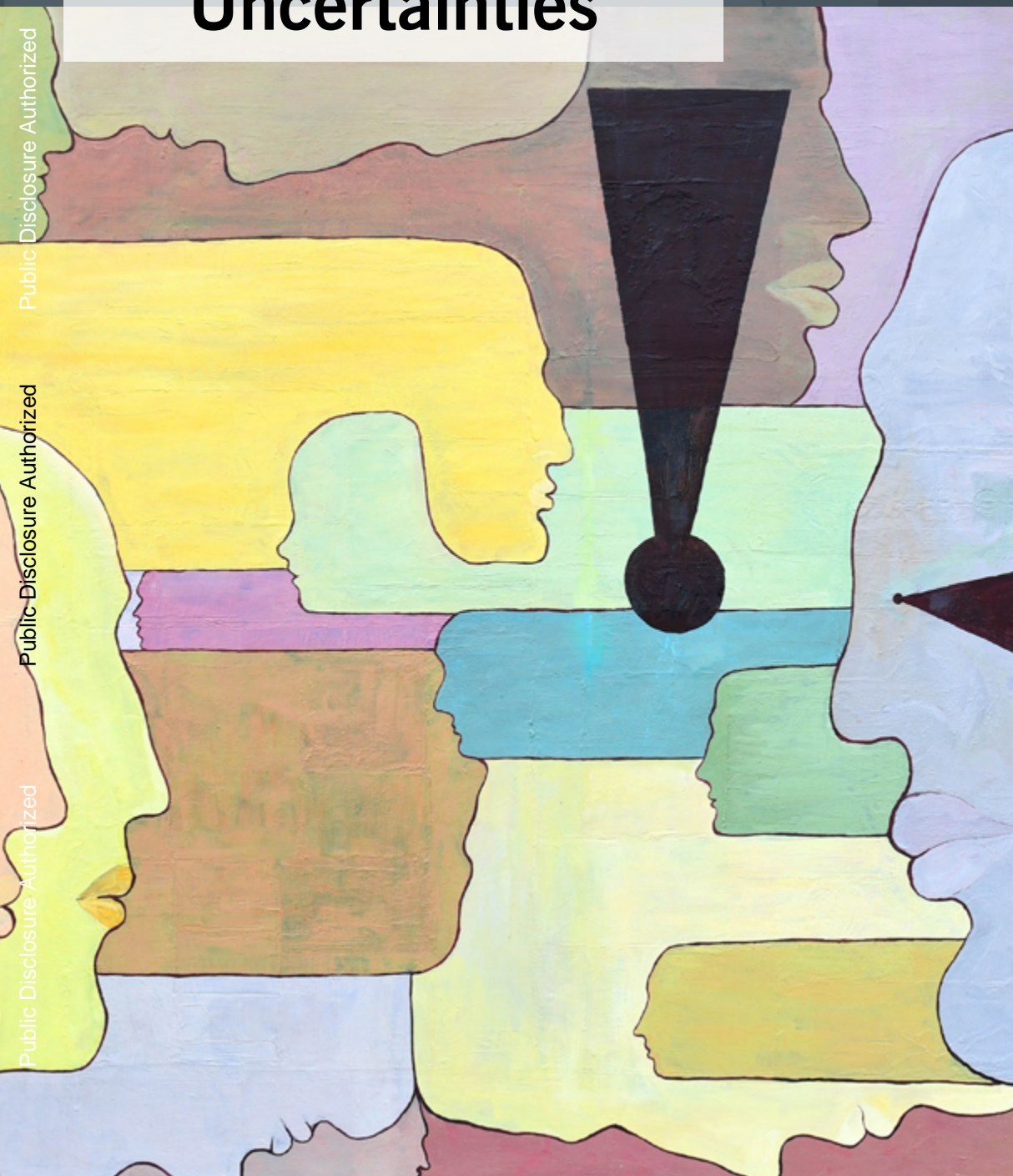




WESTERN BALKANS REGULAR ECONOMIC REPORT
No.16 | Fall 2019

Rising Uncertainties



Western Balkans
Regular Economic Report No.16

Rising Uncertainties

Fall 2019

Acknowledgements

This Regular Economic Report (RER) covers economic developments, prospects, and economic policies in the Western Balkans' region: Albania, Bosnia and Herzegovina, Kosovo, Montenegro, North Macedonia, and Serbia.

The team was led by Marc Tobias Schiffbauer and Edith Kikoni (Task Team Leaders). This issue's core team included World Bank staff working on the Western Balkan countries (with additional contributions to specific sections): Bojan Shimbov, Sandra Hlivnjak (External section), Milan Lakićević (Fiscal section), Hilda Shijaku, Johanna Jaeger, and Christoph Ungerer (Monetary and Financial section), Sanja Madžarević-Šujster (Labor section), Asli Senkal and Milan Lakićević (Growth section), and Lazar Šestović, Natasha Rovo (Outlook section). Additional contributions were made by: Stefanie Brodmann (Labor section); Alena Kantarovich (Financial sector section); Christoph Ungerer (Fiscal section); Alen Mulabdic (External section); and Collette Wheeler and Julia Norfleet (Outlook Section).

Anne Grant provided assistance in editing, and Budy Wirasmo assistance in designing. Valentina Martinovic, Nejme Kotere, Samra Bajramovic, Ivana Bojic, Eranda Troqe, Hermina Vukovic Tasic, Jasminka Sopova, Boba Vukoslavovic, Dragana Varezić, and Leah Laboy assisted the team.

The dissemination of the report and external and media relations are managed by an External Communications team comprised of Lundrim Aliu, Anita Božinovska, Paul A. Clare, Ana Gjokutaj, Jasmina Hadžić, Carl P. Hanlon, Vesna Kostić, John Mackedon, Mirjana Popović, Kym Louise Smithies, and Sanja Tanić.

The team is grateful to Linda Van Gelder (Regional Director for the Western Balkans); Lalita Moorty (Regional Director, Equitable Growth, Finance and Institutions); Gallina A. Vincelette (Practice Manager, Macroeconomics, Trade, and Investment Global Practice); and the Western Balkans Country Management team for their guidance in preparation of this report. The team is also thankful for comments on earlier drafts of this report received from the Ministries of Finance and Central Banks in Western Balkans countries.

This Western Balkans RER and previous issues may be found at: www.worldbank.org/eca/wbrer/.

© 2019 International Bank for Reconstruction and Development / The World Bank
1818 H Street NW
Washington DC 20433
Telephone: 202-473-1000
Internet: www.worldbank.org

This work is a product of the staff of The World Bank with external contributions. The findings, interpretations, and conclusions expressed in this work do not necessarily reflect the views of The World Bank, its Board of Executive Directors, or the governments they represent.

The World Bank does not guarantee the accuracy of the data included in this work. The boundaries, colors, denominations, and other information shown on any map in this work do not imply any judgment on the part of The World Bank concerning the legal status of any territory or the endorsement or acceptance of such boundaries.

Rights and Permissions

The material in this work is subject to copyright. Because The World Bank encourages dissemination of its knowledge, this work may be reproduced, in whole or in part, for noncommercial purposes as long as full attribution to this work is given. Any queries on rights and licenses, including subsidiary rights, should be addressed to World Bank Publications, The World Bank Group, 1818 H Street NW, Washington, DC 20433, USA; fax: 202-522-2625; e-mail: pubrights@worldbank.org.

