fund that will take over the management of strategic state assets from the Privatisation Agency of Kosovo.

Key priorities for 2023

- **Greening the energy sector is a critical component in ensuring energy security.** The National Energy Strategy should be finalised, featuring plans to decommission lignite-powered plants, an auctions system for renewables that would capitalise on the interest of private investors and plans to undertake necessary infrastructure investment.
- **Public-sector reforms need to continue without delay.** State-owned enterprises (SOEs) suffer from corporate governance and efficiency weaknesses, requiring greater oversight and management. Given the significant infrastructure gaps, scaling up public investment would help strengthen regional and domestic labour-market integration, lifting the country's growth prospects.
- **Enhancement of the business climate should continue.** Recent legislative changes should be followed up by developing stronger institutional capacity among implementing entities, enabling sound operational frameworks and ensuring transparency and effectiveness. Other needed reforms include improving public-private dialogue and taking more resolute measures to reduce widespread informality and tax evasion.

TABLE Main macroeconomic indicators %

	2018	2019	2020	2021	2022 proj.
GDP growth	3.4	4.8	-5.3	10.7	4.0
Inflation (average)	1.1	2.7	0.2	3.3	12.0
Government balance/GDP	-2.9	-2.9	-7.9	-1.4	-1.0
Current account balance/GDP	-7.6	-5.7	-7.0	-8.7	-10.9
Net FDI/GDP [neg. sign = inflows]	-3.4	-2.7	-4.2	-4.0	-4.4
External debt/GDP	30.5	31.2	37.2	37.4	n.a.
Gross reserves/GDP	11.5	12.2	13.3	13.8	n.a.
Credit to private sector/GDP	44.5	46.7	51.6	52.8	n.a.

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Macroeconomic developments and policy response

The rapid post-pandemic recovery is slowing. Output expanded by a stronger-than-expected 10.7 per cent in 2021 on the back of renewed mobility and support from the diaspora, reflected in a doubling of service exports compared with pre-pandemic levels and a high inflow of remittances. As the scope for recovery narrowed, growth moderated to 4.5 per cent and 2.1 per cent year on year in the first two quarters of 2022 respectively. In spite of continually strong annual credit growth, household consumption, which was previously driving the output expansion, became more muted in real terms in the second quarter and investment contracted by 17.0 per cent. In contrast to the domestic demand slowdown, external demand remained strong and net exports' contribution to growth turned positive in the second quarter of the year, helped by lower energy imports as the heating season ended. The broad-based output expansion, spanning nearly all economic segments in the first quarter, continued into the second quarter of the year but was partially offset by an 18 per cent annual contraction of the construction sector, in line with lower investment.

Inflation is rising and the current account deficit is widening. Higher food and oil prices pushed annual inflation to a high of 14.2 per cent in July 2022 before coming down to 12.7 per cent in September. Food accounts for as much as 34 per cent of the consumer price index in Kosovo, compared with 15 per cent in the European Union (EU). Electricity prices did not significantly contribute to inflationary pressures despite a state of emergency in the energy sector during the winter of 2021-22, as the public sector largely absorbed the impact of heightened electricity imports amid surging global prices. Higher energy prices (and volumes in the case of electricity during the winter) have, however, been reflected on the current account deficit which widened by a third on an annual basis in the first seven months of 2022.

Policy measures were implemented in response to the energy crisis and rising inflation. A 60-day energy emergency was first announced at the end of 2021 and reinstated in August 2022, as domestic power generation failed to meet demand and the price of imported power multiplied. The national energy distribution company, KEDS, introduced systemic temporary electricity outages both times. Kosovo's energy regulator approved a temporary discriminatory pricing model, increasing electricity tariffs from February 2022 for households consuming more than 800 kilowatts of electricity a month. In response to elevated inflation and food security concerns caused by the war on Ukraine, an export ban on agricultural products such as wheat, flour, corn and sunflower oil was introduced in April 2022. In the following months, the government scaled up agricultural subsidies, including for oil, introduced public-sector wage bonuses, approved temporary increases in social transfers and pensions and capped fuel prices. As inflationary pressures continued, another €150 million support package was introduced in September, continuing the trend of one-off aid for vulnerable citizens and public-sector wage bonuses, alongside subsidies of private-sector wage increases and electricity bills for those reducing consumption.

Growth is expected to continue at a slower pace. We forecast gross domestic product (GDP) growth of 4.0 per cent in 2022 and 3.7 per cent in 2023. The instability of the energy sector is likely to further impact the fiscal and external accounts and may adversely affect economic activity. Other key risks to the near-term outlook include elevated inflation, which is set to further dampen domestic demand, rising geopolitical uncertainty and an anticipated slowdown in external markets, affecting exports.

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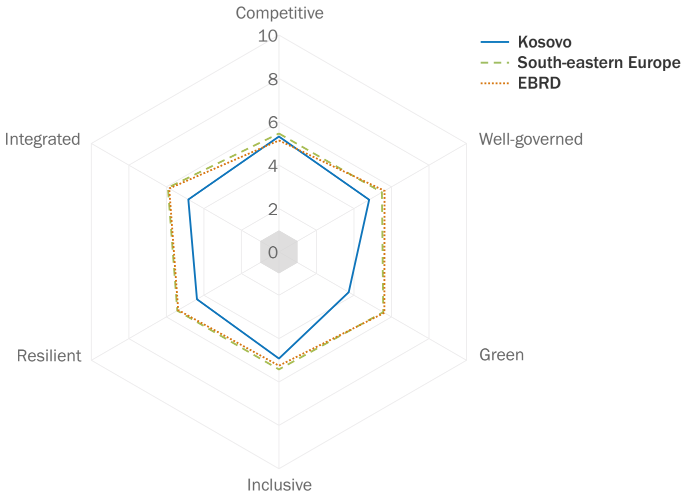
CHART Assessment of transition qualities (1-10)



Structural reform developments

There has been little progress on the EU approximation process. Kosovo signed its Stabilisation and Association Agreement (SAA) with the EU in October 2015. While the European Commission and the European Council have repeatedly stressed that the country shares the European perspective of the Western Balkans, the question of its practical integration into the EU remains contentious due to the fact that five member states do not recognise Kosovo bilaterally. Although the European Commission confirmed that Kosovo had met all visa liberalisation benchmarks, the decision on visa liberalisation is still pending in the European Parliament and European Council, and citizens of Kosovo remain unable to travel without a visa to the Schengen area.

Renewables development progressed. The Bajgora wind farm, which supplies up to 10 per cent of the country's electricity, started supplying electricity to the power grid in September 2021 and was fully operational as of March 2022. Kosovo's first biomass-fuelled heating plant opened in Gjakova in November 2021, aiming to reduce air pollution and costs incurred by the heavy oil-powered district heating system. In March 2022 the government approved the large-scale Solar Kosova project, which should span some 69,000 square kilometres and contribute to the heating system of the capital, Pristina. The National Energy Strategy, currently being finalised following public consultation in June 2022, is expected to set the pace of energy transition in the coming years.

The Commercial Court was established. In January 2022 the national assembly approved the Law on the Commercial Court, which establishes a special court for handling business disputes. Work is under way to develop an action plan to get the court up and running, including regulations on internal organisation, case transfer and the recruitment of key personnel. The Commercial Court, expected to open by the end of 2022, will take over the responsibilities of the Economic Department of the Pristina Basic Court and the Court of Appeals in handling commercial cases and those of the Administrative Department of the Pristina Basic Court in handling commerce-related administrative cases.

Inspections reform advanced. The Law on Inspections, approved by the national assembly in December 2021, is part of ongoing reforms to revise all laws and bylaws governing inspections. It is a novelty in Kosovan legislation as, to date, there has been no unified legislation governing inspections of businesses. Its approval met one of the conditions of the latest round of Development Policy Financing (DPF) from the World Bank, signed in March 2022. Amounting to €50.6 million, the DPF will support Kosovo's reform efforts to improve fiscal transparency, enhance private-sector development and strengthen environmental sustainability.

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The national assembly approved the new Law on the Protection of Competition in May 2022. The regulation represents a milestone in the alignment of the country's legislative framework with the EU *acquis communautaire*. The approval of this legislation aims to fulfil key commitments by Kosovo under three treaties: the EU-Kosovo SAA, the Energy Community Treaty, and the Central and Eastern European Free Trade Agreement (CEFTA). However, an assessment by the US State Department notes that Kosovo's Competition Authority, responsible for implementing the law, generally lacks the human resources for thorough investigations.

A sovereign fund to manage state assets is in development. In May 2021 the government dismissed the previous board of the Privatization Agency of Kosovo (PAK) as a first step in the process of closing the agency and establishing a sovereign fund to manage strategic state assets. The new PAK board identified the assets that it plans to transfer to the sovereign fund and, in June 2022, the government approved the concept paper on establishing the fund.

Montenegro

Highlights

- **Economic recovery continues.** A strong performance by the tourism sector was the driving force behind 13.0 per cent gross domestic product (GDP) growth in 2021. Robust household consumption growth continued into 2022, supported by a minimum wage hike, but rising imports are stifling the growth rate.
- **The government introduced tax measures to improve living standards and decrease informality.** In addition to an 80 per cent minimum wage hike, the authorities introduced progressive taxation and reduced the sizeable labour tax wedge.
- **Reforms in the energy sector have continued.** The Montenegrin power exchange company is making progress on establishing a day-ahead electricity market with two regional power exchanges, while the state-owned power utility has joined the day-ahead power market of the Serbian power exchange.

Key priorities for 2023

- **There needs to be continuity of economic policy and implementation despite political change.** Public institutions should be strengthened to mitigate the potentially harmful effects of frequent political changes on policymaking and reform progress.
- **The pathway to decarbonisation should be developed.** The National Energy and Climate Plan (NECP) should be finalised, setting out plans for ending coal-powered generation, while a modern regulatory framework that creates incentives for private investment in renewable generation should be developed.
- **Public-sector reform should be stepped up.** Key measures that should be prioritised include adopting the draft Public Administration Reform Strategy, formulating a state ownership policy and centralising oversight of state-owned enterprises (SOEs), and improving fiscal impact analyses of proposed social measures and public investment plans.

TABLE Main macroeconomic indicators %

	2018	2019	2020	2021	2022 proj.
GDP growth	5.1	4.1	-15.3	13.0	3.7
Inflation (average)	2.6	0.4	-0.3	2.4	12.8
Government balance/GDP	-6.2	-1.8	-10.9	-1.7	-5.0
Current account balance/GDP	-17.0	-14.3	-26.0	-9.2	-13.8
Net FDI/GDP [neg. sign = inflows]	-6.9	-6.2	-11.2	-11.7	-11.1
External debt/GDP	163.7	167.4	221.6	191.5	n.a.
Gross reserves/GDP	22.3	27.6	41.5	35.3	n.a.
Credit to private sector/GDP	49.6	49.0	60.0	52.3	n.a.

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Macroeconomic developments and policy response

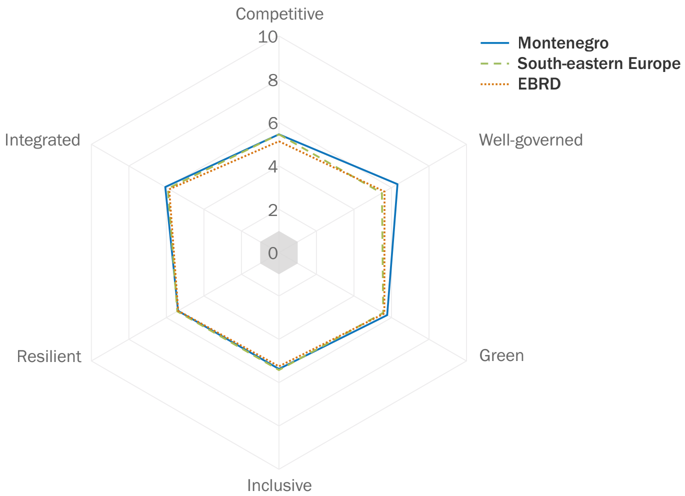
Economic recovery continues. Output grew by a strong 13.0 per cent in 2021 on the back of a successful summer tourism season, following a deep pandemic-induced recession in 2020. The expansion continued in 2022 with the economy growing by 7.1 per cent and 12.7 per cent year on year in the first two quarters of the year, respectively, as household consumption remained elevated but imports surged, leading to negative net exports. Household demand was supported by an 80 per cent minimum wage hike in January 2022 and the abolition of mandatory health contributions, driving a 33 per cent nominal increase in the average net wage in the first eight months of the year, albeit more muted in real terms due to high inflation. Retail trade led growth on the production side as foreign tourist arrivals were up by 59 per cent year on year by the end of August, although still below record 2019 levels. Investment remained weak amid a strong contraction in construction activity, as work on the Bar-Boljare highway, the country's largest infrastructure project, nears first-phase completion and political turmoil acts as a drag on new projects.