Contents

| | |
|--|-----------|
| Rising Uncertainties | 1 |
| 1. Overview | 2 |
| 2. Growth slows with lower contributions from exports and investments | 5 |
| 3. As employment picked up in 2019, unemployment fell to historic lows | 9 |
| 4. Rising uncertainties call for rapid improvement in public finances | 14 |
| 5. Positive credit growth is driven by household lending | 21 |
| 6. Exports slow amid rising international trade tensions | 26 |
| 7. The outlook is positive but vulnerable to rising external risks | 29 |
| Country Notes | 33 |
| Albania | 34 |
| Bosnia and Herzegovina | 39 |
| Kosovo | 44 |
| Montenegro | 49 |
| North Macedonia | 54 |
| Serbia | 59 |
| Key Economic Indicators | 65 |

List of Figures

| | |
|---|----|
| Figure 1.1. After strong growth in 2018, employment increased. | 4 |
| Figure 1.2. But economic growth is slowing in 2019 with lower contributions from exports and investment. | 4 |
| Figure 1.3. Growth is slowing despite a surge in public spending and widening internal imbalances... | 4 |
| Figure 1.4. ...at a time when external imbalances are also growing. | 4 |
| Figure 1.5. The positive outlook for 2020–21 is thus surrounded by downside risks, including higher external risks amid rising trade tensions. | 4 |
| Figure 1.6. The global economy continues to slow adding to rising uncertainties. Creating more job opportunities thus requires strong commitment to structural reforms to unleash productivity. | 4 |
| Figure 2.1. In 2019 growth in the Western Balkans is projected to decelerate. | 5 |
| Figure 2.2. Higher public spending supported consumption and investment growth in 2018. | 5 |
| Figure 3.1. Employment picked up and... | 9 |
| Figure 3.2. ...unemployment fell in all Western Balkans countries. | 9 |
| Figure 3.3. Kosovo's 2016 labor market gains were nullified. | 11 |
| Figure 3.4. While more people joined the labor force and found jobs, progress is slow and uneven. | 11 |
| Figure 3.5. In some countries, inactivity is high and heading up. | 12 |
| Figure 3.6. The female–male labor participation gap narrowed to below 18 percentage points. | 12 |
| Figure 3.7. While across the region minimum wages have gone up recently... | 13 |
| Figure 3.8. ...in several countries productivity has not. | 13 |
| Figure 4.1. The fiscal deficit is projected to go up in all countries except Kosovo and Montenegro... | 14 |
| Figure 4.2. ...higher revenues are offset by a surge in spending. | 14 |
| Figure 4.3. Social benefits are driving increased government spending... | 15 |
| Figure 4.4. ...and together with public wages account for over half of total spending. | 15 |
| Figure 4.5. Public and publicly guaranteed debt (PPG) rises in Montenegro, North Macedonia, and Kosovo... | 18 |
| Figure 4.6. ...and external PPG debt is expected to go up in Montenegro, Serbia, and North Macedonia. | 18 |
| Figure 5.1. Inflation is trending down, tracking global food and oil prices. | 21 |
| Figure 5.2. Core inflation remains subdued. | 21 |
| Figure 5.3. Central banks in North Macedonia and Serbia further lowered policy rates... | 22 |
| Figure 5.4. ...and Serbia intervened in foreign exchange markets. | 22 |
| Figure 5.5. Credit outstanding continued to be positive throughout the region. | 22 |
| Figure 5.6. Credit to households grew consistently, but not credit to firms. | 22 |
| Figure 5.7. Nonperforming loans are declining. | 23 |
| Figure 5.8. Banks are adequately capitalized. | 23 |
| Figure 6.1. By yearend-2019, the CAD is expected to widen slightly for the region... | 26 |

| | |
|--|----|
| Figure 6.2. ...mainly because of rising imports for infrastructure projects. | 26 |
| Figure 6.3. Total FDI inflows to the region were generally steady in 2019... | 28 |
| Figure 6.4. ...but net FDI inflows fell in North Macedonia and Serbia. | 28 |

List of Tables

| | |
|--|----|
| Table B.4.1. Recent Eurobond issuances in the Western Balkans. | 19 |
| Table 7.1. Growth Rates in the Western Balkans, 2017–21f | 29 |

List of Boxes

| | |
|---|----|
| Box 2.1. Low productivity limits Western Balkan's potential output | 7 |
| Box 3.1. Unemployment declines in the Western Balkans | 10 |
| Box 4.1. Fiscal Rules in the Western Balkans: What Does the Public Say? | 16 |
| Box 4.2. Recent Eurobond Developments in the Western Balkans. | 19 |
| Box 5.1. The Assessment Framework on Preconditions and Capital Market Development | 24 |
| Box 6.1. The Central European Free Trade Agreement (CEFTA) | 27 |
| Box 7.1. Emerging Global Risks | 30 |

Rising Uncertainties

1. Overview

Supported by strong economic growth in 2018, unemployment fell to historic lows in the first half of this year. By June 2019, 150,000 additional jobs have been created in the Western Balkans compared to a year earlier. Some 43,000 young people have found jobs, especially in Albania, as youth unemployment in the region has fallen supported by the growing business-process outsourcing sector. Economic activity in 2018 has also attracted more women into the labor force. Despite these positive labor market developments, less than half of those of working-age in the Western Balkans have a job (44 percent). In Bosnia and Herzegovina and in Kosovo, only 34 percent and 30 percent of the working-age population has a job and youth unemployment remains high in both countries. Sustaining high and equitable economic growth is thus essential to create many more, much-needed job opportunities in the region.

But economic growth in the Western Balkans is slowing after a short-lived revival in investment in previous years. In 2019, economic growth in the Western Balkans is projected to reach 3.2 percent, down from 3.9 percent in 2018. Except for Kosovo and North Macedonia, where growth has continued to recover after a major slowdown, growth is expected to be lower than in 2018 in all other countries. Economic growth slows as the contribution of investment and exports to growth is fading in several countries in the region. Net exports continue to subtract from growth, as the region's trailing competitiveness weighs on opportunities for its small open economies to access larger markets. Instead,

consumption continues to be the main driver of economic activity in Western Balkan countries. Consumption growth has been fueled by higher public spending and near double-digit growth in household lending, raising questions on the sustainability of the consumption-driven growth in the region.

And internal and external imbalances are rising. Growth is slowing despite a surge in public spending stimulated by buoyant cyclical revenues. The rise in revenues has not been enough to offset the rise in current spending which was dominated by public wages and social benefits, including higher spending on untargeted social programs in Bosnia and Herzegovina and Kosovo. As a result, fiscal deficits are projected to go up in 2019 in all countries in the Western Balkans except Kosovo and Montenegro. External imbalances also started to rise as exports slow because of falling demand from EU trading partners amid rising trade tensions. The current account deficit (CAD) is expected to go up in all Western Balkan countries in 2019. Stable remittances and foreign direct investments (FDI) help finance the CAD. Nevertheless, sizeable external imbalances in several Western Balkan countries, together with elevated public debt, expose the region to adverse economic shocks. The higher public spending has thus compromised an opportunity to build the much-needed fiscal buffers to be able to cushion the impact of rising external uncertainties.