Inflation has risen sharply and the current account deficit has widened. The rate of inflation accelerated to 16 per cent year on year in September 2022, driven by rising prices for food and energy imports and exacerbated by wage growth. In the first half of the year, the current account deficit widened by 31 per cent annually, mainly because of higher prices for fossil-fuel imports, primarily petroleum. The country managed to satisfy power demand from local production in the 2021-22 winter, as the state-owned aluminium smelter, a significant electricity consumer, was closed temporarily. Meanwhile, foreign direct investment (FDI) increased by 80 per cent on the year in the first half of 2022 as investment in real estate more than doubled, with the largest portion of FDI coming from Russia.

Policy responses to rising prices were introduced with a delay due to political changes. In May 2022 the new government temporarily abolished value added tax (VAT) on cooking oil and flour and halved excise duty on fuel. In June 2022 retail profit margins on basic foodstuffs (cooking oil, flour, sugar and salt) were capped, VAT on bread was abolished and excise duties on single-use plastic were removed, to the benefit of domestic food producers. The government capped the rising price of wood pellets in July, and in September took steps to limit their export.

The short-term growth outlook is uncertain. We forecast GDP growth of 3.7 per cent in 2022 and 4.0 per cent in 2023. The economic impact of the war on Ukraine is reflected in continually elevated inflation, which is set to dampen demand. At the same time, stronger than expected private consumption and robust performance of the hospitality sector tilt the short-term outlook towards the upside. Political instability – with two governments being voted out in no-confidence ballots in parliament in the space of a few months – is creating uncertainty about the implementation of reforms needed to improve medium-term growth prospects.

CHART Assessment of transition qualities (1-10)



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Structural reform developments

The authorities are focused on closing European Union (EU) accession negotiating chapters. Having opened all negotiating chapters of the EU accession negotiating framework, the *acquis communautaire*, the focus has now shifted to closing chapters. Only three chapters have been provisionally closed since the opening of accession negotiations in June 2012 and there has been no progress in this regard over the past year. According to the European Council and European Commission, further progress in negotiations will depend on Montenegro meeting the interim benchmarks set in the rule-of-law chapters (23 and 24) of the *acquis*.

Important tax and wage changes have been adopted. In December 2021 key components of a previous government's Europe Now programme were included alongside the state budget for 2022 in a bid to reduce the sizeable labour tax wedge and reduce informality. Changes from the start of 2022 included an 80 per cent hike in the minimum wage to €450, the introduction of progressive personal and corporate taxation, the introduction of a non-taxable salary base and the abolition of obligatory healthcare contributions. These reforms were designed to attract new investment and lead to the formalisation of employment, but are likely to lead to lower net tax revenues, partially as all proposed revenue-reducing measures were adopted, including additional last-minute ones, while also not including all proposed revenue-enhancing measures. A budget rebalance was adopted in September 2022.

The first section of the country's biggest infrastructure project has been completed. The planned 170-kilometre Bar-Boljare highway is set to eventually connect the Montenegrin coast with the Serbian border. Highway construction started in 2015, led by the China Road and Bridge Corporation and supported by financing from China ExIm Bank. The first section, opened in July 2022, is 41 kilometres long and, due to the difficult terrain, the most expensive section.

The government has adopted an economic recovery platform for 2022-26. The platform, adopted by the then government in March 2022, aims to provide a detailed picture of the Montenegrin economy and presents a vision for medium-term development that should serve as a basis for further strategic documents. The six key objectives of implementation are: macroeconomic stability, stabilisation of demographic challenges, economic diversification, better implementation of infrastructure projects, innovation, digitalisation and the green economy, and good governance. The effectiveness of the platform remains to be seen in light of political changes since adoption.

Regulatory requirements for banks have been strengthened. The new Law on Credit Institutions, the Law on Resolution of Credit Institutions and an accompanying set of by-laws came into effect at the start of 2022, aligning regulation and supervision with Basel III standards (with a transition period) and the EU's regulatory framework. The Law on Credit Institutions strengthens the capital requirements of banks, introduces mandatory board supervision, tightens norms for the identification and classification of non-performing loans and sets criteria for determining the systemic importance of banks, while the latter introduces the resolution fund, minimum requirements for eligible liabilities (MREL) and a bail-in tool.

The Strategy for the Development of Women's Entrepreneurship was adopted in October 2021. The Strategy and accompanying action plan run from 2021 to 2024 and set out four strategic priorities: enhancing the business environment for women in business, access to finance, access to knowledge and skills, and promotion and networking.

A day-ahead power market is in the works as the energy regulator strengthens supervision. The Montenegrin power exchange company, BELEN, signed a service agreement in October 2021 with the European Power Exchange (EPEX SPOT) and the Slovenian SouthPool Energy Exchange (BSP) to establish a day-ahead electricity market in Montenegro. According to the Energy Community Secretariat, the agreement is a key step in improving competition and liquidity in the power market. In June 2022, the state-owned power utility, EPCG, joined the day-ahead power market of the Serbian power exchange, SEEPEX, primarily selling output from the Piva hydropower plant. In January 2022 legislation on the supervision of wholesale electricity and gas markets entered into force, empowering the national energy regulator to monitor markets and investigate abuse, thus helping to ensure fair energy prices.