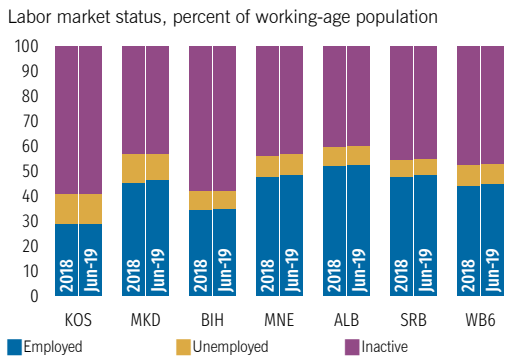
The positive outlook for 2020–21 masks underlying vulnerabilities as downside risks intensify. All countries are projected

to grow faster, except Montenegro, where the phasing-out of an investment cycle is projected to moderate growth somewhat. In several countries, however, the positive outlook reflects one-time factors. In Albania, energy production is expected to rebound as rainfall is assumed to return to historical averages. In Kosovo and in Bosnia and Herzegovina, public investment is expected to pick up. In Serbia, the contribution to growth from consumption is expected to continue to accelerate in 2020 as increases in public sector wages and pensions materialize. However, the positive outlook is vulnerable to mounting downside risks. The region faces rising uncertainty as economic growth slows globally, including in the EU—the Western Balkans’ major trading partner and source of financial flows. Rising trade tensions and oil price volatility further raise the external risks. At the same time, elevated political polarization in several countries in the region, as well as weather-related shocks affecting agricultural and energy production, add to domestic uncertainties.

Rising uncertainties call for rapid improvement in public finances and competitiveness. Improving the efficiency and equity of public spending and strengthening revenue mobilization remains a priority in all Western Balkan countries. Public sector wage bills and pensions constitute the largest share of public spending in the region. Tighter controls on wage bills, reducing tax expenditures, and better targeting of social benefits would open space for more public investment, improve equity, and enable the build-up of fiscal buffers to mitigate rising risks. As outlined in this report, fiscal rules can help anchor spending and fiscal sustainability. However, their credibility in the region needs to be restored after they have been repeatedly breached in some countries. Fiscal

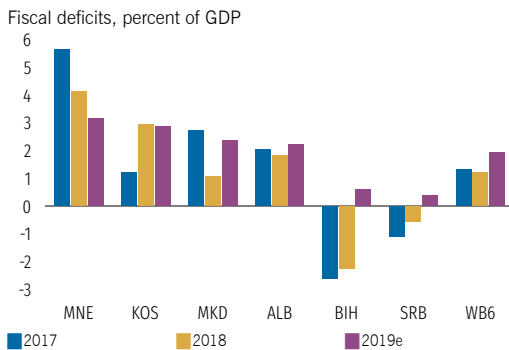
management reforms are needed as a part of broader structural reforms that help increase the region’s export competitiveness. This includes strengthening state institutions that protect the rule of law and private sector competition to unleash productivity growth and innovation by enabling a level playing field between firms. Together, these reforms would help unlock stronger, more equitable, and more sustainable growth, ensuring faster convergence with EU income levels. A strong commitment to sound macro-fiscal policy and structural reforms was always important—rising uncertainties have made it an imperative.

Figure 1.1. After strong growth in 2018, employment increased.



Source: National authorities and World Bank estimates.
Note: June 2019 data refer to 4-quarter moving average.

Figure 1.3. Growth is slowing despite a surge in public spending and widening internal imbalances...



Source: National authorities and World Bank estimates.

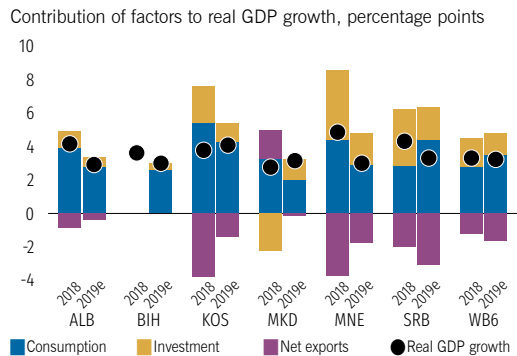
Figure 1.5. The positive outlook for 2020–21 is thus surrounded by downside risks, including higher external risks amid rising trade tensions.

Growth rates, 2017–21f, percent

| | 2017 | 2018 | 2019e | 2020f | 2021f |
|------------------------|------------|------------|------------|------------|------------|
| Albania | 3.8 | 4.1 | 2.9 | 3.4 | 3.6 |
| Bosnia and Herzegovina | 3.2 | 3.6 | 3.1 | 3.4 | 3.9 |
| Kosovo | 4.2 | 3.8 | 4.0 | 4.2 | 4.1 |
| North Macedonia | 0.2 | 2.7 | 3.1 | 3.2 | 3.3 |
| Montenegro | 4.7 | 4.9 | 3.0 | 2.8 | 2.7 |
| Serbia | 2.0 | 4.2 | 3.3 | 3.9 | 4.0 |
| Western Balkans | 2.6 | 3.9 | 3.2 | 3.6 | 3.8 |
| EU28 | 2.5 | 2.0 | 1.4 | 1.3 | 1.4 |

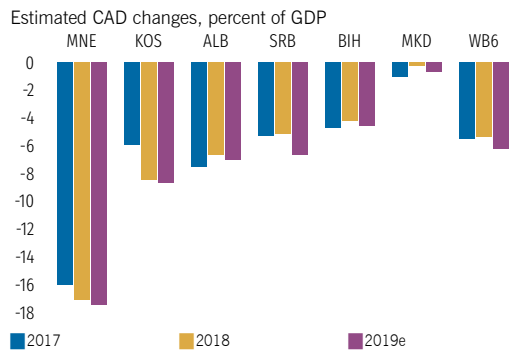
Source: World Bank estimates (see text for details).

Figure 1.2. But economic growth is slowing in 2019 with lower contributions from exports and investment.



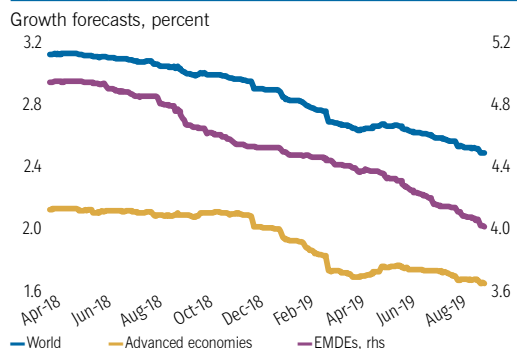
Source: National statistical offices.

Figure 1.4. ...at a time when external imbalances are also growing.



Source: National authorities and World Bank estimates.

Figure 1.6. The global economy continues to slow adding to rising uncertainties. Creating more job opportunities thus requires strong commitment to structural reforms to unleash productivity.



Source: Western Balkans Urbanization and Territorial Review, World Bank.

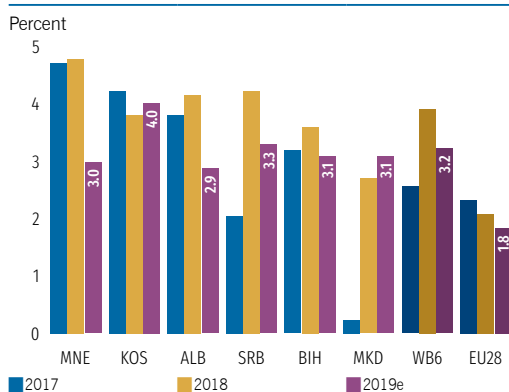
2. Growth slows with lower contributions from exports and investments

Growth in the Western Balkans is projected to slow from a high of 3.9 percent in 2018 to 3.2 percent in 2019 (Figure 2.1). Except for North Macedonia, where growth has continued to pick up after a major slowdown in 2017, and Kosovo, where it is expected to remain strong at 4.0 percent, in the rest of the region growth will be somewhat lower than in 2018. By yearend, growth in North Macedonia is projected to reach 3.1 percent, driven by higher investment. In Kosovo growth is expected to be driven mainly by consumption and service exports. Serbia, the largest economy in the region, is expected to grow at 3.3 percent in 2019, down from 4.2 percent in 2018, as higher consumption is undermined by the negative contribution of net exports and a deceleration of investment growth. In Albania, also despite strong consumption growth, a plunge in energy production is projected to slow growth to 2.9 percent. In Bosnia and Herzegovina, growth is expected to slip to 3.1 percent because of lower contributions from net exports and investment. In Montenegro, growth is

expected to moderate to 3 percent from a high of 4.9 percent in 2018 as the public investment cycle is phased out.

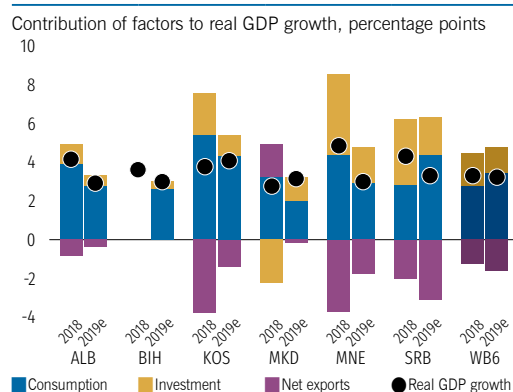
Consumption continues to be the main driver of economic activity this year, supported by higher consumer lending and wage and employment growth. All countries in the region but Montenegro and Albania saw public wages go up, boosting consumption (Figure 2.2). In Serbia and North Macedonia, pension increases strengthened total consumption, which is projected to contribute 4.4 pp to growth in Serbia, the strongest in the Western Balkans, and 2 pp in North Macedonia. However, the increases are pushing up already high levels of spending on wages and pensions in the region. In addition to rising wages and employment, solid remittances growth is expected to fuel consumption in Kosovo which contributes 4.3 pp to growth. In Montenegro, booming tourism, strong lending to households, and higher employment are driving private consumption, which is projected to add

Figure 2.1. In 2019 growth in the Western Balkans is projected to decelerate.



Source: National authorities and World Bank estimates.

Figure 2.2. Higher public spending supported consumption and investment growth in 2018.



Source: National statistical office data; World Bank estimates.

2.9 pp to growth. Robust employment and lending activity also supported Albania's overall consumption, which will add an estimated 2.8 pp to growth. The acceleration in lending to households, which saw near double-digit growth in Kosovo, Serbia, North Macedonia, and Montenegro, as well as the high levels of public spending on wages and pensions in the region, raise questions about how sustainable the consumption-driven growth is.

Investment is still adding to growth, but more slowly than in 2018. In Montenegro investments are projected to fall from their 2018 contribution of 4.2 percentage points (pp) to just 1.9 pp because of delays in large public infrastructure projects in the first half of the year while private investment is expected to remain at a similar level as in 2018. Kosovo will see a drop in the contribution of investment to growth from 2.1 to 1.1 percent growth, as public capital spending is projected to be under-executed. The contribution of investment is projected to remain muted in Bosnia and Herzegovina (0.4 pp) and Albania (0.5 pp), despite more private investment spurred by better credit conditions and a pick-up in public-private partnerships (PPPs) in the latter. The low contribution in Bosnia and Herzegovina also comes from delays in capital spending plans due to lack of government formation in the Federation. In contrast, investment is firming up and is projected to add 1.2 pp to growth in North Macedonia, as both public and private investments started growing, as large scale public investment projects were resumed and corporate investment lending intensified. In Serbia private and public investments are projected to remain strong in 2019 but a reduction in inventories accumulated in the previous year is lowering the contribution to growth.

Net exports continue to subtract from growth, as the region's trailing productivity weighs on opportunities to access larger markets (Box 2.1). Net exports are subtracting the most in Serbia, with a negative contribution of 3.1 pp, due to a 10.2 percent surge in imports and a slow-down in goods exports. In North Macedonia, net exports are not expected to contribute to growth as rising exports cannot compensate for the increase in imports. In Bosnia and Herzegovina, as imports rise, the contribution of net exports to growth is expected to be minimal because exports of some commodities, such as milk, are losing markets. In Montenegro, where investments and consumption have high import content, net exports are projected to subtract 1.8 pp from 2019 growth. In Albania, net exports are expected to subtract 0.4 pp due to lower energy exports and higher imports. In Kosovo, an increase in exports is overshadowed by import growth, due to a high base.

On the production side, services are driving growth in the Western Balkans. Tourism is again the anchor of Montenegro's economy, but in the first half of 2019 Albania, Bosnia and Herzegovina, and Serbia also enjoyed solid growth in tourist arrivals. Tourism also supported solid growth in retail trade in these countries; higher retail trade in North Macedonia was mainly driven by increased employment and higher wages and pensions. Construction continued to be an important driver of growth in several countries, also due to high public capital spending. Low precipitation early in the year severely depressed energy production in Albania, Montenegro, and Bosnia and Herzegovina, which caused industrial production to fall. Serbia's industrial output also declined, led by a fall in manufacturing as leading companies in oil derivatives and

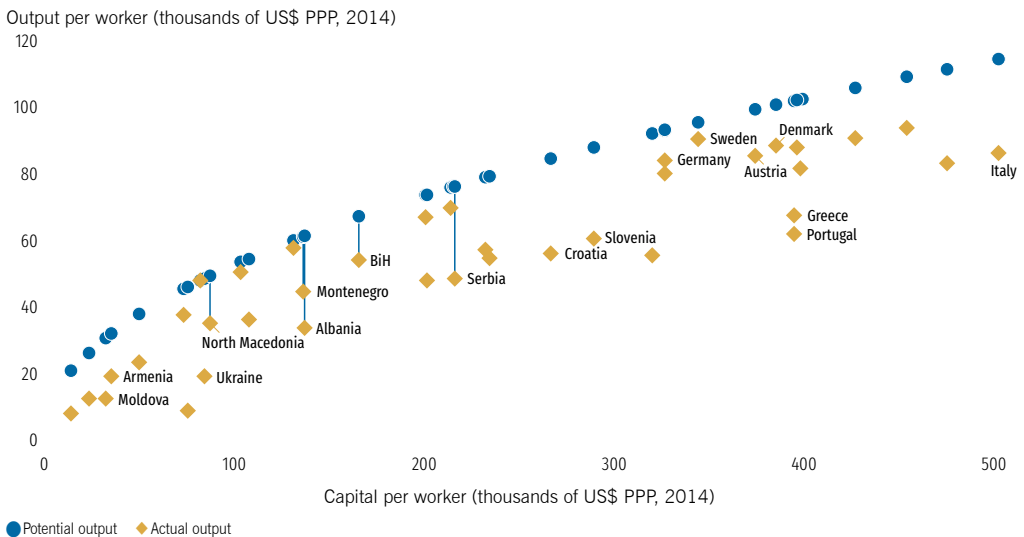
Box 2.1. Low productivity limits Western Balkan’s potential output

The gap between a country’s actual output and the potential output achieved by other countries with comparable resources (that is, the production frontier) measures its productivity. The way firms and the economy as a whole combine labor and capital inputs into ever more efficient uses (known more simply as productivity) can be measured in several different ways. One approach to estimate productivity is through the stochastic frontier approach (SFA). The production frontier represents the maximum amount of output that can be obtained given the factors of production and the technology available. For a given sample of countries, the SFA makes it possible to estimate each country’s production frontier, recognizing that an economy may be operating below what would be predicted by the production frontier because of the country’s level of development and structural factors.

The Western Balkans countries have large productivity gaps.^a The SFA methodology produces three results: (1) As of 2016, the Western Balkans countries had relatively little capital per worker. (2) For a given level of capital per worker, actual output is below what could be achieved. (3) Efficiency gaps across Western Balkan countries are large and comparable in size across the six countries in the region (see Figure B.2.1).