Montenegro Works, the SOE management company, was liquidated in July 2022, less than a year after its founding. The company was established in August 2021, tasked with overseeing and analysing the financial performance of SOEs.

North Macedonia

Highlights

- **Economic growth has moderated during 2022.** North Macedonia recovered well from the Covid-19 pandemic, as pent-up demand pressures led to an increase in domestic trade and stronger manufacturing in 2021. In 2022, however, inflation is growing and uncertainty has increased, holding back consumption and economic activity.
- **The commitment to a green transition has been strengthened.** In adopting its final National Energy and Climate Plan (NECP), the country set a date of 2027 for the closure of its two coal power plants. The ambitious plan features carbon taxation, energy efficiency measures and gas as a transition fuel.
- **Fiscal decentralisation reform has been adopted.** Municipalities are set to manage a higher portion of tax revenue and service their own debt, in line with defined responsibility and transparency guidelines.

Key priorities for 2023

- **Fiscal sustainability should be carefully maintained.** While policy responses to protect the living standards of citizens in an environment of surging inflation are warranted, care should be taken to avoid untargeted measures or ones that are difficult to reverse. A credible medium-term fiscal strategy in line with the Organic Budget Law would help govern decision-making.
- **Scaling up clean energy is key.** Diversifying energy sources with clean energy would boost the competitiveness of exports in the context of high energy import prices, strong trade links with the European Union (EU) and the EU's upcoming carbon border adjustment mechanism.
- **Enhancement of the business environment would help unleash private-sector potential.** Key steps that should be given priority include the systematisation and streamlining of state subsidies, in addition to linking them to outcomes, addressing informality and, in the long term, comprehensively revamping the education system to address skills mismatches.

TABLE Main macroeconomic indicators %

	2018	2019	2020	2021	2022 proj.
GDP growth	2.9	3.9	-4.7	3.9	2.7
Inflation (average)	1.5	0.8	1.2	3.2	10.6
Government balance/GDP	-1.8	-2.0	-8.2	-5.4	-5.3
Current account balance/GDP	0.2	-3.0	-2.9	-3.1	-6.7
Net FDI/GDP [neg. sign = inflows]	-5.6	-3.2	-1.4	-3.3	-3.2
External debt/GDP	73.0	72.4	78.7	81.9	n.a.
Gross reserves/GDP	26.7	29.0	31.0	31.2	n.a.
Credit to private sector/GDP	50.2	51.3	56.9	56.0	n.a.

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Macroeconomic developments and policy response

The economic recovery has slowed. Following a relatively strong demand-driven rebound of 3.9 per cent in 2021, economic activity moderated to 2.6 per cent year-on-year growth in the first half of 2022. Supporting economic expansion were strong annual gross investment growth (upwards of 40 per cent), driven by base effects in the first quarter and inventory changes in the second quarter, and persistent household consumption. On the flip side, imports surged 25 per cent year on year, outpacing export growth and damping the growth rate in the first half of 2022. On the production side, strong annual growth in domestic trade, reflecting continued pent-up demand pressures, led the expansion, while the second biggest economic sector, industry, recorded a more muted 2.3 per cent annual growth rate.

Inflationary pressures have accelerated, while energy imports have widened the current account deficit. Annual inflation reached 18.7 per cent in September 2022 as consumers in North Macedonia felt the rising prices of food and energy on world markets through imports. Despite an 18 per cent increase in the minimum wage, effective April 2022, real wage growth turned negative in May. A seven-month state of emergency was declared in the country's energy sector in October 2021 and reinstated in August 2022 due to vulnerabilities in domestic electricity production; household electricity bills increased twice in 2022, while heating prices rose 14 per cent on gas import prices alone. Higher energy prices have also prompted a sharp rise in the current account deficit. Macroeconomic stability is being supported by the managed floating exchange-rate regime, backed by sizeable foreign-exchange reserves of €3.8 billion as of September 2022. The National Bank of North Macedonia raised the key interest rate six times from 1.25 per cent in April to 3.5 per cent as of October 2022.

The government undertook extensive fiscal measures. A 26-measure €400 million package was introduced in March 2022, aiming to protect the living standards of citizens primarily through various tax relief measures, such as a value added tax (VAT) decrease on basic foodstuffs and energy, a delay in applying the upcoming environmental energy tax, the capping of retail trade margins and subsidies, and supporting companies' liquidity through favourable loan terms. Also in March, temporary export bans were introduced for key agricultural products. Fiscal space has tightened since the adoption of the package, prompting the government to undertake a budget rebalancing, featuring a higher 2022 deficit of 5.3 per cent of gross domestic product (GDP) and space for pension increases. The latest €360 million package, adopted in October 2022, is largely an extension of measures introduced in March, with more of the targeted and fewer of the broad-based support measures continued. To help safeguard the economy, the authorities requested a two-year Precautionary and Liquidity Line with the International Monetary Fund (IMF) and reached a staff-level agreement in October.

The economy will continue to grow, albeit at a slower pace. We forecast economic growth of 2.7 per cent in 2022 and 2.3 per cent in 2023 amid an unfavourable global outlook. Although North Macedonia has only limited direct economic links to Russia or Ukraine, the economic impact of the war on Ukraine has already partly materialised in the form of a further rise in prices, which is set to dampen household consumption further. The anticipated slowdown in eurozone export markets, relevant for the automotive sector, in particular, alongside increased uncertainty and tighter financing conditions, which may weigh on investor confidence, may further impact the economy. Fiscal vulnerabilities primarily relate to the upcoming 2022-23 heating season, which is likely to be challenging due to high energy prices worldwide, insufficient domestic production and illiquid state-owned utility companies.