How can countries in the Western Balkans boost productivity? To boost productivity and reach potential, an acceleration of structural reforms is critical. This includes reinforcing the state institutions that protect the rule of law and private sector competition to fight corruption and level the playing field between firms. And it includes improving public services to boost human capital while preserving macro-fiscal and financial stability. Together, these structural reforms would help unlock stronger, more equitable, and more sustainable growth, ensuring faster convergence with EU income levels (see section 8).

Figure B.2.1. Western Balkan countries face large productivity gaps, limiting their income levels



Source: Authors’ calculations.

Note: a The analysis builds on the dataset developed by Lusinyan (2018). Data sources: real GDP in billions, constant 2011 international dollars, from the IMF WEO; total capital stock and employment are from PW Table and the WEO. The sample consists of 47 countries in the Europe and Central Asia region for the period 1980–2016, with data availability varying depending on the variable and/or the country. International statistics adopted for the calculation do not cover Kosovo.

chemicals overhauled their production processes earlier this year, and FIAT continues to lower its production. In contrast, industrial production went up in North Macedonia, supported by higher energy production and a rise in the manufacturing output primarily of foreign companies. Agricultural production is projected to subtract from growth in Serbia after a strong increase in 2018 but is expected to contribute to growth in North Macedonia.

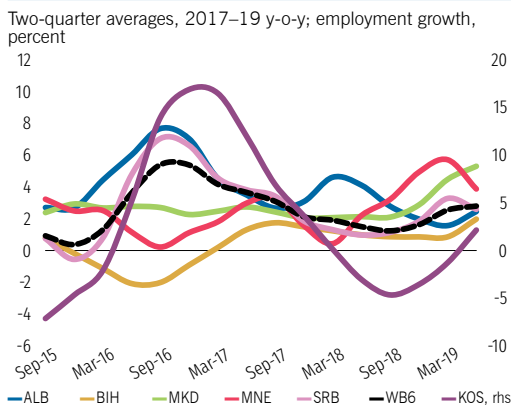
3. As employment picked up in 2019, unemployment fell to historic lows

Employment picked up across the Western Balkans in 2019. In June 2019 employment in the Western Balkans was 2.4 percent higher (y-o-y), adding 149,430 new jobs to the labor market compared to the same period a year ago. North Macedonia registered the highest rate of employment growth—5.2 percent y-o-y—supported by the country’s expanding employment subsidy scheme. In Albania and Bosnia and Herzegovina, most new jobs were created in services, as employment in agriculture continued to slide. Meanwhile, supported by growth in tourism and construction, employment also continued upward in Montenegro. Serbia, however, saw a major slowdown in jobs in the second quarter of 2019, after an impressive start of the year. Notwithstanding the increase in employment across the region, only 44 percent of the working age population is actually engaged in work. Employment rates ran the range from 53.6 percent in Albania to 29.8 percent in Kosovo, with stark gender differences in the

latter; the employment rate of men was as low as 43 percent and of women 13.3 percent. In Bosnia and Herzegovina, where the labor force again shrank, in 2019 the employment rate rose to 35.5 percent, though that is still the second lowest in the region.

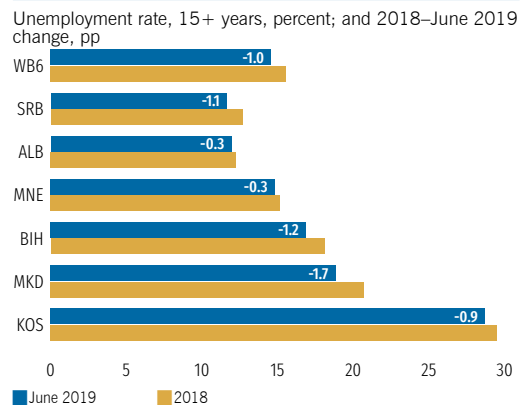
Owing to higher employment, the unemployment rate in the region reached 15.8 percent in June 2019—the lowest on record. North Macedonia had a drop of almost 17 percent y-o-y in the number of unemployed and in Bosnia and Herzegovina unemployment declined by close to 15 percent y-o-y. In contrast, Montenegro saw a rise in unemployment because its growth model relies mostly on tourism and construction, which have plateaued. Unemployment rates in all countries in the region reached historical lows. Albania’s unemployment rate dropped to 11.5 percent and North Macedonia’s to 17.5 percent. The decline was largest in Kosovo where, at 25.3 percent, unemployment remains

Figure 3.1. Employment picked up and...



Source: National statistics offices and World Bank staff estimates.
 Note: June 2019 data refer to 4-quarter moving average.

Figure 3.2. ...unemployment fell in all Western Balkans countries.



much higher. The lowest unemployment rate in the region is still Serbia's, which stood at 10.3 percent in the second quarter of 2019. In Bosnia and Herzegovina, unemployment went down to 15.7 percent due to increased employment but more significantly because of a continued decline in its working age population. In Montenegro the unemployment rate stood at 14.3 percent in June 2019.

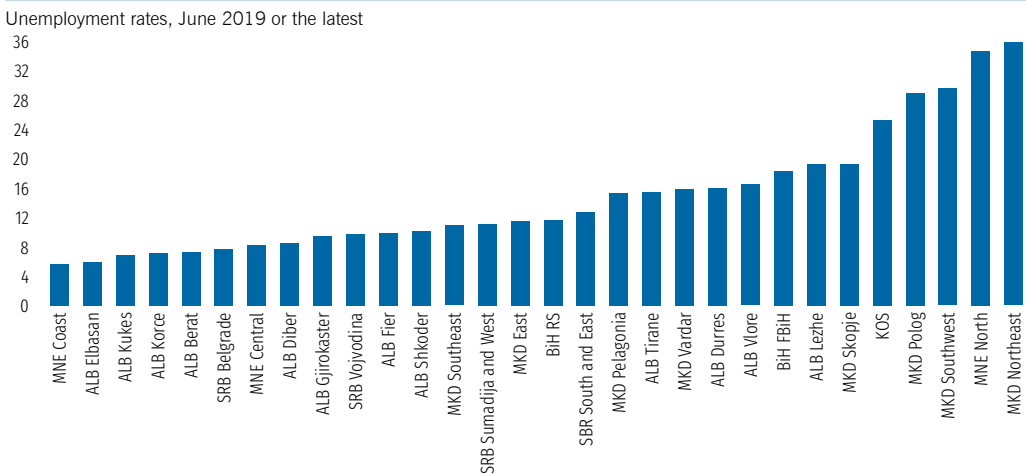
Long-term unemployment in the Western Balkans decreased by 1 pp but at 73 percent is still very high; in some countries it has led to discouragement and early withdrawal to inactivity. The aggregate numbers mask stark, though declining, differences in unemployment across regions—from 5.9 percent in Elbasan, Albania, to close to 36 percent in the northeast part of North Macedonia (Box 3.1).

Box 3.1. Unemployment declines in the Western Balkans

Within the region there are still stark differences in unemployment—from 5.7 percent in the coastal region of Montenegro, to close to 36 percent in the northeast part of North Macedonia. But while regional differences in unemployment are significant in several other Western Balkan countries, in Serbia the disparities are diminishing. Unemployment in the Serbian South-East is now only 1.6 times higher than in the Belgrade area. In Montenegro, however, unemployment is 6.1 times higher in the North than in the Coastal area.