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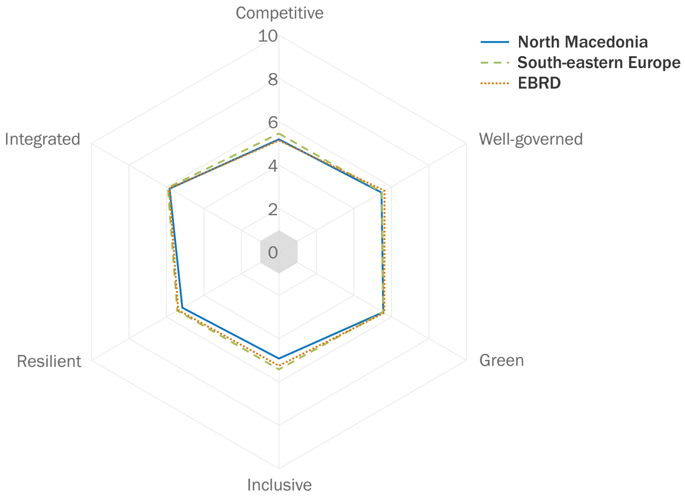
CHART Assessment of transition qualities (1-10)



Structural reform developments

EU accession negotiations have been opened. The long-awaited formal opening of North Macedonia's EU accession negotiations, the first intergovernmental conference, took place on 19 July 2022. It was followed by the European Commission's launch of the screening process. However, while screening will go ahead, to start accession negotiations in earnest (which requires an additional intergovernmental conference), North Macedonia will have to first adopt constitutional amendments related to the status of Bulgarian minorities in the country.

The government has adopted an ambitious Growth Acceleration Plan for 2022-26. The plan, adopted by the government in October 2021, aims to support the post-pandemic recovery and GDP growth. It foresees a 5 per cent annual GDP growth rate, partly through a €4 billion allocation to public investment, which is expected to mobilise double that amount in private investment, enhancing competitiveness. Fiscal consolidation, too, is part of the medium-term vision, as public debt is set to be below 60 per cent of GDP by the plan's end. Since the plan's adoption, fiscal consolidation has been delayed, however, because of the worsening external environment.

The minimum wage was increased. The new minimum wage law, adopted by parliament in February 2022 and effective from April, brings the minimum wage to 62 per cent of the average wage – a relatively high proportion compared with most EU countries. Nearly a fifth of workers in North Macedonia are set to benefit from the 18 per cent increase. The law also prescribes an annual adjustment of the minimum wage in line with the average net wage and inflation, as well as a benchmark that prohibits the minimum wage going below 57 per cent of the average wage. The policy sparked protest in the public sector, as non-minimum wages were not raised accordingly, most notably among workers employed in education, resulting in a 12 per cent increase in teachers' wages.

Fiscal decentralisation reform is beginning. The reform encompasses three pillars: (i) the improved fiscal capacity of municipalities, (ii) greater fiscal discipline and (iii) the transparency and accountability of municipal operations. Under the legal amendments adopted in July 2022, municipalities are to be allocated a progressively larger share of personal income tax and VAT revenues, with these revenues set to double from some €45 million in 2022 to more than €80 million in 2024. Two new funds will be established from which municipalities will be able to draw funds, based on their performance in terms of revenue collection. As far as fiscal discipline is concerned, municipalities are set to plan their own revenues and expenditures and will be expected to regularly service debt, while those that declare financial instability will be eligible for a credit line from the ministry of finance.

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The country committed to its energy transition pathway. The government adopted the final National Energy and Climate Plan (NECP) for 2021-30 in May 2022. The plan outlines the country's decarbonisation pathway, making North Macedonia the second Western Balkans country to firmly commit to the obligations of an Energy Community contracting party. The plan's ambitions include the closure by 2027 of coal power plants, which currently produce half the country's electricity supply, the introduction of a carbon tax, and a 20 per cent cut in consumption through energy-efficiency measures. Since its adoption, the energy regulator has approved a new pricing model for electricity, valid from July 2022, pegging price to consumption. Diversification efforts through the increased usage of natural gas are also included in the NECP; currently, gas is mostly used for heating in the country's capital, Skopje, and, to a limited degree, by industrial producers. It is sourced entirely from Russia on market terms. Having partially secured financing for a gas interconnector with Greece at the end of 2021, in February 2022, North Macedonia reserved liquefied natural gas (LNG) capacities at the floating terminal in Alexandroupolis, currently under construction, and, in March, joined the EU-led platform for joint LNG purchasing.

The Organic Budget Law was adopted. Adopted in September 2022, it introduces a new set of fiscal rules to guide fiscal consolidation and improve the budget process. Key reforms include medium-term projection, spanning both medium-term budgeting and a five-year fiscal strategy, as well as establishing a Fiscal Council, an independent body assessing fiscal policy.

Romania

Highlights

- **The Romanian economy was resilient in the first half of 2022.** After finishing 2021 on a high note, gross domestic product (GDP) growth reached 5.7 per cent year on year in the first half of 2022, driven by strong domestic demand, despite rising headwinds. The currency remained stable in the face of rising inflationary pressures.
- **The government extended its intervention in the energy market in September 2022.** As the previous iteration of the energy price cap brought fiscal uncertainty, the state will regulate the energy market until October 2023 by levying windfall taxes on all market participants.
- **Justice system reform has commenced amid Recovery and Resilience Plan (RRP) milestones.** The government adopted revised justice laws in August 2022, in addition to accompanying operational strategies, but parliamentary approval is pending.

Key priorities for 2023

- **Energy crisis support for households should be targeted at the vulnerable.** The energy price cap introduced in April 2022 has come at a high cost to the government, complicating much-needed fiscal consolidation efforts. This is why support needs to be targeted and tied to incentives to decrease energy consumption.
- **RRP implementation should be prioritised as the main reform instrument.** The authorities included a comprehensive set of reforms and investments in the RRP, presenting an opportunity for structural reforms that should be grasped firmly, with a particular focus on implementation and disbursement.
- **The government should accelerate improvements in the rule of law.** Delays in the revision of the justice laws since 2019 have prompted the European Union (EU) to keep the Cooperation and Verification Mechanism in place. Moreover, further reforms are needed to strengthen anti-corruption measures and media independence.