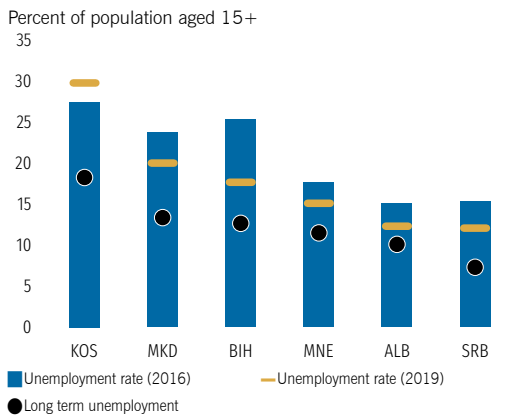
Disparities within country have narrowed. A drop in the unemployment rate in the Central region of Montenegro was partly driven by highway construction that absorbed some workers. Yet despite employment opportunities in construction and tourism, and the short commuting areas, internal migration and mobility within Montenegro seem to be low. In North Macedonia, despite a lower unemployment rate nationally, the North-East is still deeply disadvantaged—unemployment there is stubbornly high and apparently entrenched, with no change over the year. Yet employers in North Macedonia as well as across the Western Balkans see labor and skill shortages as an obstacle to expanding their business. Higher within-country and inter-regional mobility could help reduce unemployment in lagging areas of the Western Balkans.

Figure B.3.1. Unemployment disparities declined but are still high.



Source: National statistical offices.

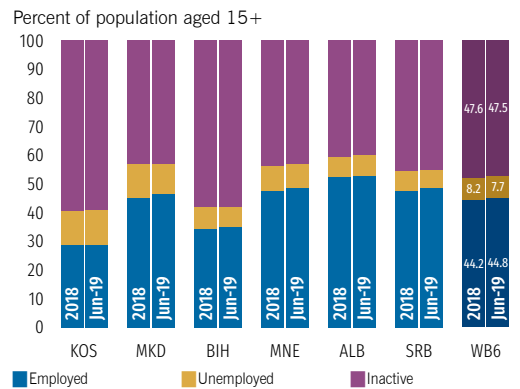
Figure 3.3. Kosovo's 2016 labor market gains were nullified.



Source: National statistics offices and World Bank staff estimates.
 Note: June 2019 data refer to 4-quarter moving average.

Over the year, some 43,100 young people found jobs in the Western Balkans, with Albania accounting for half of these. Youth unemployment in the region has fallen 5 pp since June 2018, but at 30.6 percent, it is still stubbornly high. The lowest youth unemployment rate was in Montenegro at 20.7 percent, followed by Albania and Serbia, both below 25 percent. Moreover, further declines in youth unemployment in Montenegro are expected as the new labor law, designed to make the labor market more flexible, could speed up employment of youth and women and shorten job searches. In Kosovo, authorities must deal with a youth unemployment rate of more than 49 percent, a problem that is becoming endemic. To this end, youth employment programs—combinations of employment subsidies and occupational and training programs—could help put youth to work and discourage their emigration. Such programs would also help address youth joblessness in North Macedonia, which has seen the largest decline in the youth unemployment rate (a drop by close to 13 pp to 37 percent, from the peak in Q3 2017), but without

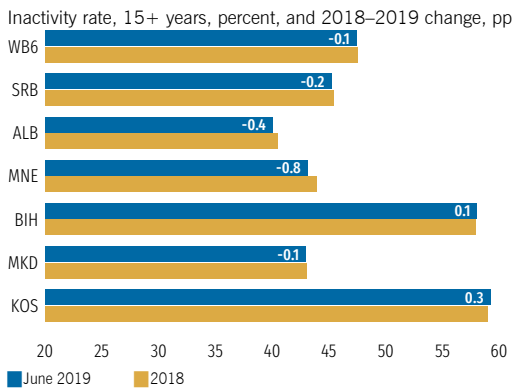
Figure 3.4. While more people joined the labor force and found jobs, progress is slow and uneven.



a proportional rise in youth employment. Overall, the still high youth employment rate in the Western Balkans not only lowers the labor supply but likely undermines the future stock of human capital. Despite recent stagnation in emigration rates in several Western Balkan countries, young people are still the most numerous among those emigrating.

Labor force participation has improved but current levels continue to depress employment and country differences remain marked. Sustained growth in the region has not only supported job creation but also attracted people back into the labor force. In June 2019 the labor force participation rate averaged 52.1 percent—up 0.4 pp since June 2018, with the largest gain, 1.6 pp, in Montenegro. Labor force participation reached 60.6 percent in Albania—a new record in the region. For Serbia, lower labor force participation in the second quarter of 2019 was coupled with a 0.5 percent decline in the working-age population; the country is aging and facing emigration. In Kosovo and Bosnia and Herzegovina participation rates have

Figure 3.5. In some countries, inactivity is high and heading up.

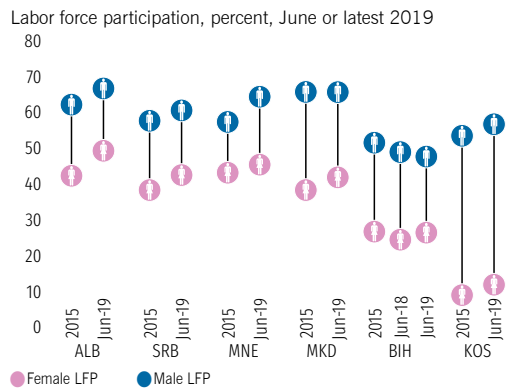


Source: National statistics offices and World Bank staff estimates.

stagnated at or below 42 percent. At a regional level, improvements in labor force participation have been driven by more female entrants into the labor market. In Albania the female participation rate (ages 15–64) shot up above 53 percent, narrowing the gender gap to just 15 pp. Serbia and Montenegro also hold female participation rates above the regional median of 47 percent. Over the year the gender gap in the Western Balkans declined by over 1 pp, to 17.7 percent, but at 39 pp the gender gap in Kosovo is a stark outlier.

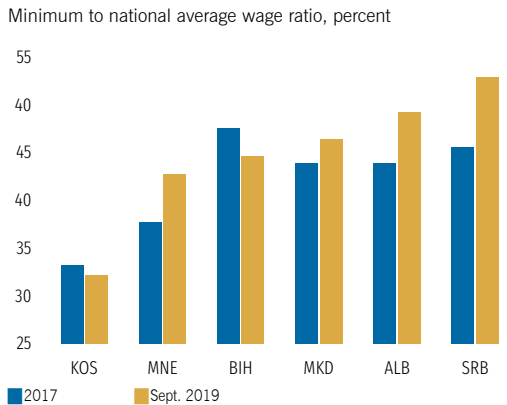
Despite improvements, years of growth, and state aid programs to support job creation, in the Western Balkans inactivity is still 48 percent. In Kosovo and Bosnia and Herzegovina inactivity increased by June 2019 (on a four-quarter basis), suggesting that exit from unemployment into inactivity was higher than entry into employment. However, in other countries growth supported job creation and encouraged labor force participation. High working-age inactivity also requires higher productivity of those employed to maintain the living standard for the larger group.

Figure 3.6. The female–male labor participation gap narrowed to below 18 percentage points.



Wages are increasing throughout the region, partly due to hikes in the minimum wage; any further minimum wage increases should track productivity growth. In Albania, since 2017 the minimum wage has gone up by over 18 percent. This especially affected wages in agriculture and construction, which are labor-intensive. In the first half of 2019, average real wages rose by 3.3 percent, led by trade, transport and tourism. Since 2017 North Macedonia and Serbia have also seen the minimum wage go up. In North Macedonia in the first half of 2019, average real net wages increased by more than 2 percent y-o-y because of rises in the minimum wage in July 2018 and April 2019 and raises for public servants from early 2019. The highest wage increases in North Macedonia were in health, education, and social protection, transport, construction, and agriculture. The combination of continuing wage growth, particularly in labor-intensive industries, and a decline in labor productivity is jeopardizing the country's competitiveness (Figure 3.8). In September, the government approved another program to boost formalization of wages by subsidizing social security contributions. In Serbia, in the first half of 2019 the average

Figure 3.7. While across the region minimum wages have gone up recently...

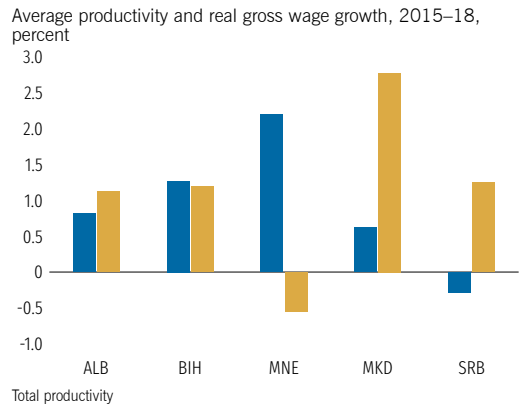


Source: National statistics offices and World Bank staff estimates.

wage increased most—by 7.2 percent y-o-y in real terms, as private sector wages rose because of skills shortages in services. Even though as recently as January of 2019 the minimum wage went up 8.6 percent, the government agreed to raise it again by 11 percent. Minimum wages are highest in Serbia and Albania; any further increases should track productivity growth to avoid undermining cost competitiveness, which is crucial for attracting foreign investment. In fact in Serbia, North Macedonia, and Albania, growth in real wages was misaligned given meager productivity growth, or a decline in the case of Serbia. In Montenegro, the minimum wage went up 15 percent in July, though the employer health contribution rate was reduced from 4.3 to 2.3 percent to prevent a rise in unit labor costs and thus a loss in competitiveness.

Growth in disposable incomes and low inflation are helping reduce poverty. In 2018, roughly 114,000 people in Albania, Kosovo, Montenegro, North Macedonia, and Serbia were lifted out of poverty (living on under \$5.5/day in 2011 PPP) from a year earlier, bringing the region’s average weighted

Figure 3.8. ...in several countries productivity has not.



Source: World Development Indicators, World Bank.

Note: Productivity is measured as GDP per capita in constant 2011 US\$ PPP; gross wages are deflated by the CPI.

poverty rate to an estimated of 21.6 percent.¹ Still, poverty in the Western Balkans remains higher than Central and Eastern Europe or the European Union more broadly. Social assistance reform in North Macedonia should help reduce poverty; the government replaced the fragmented system of social benefits with a more unified Guaranteed Minimum Allowance, for which the benefit is higher, and more people are eligible. The government has also increased amounts and coverage of the child and educational allowances; introduced means-testing for the parental allowance, which should reduce inclusion of medium- and high-income families; and introduced a social safety net for those older than 65.

¹ Poverty figures reflect the upper-middle-income-country standardized benchmark of living on less than US\$5.50 a day in 2011 PPP terms.

4. Rising uncertainties call for rapid improvement in public finances

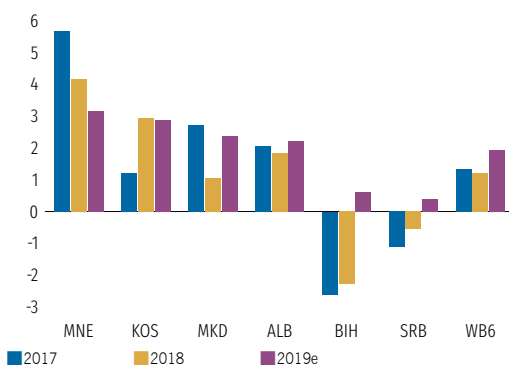
In all countries in the Western Balkans except Kosovo and Montenegro, fiscal deficits are projected to go up in 2019. The average unweighted fiscal deficit is expected to rise from 1.2 percent of GDP in 2018 to 2 percent in 2019 (Figure 4.1). The largest increase is expected in Bosnia and Herzegovina as a result of implementation of a new law on demobilized veterans in the Federation and higher public wages in Republika Srpska. The fiscal deficit in Albania is projected to widen to 2.2 percent of GDP in 2019 as slower than expected economic growth weighs on revenues, but also because the government is paying off VAT arrears to the private sector. In North Macedonia, a surge in current spending has driven the deficit from 1.1 percent of GDP in 2018 to an estimated 2.4 percent for 2019, and Serbia's fiscal position is expected to turn to deficit due to intensified capital spending. Kosovo's fiscal deficit is projected to be largely unchanged at just below 3 percent of GDP. In Montenegro, fiscal consolidation efforts and

a solid increase in revenues, thanks to strong economic activity, have reduced the fiscal deficit by 0.9 pp. But at 3.2 percent of GDP, Montenegro still has the largest fiscal deficit in the region.

Revenues are rising in most countries, but not enough to offset rising government spending (Figure 4.2). Cyclical factors resulting from stronger economic growth, combined with improved debt collection, were largely responsible for strong revenue growth in Montenegro and Kosovo. Although Kosovo's revenues-to-GDP ratio has improved, at 27.4 percent it is still the lowest in the Western Balkans. For North Macedonia, revenues are projected to increase by 1.6 pp, to 32 percent of GDP, due to an increase in pension contribution rates; a return to progressive income taxation; higher tax rates for capital gains; higher tobacco excises; and closing income tax exemption loopholes. In contrast, despite growing in nominal terms, revenues in Albania, Serbia,

Figure 4.1. The fiscal deficit is projected to go up in all countries except Kosovo and Montenegro...

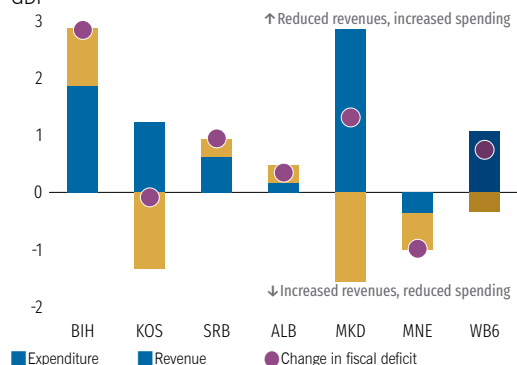
Fiscal deficits, pp of GDP



Source: National statistics offices and World Bank staff estimates.

Figure 4.2. ...higher revenues are offset by a surge in spending.

Contribution to change in the fiscal deficit, 2019e, percent of GDP



Source: National statistics offices and World Bank staff estimates.

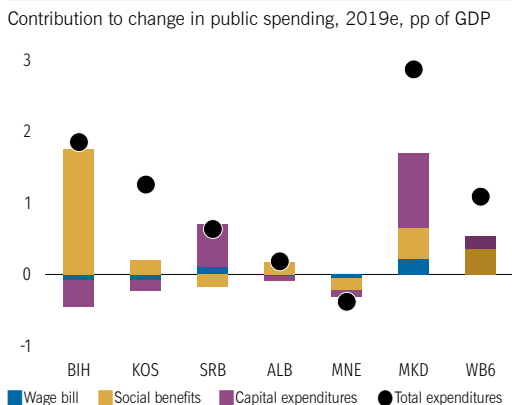
and Bosnia and Herzegovina are projected to decline as a share of GDP: In Albania, lower GDP growth and repayment of VAT-refund arrears have cut into revenue growth, although revenues did go up, supported by a rise in personal income tax and social contribution receipts as formal employment increased, informality was reduced, and wages went up. More formal employment and rising wages also supported revenue growth in Serbia, assisted by higher VAT receipts from imports. In Bosnia and Herzegovina, indirect taxes contributed to marginal nominal growth in revenues.