TABLE Main macroeconomic indicators %

	2018	2019	2020	2021	2022 proj.
GDP growth	6.0	3.9	-3.7	5.1	5.4
Inflation (average)	4.1	3.9	2.3	4.1	13.3
Government balance/GDP	-2.8	-4.3	-9.2	-7.1	-6.4
Current account balance/GDP	-4.6	-4.9	-4.9	-7.3	-8.4
Net FDI/GDP [neg. sign = inflows]	-2.4	-2.3	-1.3	-3.7	-2.5
External debt/GDP	48.5	49.0	57.6	57.3	n.a.
Gross reserves/GDP	17.9	16.7	19.3	19.1	n.a.
Credit to private sector/GDP	25.4	24.3	25.5	26.3	n.a.

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Macroeconomic developments and policy response

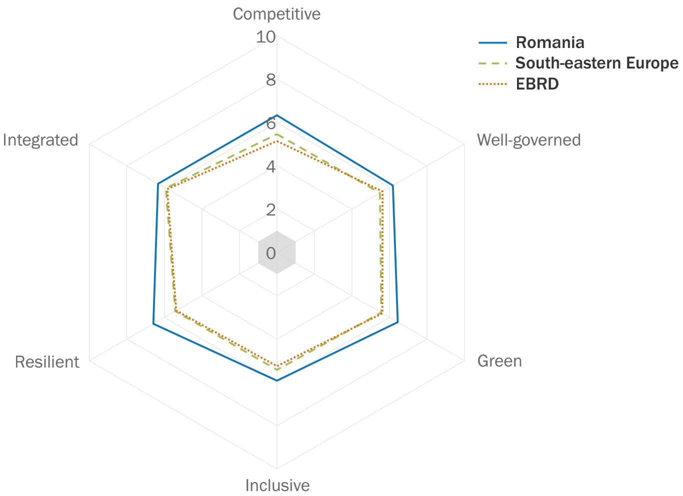
The economy has performed well so far in 2022, but is coming under increasing pressure. After a rebound of 5.1 per cent in 2021, mainly driven by strong private consumption, GDP expanded 6.4 per cent year on year in the first quarter and 5.1 per cent year on year in the second quarter of 2022. The buoyant private consumption of services, in particular, as well as fiscal stimulus and an inventory build-up contributed to growth. In the second half of the year, high inflation, deteriorating financing conditions and an uncertain global outlook are weighing more on consumers and, hence, overall economic growth.

Inflation plateaued at 15 per cent in summer 2022, triggering monetary tightening. The sharp rise in inflation in 2022 has been driven mainly by food and energy prices since the start of the war on Ukraine, but has shown signs of stabilisation since June, although it again accelerated in September 2022 to 15.9 per cent. Inflation depressed real wage growth to an average 0.2 per cent in the first half of 2022, as nominal wages rose at a double-digit rate. The National Bank of Romania raised the policy rate to 6.25 per cent in October 2022. It has also intervened in the secondary market for sovereign debt and has held a tight grip on the RON/EUR rate. The lack of RON liquidity on the market has led to increased financing costs, significantly above the policy rate.

Unforeseen expenses and weaker economic growth are threatening fiscal consolidation. The August 2022 budget revision maintained the government's fiscal deficit target for the year at 5.8 per cent of GDP, although the Fiscal Council expects the cash-based deficit to reach 7 per cent of GDP. Budget execution for the first half of the year was favourable, with the deficit reaching just 1.7 per cent of GDP. Considerable uncertainty surrounded the cost of capping electricity and gas prices for one year, which has not been fully budgeted; some estimates placed the costs at 3 per cent of GDP. The government modified its main energy measure in September 2022 and extended the price cap to October 2023, along with windfall taxes on all energy market participants, subject to adoption by parliament. A controversial provision includes limits on energy exports, which goes against EU regulations. Other support measures announced by the government include social support – one-off payments to pensioners and payments every two months to vulnerable families – as well as options to defer loan payments, along with extended state aid and credit guarantee schemes for small and medium-sized enterprises and companies in agriculture, production and construction.

The economy remains resilient, but the short-term outlook is highly uncertain. Taking into account the strong economic performance of the first half of 2022, we forecast GDP growth for the year as a whole at 5.4 per cent, but with significant downside risks depending on developments in the second half of the year. Deteriorating savings and income, lower credit demand and the weak performance of Romanian industrial production and exports all suggest a drop in GDP growth to 1.9 per cent in 2023. From an energy security standpoint, Romania largely relies on domestic production, which could help shield it from a shutdown of gas imports, but the spillover effects of any eurozone recession would still be considerable.

CHART Assessment of transition qualities (1-10)



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Structural reform developments

Legislation has been introduced to improve governance and policymaking. In March 2022 the government adopted two acts introducing new methodologies for implementing government strategies and institutional strategic plans, including guidelines for the *ex ante* and *ex post* impact evaluation of policies. In April 2022 the government adopted another executive order devising methodology for the better elaboration and monitoring of budgetary programmes, all of which are included in the RRP milestones. The challenge now lies in the application of these guidelines to ensure quality policymaking.

The government has accelerated work on improving the rule of law, albeit with shortcomings. In addition to approving changes to the three central laws that form the justice laws in August 2022, the government, as part of the RRP, also adopted an anti-corruption strategy 2021-25 in December 2021 and a strategy for the development of the justice system 2022-25. A more difficult milestone has been the transposition of EU Directive 2019/1937 on whistle-blower protection. Civil society groups have argued that these amendments have weakened the position of whistle-blowers by removing both the presumption of good faith and the possibility of anonymous reporting of suspected fraud. The President has sent the law back to parliament for re-examination.

Pension reform is under way. As part of the RRP, the authorities agreed to conduct a comprehensive reform of the pension system, mainly to ensure fiscal sustainability. A first step was taken in early 2022, when the government approved the decision to increase the contribution of employees to the second pension pillar from 3.75 per cent to 4.75 per cent, starting in 2024. The Authority for Fiscal Stability approved complementary acts to digitalise the second pillar and diversify investments, but stakeholders have criticised the decision to exclude investments in private equity funds. The authorities have committed to proposing a comprehensive reform of the pension system by the end of 2022.

The governmental cloud project has started, but the schedule has been delayed. The implementation of the governmental cloud is the central element of the digitalisation component of the RRP. However, the first step, to form a working group tasked with defining the scope of the reform, was delayed until the middle of 2022. In June 2022 the government adopted an emergency ordinance on the governance of the public-sector cloud and a law on interoperability. In conjunction, it adopted a cybersecurity strategy for 2021-26.

School dropout rates are being tackled. Romania recorded the highest share of early school leavers in the EU in 2021 (at 15.3 per cent) and this remains a key problem in the educational system. In response, a government decision on implementing a national programme to reduce school dropout rates was adopted at the end of 2021. The project has two main dimensions: first, RRP funding will allocate resources to schools in vulnerable areas, where the share of early leavers is high, and, second, grants will be offered to pupils at risk of not going to high school. School selection will be conducted through a mechanism that considers five key indicators related to educational outcomes.

EU financial institutions will support Romania in channelling RRP funds to the economy. In May 2022 the European Investment Bank (EIB) said that, together with the Romanian Ministry for EU Investment and Projects, it had created a €300 million fund of funds for on-lending under the RRP. The EIB will manage the fund and provide direct and intermediated on-lending to Romanian schemes in line with outlined priorities. This complements the agreement signed with the European Investment Fund (EIF) in December 2021 for the implementation of equity instruments worth €400 million, in addition to the implementation of guarantee instruments worth €500 million under the InvestEU programme. The instruments should be launched in the second half of 2022 and will be injected into the banking sector, which will channel most of the funds to the economy, in early 2023.

The government has launched support schemes to improve the energy efficiency of buildings. A key green measure devised in the RRP is a support scheme for renovation and integrated energy and efficiency renovation, including the seismic strengthening of multi-family residential buildings and public buildings. The government also held a call for tenders on a €595 million scheme of wind and solar investments, which closed in May 2022.

Serbia

Highlights

- **The economic recovery is slowing.** Domestic and external pent-up demand pressures resulted in strong, broad-based expansion in 2021, but Serbia's growth performance has been more moderate in the first half of 2022.
- **Key infrastructure improvements are advancing.** These include the high-speed railway, broadband in rural areas, the gas interconnector with Bulgaria, the modernisation of one of Europe's biggest landfills and the airport in Belgrade.
- **The energy sector is at a crossroads.** An energy crisis is affecting the country as structural vulnerabilities in domestic electricity production have come to light amid surging global energy prices. The authorities rolled out a set of short-term coping measures, while strategic plans are being developed.

Key priorities for 2023

- **The energy sector should be reformed with both immediate and long-term goals in mind.** As power production from coal proves undependable and expensive in light of domestic production weaknesses and the European Union (EU)'s forthcoming carbon border adjustment mechanism, the development of renewables should be accelerated by the adoption and implementation of the new regulatory framework. This should take place in tandem with the reform of state-owned enterprises (SOEs) in the sector and the finalisation of key strategic documents outlining the decarbonisation vision.
- **SOE reform needs to progress.** In line with the adopted action plan on state ownership policy, SOE reform should be stepped up to improve productivity and contain fiscal risk. Among the key measures needed are the centralisation of ownership, a unified legal framework and strengthened governance requirements.
- **The business environment needs improvement.** The playing field should be levelled for small and medium-sized enterprises (SMEs) and large foreign investors by streamlining business procedures and consistently applying legislation. The rule of law and the fight against corruption should be strengthened.

TABLE Main macroeconomic indicators %

	2018	2019	2020	2021	2022 proj.
GDP growth	4.5	4.3	-0.9	7.5	3.3
Inflation (average)	2.0	1.7	1.6	4.1	11.5
Government balance/GDP	0.8	0.0	-7.2	-3.3	-2.8
Current account balance/GDP	-4.8	-6.9	-4.1	-4.3	-8.4
Net FDI/GDP [neg. sign = inflows]	-7.4	-7.7	-6.3	-6.9	-4.8
External debt/GDP	62.2	61.4	65.8	68.4	n.a.
Gross reserves/GDP	26.3	29.1	28.8	30.9	n.a.
Credit to private sector/GDP	41.4	42.0	45.5	43.5	n.a.

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Macroeconomic developments and policy response

Growth has moderated in 2022. The 7.5 per cent gross domestic product (GDP) growth of 2021 was broad based, reflecting pent-up domestic demand pressures and a rebounding external sector. Growth continued at a more moderate pace of 4.3 per cent and 3.9 per cent year on year in the first two quarters of 2022, respectively. As inflation accelerated and real wage growth muted, the expansion of household consumption slowed from 7 per cent in the first quarter to 4 per cent in the second quarter of the year. Investment growth remained moderate throughout the period as construction output contracted. Imports surged in the first quarter due to high volumes of electricity imports, slowing to a more moderate expansion in the warmer second quarter of the year when export growth (20 per cent year on year) overshot import growth. The expansion of services, leading growth on the production side, moderated in the second quarter in line with lower household demand and retail trade output. This effect was partially offset by an increase in industrial activity which posted 5 per cent growth on the year in the second quarter, compared with 2 per cent in the first quarter.

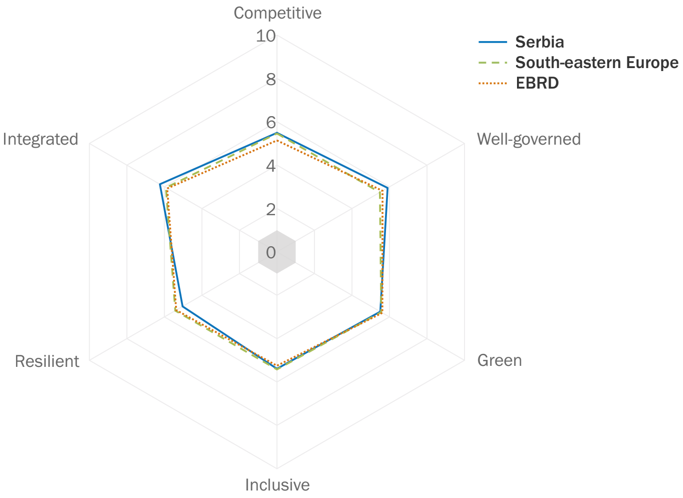
Inflation has surged and the current account deficit has widened on energy imports. With food and, to a lesser extent, oil prices rising sharply, inflation had already been at the upper end of the central bank's target band from May 2021, overshooting it in September 2021. Since then, consumer price inflation has continued to rise, reaching 14 per cent year on year in September 2022. The increase in food prices is caused by rising import prices, coupled with poor weather conditions, which had a negative effect on this year's harvest. Energy prices did not go up in Serbia during the winter of 2021-22 as SOEs and the state absorbed the impact of surging global prices, while there was a higher-than-usual volume of electricity imports, caused by a breakdown at a vital power plant and lower supply of domestic coal. These higher import volumes at elevated prices were reflected in the current account deficit, which increased threefold year on year in the first seven months of 2022.

The authorities employed policy measures to shield the economy. Price caps on basic foodstuffs were set at the end of 2021 and on oil in February 2022, followed by a reduction in excise duty. From March 2022, multiple temporary export bans were put in place; those on wheat, flour and sunflower oil have since been abolished, but those on certain types of fuel and capped-price wood pellets remained in place as of October 2022. Subsidies for flour producers were introduced in June 2022. In July the government decided to cover the price difference in gas imports (compared with November 2021) for wholesale suppliers over the winter from the state budget, banning gas exports for a month in October. Moderate electricity and gas price increases (6.5 per cent and 9.0 per cent respectively) were adopted ahead of the 2022-23 winter. The National Bank tightened monetary policy seven times during the first 10 months of 2022, increasing the historically low policy rate from 1 per cent in March to 4 per cent in early October.

The economy is expected to continue growing at a slower pace. Growth is projected at 3.3 per cent in both 2022 and 2023. Serbia is not immune to the indirect effects of the war on Ukraine. These include an expected slowdown in eurozone export markets, which would impact Serbia's large manufacturing sector, and rising food and energy prices on global markets, which will weigh on the budgets of households, utility SOEs and the state. The continuation of sizeable public investment bodes well for Serbia's economic outlook, but the protracted energy crisis will be a drain on fiscal resources.

CONTINUES

CHART Assessment of transition qualities (1-10)



Structural reform developments

EU accession negotiations are advancing, albeit slowly. After two years of stagnation, the end of 2021 saw the opening of Cluster 4 (green agenda and sustainable connectivity) of the EU *acquis communautaire*, comprising four negotiating chapters, bringing the total number of opened chapters to 22 out of 35. However, no new chapters have been opened in 2022. According to the European Commission, the future speed of negotiations will depend, among other things, on the pace of reforms with regard to the rule of law, as well as on progress on the normalisation of relations with Kosovo. The European Commission expects Serbia to align its foreign policy with the common foreign and security policy of the EU, including restrictive measures against Russia.

The energy sector is in crisis-management mode. Energy security concerns have increased as high global energy prices and geopolitical uncertainty caused by the war on Ukraine have intersected with vulnerabilities in domestic electricity production. High import volumes at high prices in the winter of 2021-22 raised costs for the utility SOEs and the state budget. The regulator approved a 9.0 per cent hike in the price of gas and a 6.5 per cent increase in the electricity price from August and September 2022, respectively. To ensure adequate coal reserves, the electricity SOE, EPS, signed import contracts in May and June 2022 with coal mines from Montenegro, Bulgaria and Bosnia and Herzegovina. While Serbia secured a new bilateral three-year contract to source the bulk of its gas supply from Russia at an oil-indexed price in May 2022, a significant share of gas continues to be bought on the market, weighing on the energy balance. Construction on a gas interconnector with Bulgaria began in February 2022 in an effort to diversify gas sources. To better manage gas demand in the peak winter months, the government reached an agreement with its Hungarian counterpart in March 2022, ensuring up to 500 million cubic metres of additional gas storage space in Hungary for the coming winter. Strategic energy documents, such as the National Energy and Climate Plan (NECP) and the National Energy Strategy, are expected to whet appetites for the development of renewables and to carve out the energy transition pathway.

Infrastructure improvements continue. A 75 km high-speed railway line, allowing trains to travel at up to 200 km per hour and connecting two of Serbia's biggest cities, Belgrade and Novi Sad, opened for passengers in March 2022. The stretch is the start of an ongoing project to connect Belgrade with Budapest as part of the Chinese government's Belt and Road Initiative. Other significant ongoing projects include the roll-out of ultra-fast broadband in rural areas, large public-private partnership projects to modernise Belgrade's airport, and for Vinca, previously one of Europe's biggest unmanaged landfills, to include a waste-to-energy facility. The construction of a gas interconnector between Serbia and Bulgaria started in February 2022.

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Capital markets development has been advanced. The Law on Capital Markets was adopted in December 2021, aligning the domestic legal and institutional framework further with the EU *acquis* in terms of increasing transparency and offering greater investor security guarantees, while also developing the offering of financial instruments on the market. Serbia had previously joined the Clearstream network in October 2021, enabling foreign investors to directly settle dinar-denominated government bonds. In January 2022 Serbia signed an agreement with Euroclear on the creation of a Euroclearable link once appropriate market conditions have been established.

A new model of fiscalisation has been introduced. Following the adoption of the amended Law on Fiscalisation in September 2021, the end of April 2022 was set as the deadline for implementing the new model, which introduces the use of electronic fiscal devices connected to the internet, making data immediately available to the Tax Administration. The new model aims to reduce the administrative burden, support revenue collection and help the authorities to reduce the size of the informal economy.

Amid incremental progress on SOE reform, broader public-sector adjustment has been delayed. A consolidated list of SOEs owned by the central government was developed and made public in December 2021, in a first step towards implementing the country's SOE reform plan. A new wage system that introduced pay grades to the public sector was set to come into force 2022, but was postponed to 2025 in December 2021, with the pandemic cited as the reason. The implementation of pay grades has been delayed several times since the original deadline of 2019.

Support for SMEs has been scaled up. A set of decrees adopted at the beginning of 2022 set aside RSD 2.5 billion (some €21 million) in financial support for SMEs, start-ups, and women and young entrepreneurs.