Buoyant cyclical revenues stimulated national appetite for spending. The surge in government spending has been particularly pronounced in North Macedonia, where it is projected to rise by 2.8 pp, and in Bosnia and Herzegovina, where the expected rise is 1.9 pp (Figure 4.3). While the latter’s heightened spending will be entirely driven by current spending on war veteran benefits and by higher public wages, in North Macedonia both capital and current spending are projected to contribute to spending growth. The expected current spending increase in North Macedonia

is on account of rising pensions, public wages, health spending, and subsidies, as well as transfers to local governments and the clearing of arrears. In Kosovo, new laws on public salaries and social transfers for specific groups heighten the pressures on spending in 2020. Moreover, war veteran benefits are both costly and untargeted. Serbia is using fiscal space created by its solid fiscal performance in recent years to unwind pension and public wages cuts and to increase capital spending (Figure 4.4). This is reflected in an increase of 0.6 pp in government spending. Although Montenegro is expected to reduce government spending as a percent of GDP, current spending has not been fully contained as wages grew in nominal terms due to delays in carrying out the public administration optimization plan.

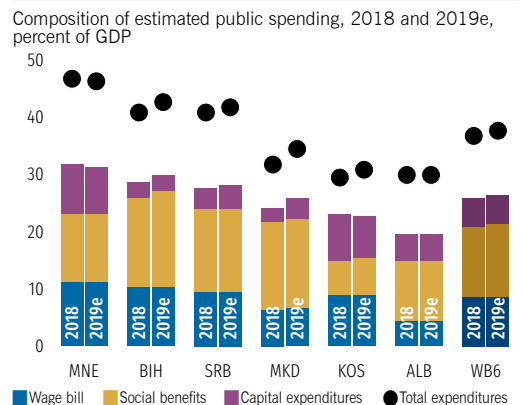
Fiscal rules can anchor fiscal sustainability. Except for North Macedonia, all Western Balkan countries have fiscal rules on debt and deficit limits (Box 4.1). Albania has been complying with its main rule—keeping its public debt-to-GDP ratio declining until it falls below 45 percent. However, the country’s strict definition of public debt has incentivized

Figure 4.3. Social benefits are driving increased government spending...



Source: National statistics offices and World Bank staff estimates.

Figure 4.4. ...and together with public wages account for over half of total spending.



Source: National statistics offices and World Bank staff estimates.

the reliance on non-marketable liabilities (e.g., public-private partnerships (PPPs) and arrears). Bosnia and Herzegovina and Kosovo are complying with their debt and deficit rules, but Kosovo's new law on public salaries calls for more spending on wages, which, could breach the fiscal rule on wage growth, if employment and allowances are not contained through the 2020 budget. Furthermore, in Bosnia and Herzegovina, indebtedness varies between the

two entities, with the ratio of debt-to-GDP in Republika Srpska now significantly higher than for either the BiH Institutions or the FBiH and above its debt limit (60 percent of GDP). Serbia is complying with its formula-based deficit rule, but Montenegro did not manage to keep its deficit below the 3 percent of GDP defined by its fiscal rule, and its debt-to-GDP ratio is rising to new highs.

Box 4.1. Fiscal Rules in the Western Balkans: What Does the Public Say?

Fiscal rules have become an important subject of policy debate in the Western Balkans, but the question remains what rules should govern fiscal policy in the Western Balkans and how can they be made more effective? The rise in public debt following the global financial crisis focused attention on strategies for restoring sound public finances, while plans to join the European Union (EU) mean that the countries will need to be in a position to adopt and comply with the EU's fiscal rules. Four of the countries in the region—Albania, Montenegro, North Macedonia, and Serbia—are official candidates to join the European Union (EU). The other two—Bosnia and Herzegovina and Kosovo—are “potential candidates.” When the countries do join the EU, they will be required to adopt and comply with the EU's fiscal rules. In the meantime, they need to consider their own approaches and ensure that they work.

Fiscal rules are long-term numerical constraints on fiscal aggregates that aim to improve fiscal discipline by requiring governments to declare and commit to a monitorable fiscal policy and strategy. Often, a driving force behind fiscal rules is the wish to make fiscal policies more predictable and credible by establishing rules and procedures the government must follow in the design and implementation of fiscal policy, and by setting up transparent mechanisms by which others can judge if the government is complying with the established goals and priorities. If well designed and implemented, fiscal rules can promote policy credibility, enhance investor confidence, help maintain macroeconomic stability, maintain or help restore fiscal sustainability, contribute to sustained growth and improve transparency and intergenerational efficiency.

Despite having fiscal rules in most Western Balkan countries, they have often not been rigorously enforced. National fiscal rules are more likely to be rigorously enforced when noncompliance is politically embarrassing. This in turn is more likely if the rules are reasonably well understood and enjoy cross-party political support. To shed some light on the extent of public awareness of fiscal rules and fiscal watchdogs in the six Western Balkan countries, in December 2018 the World Bank conducted an online survey among various targeted stakeholders (government, journalists, academics, bankers, think-tank analysts, and others interested in public finances) on the subject.

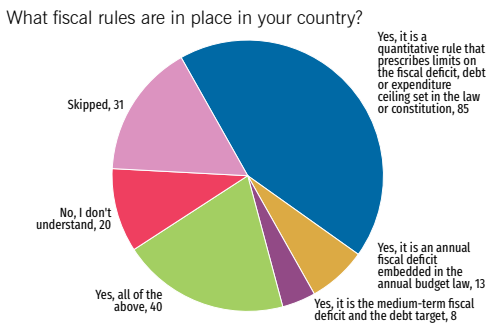
Results show some understanding of fiscal rules in the Western Balkans (Figure B.4.1). Among the presumably relatively well-informed respondents, a large majority said they knew what fiscal rules were, and many had an understanding consistent with the definition of a fiscal rule—a long-term numerical constraint on debt, deficit, or other fiscal aggregate. But there are also some differences: in

Box 4.1 continued

particular, some respondents could not distinguish fiscal rules from annual budget limits or medium-term fiscal targets. Not all respondents knew exactly what rules were in force in their own country.

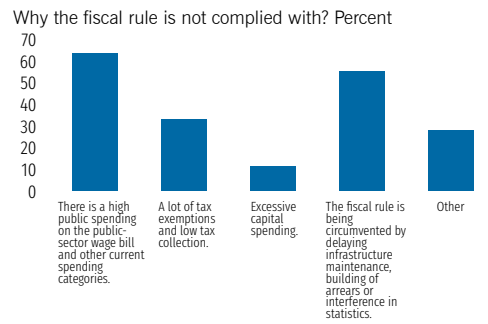
Around 43 percent of respondents believe rules are complied with; however, over half of them believe rules are circumvented. Around 39 percent of respondents think the rules are not complied with, and almost one-fifth could not provide a response, suggesting they are not clear given the rules complexities or could not find the monitoring body reports. The respondents believe rules are not complied with due to high public spending on the wage bill and other current spending, tax exemptions and low collection, as well as excessive capital spending. However, over half of respondents believe rules are circumvented (Figure B.4.2).

Figure B.4.1. There is some understanding of fiscal rules among well-informed survey participants...



Source: World Bank 2019.

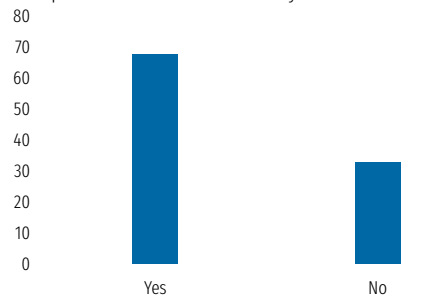
Figure B.4.2. ...but not so much understanding as to whether fiscal rules are complied with.



Source: World Bank 2019.

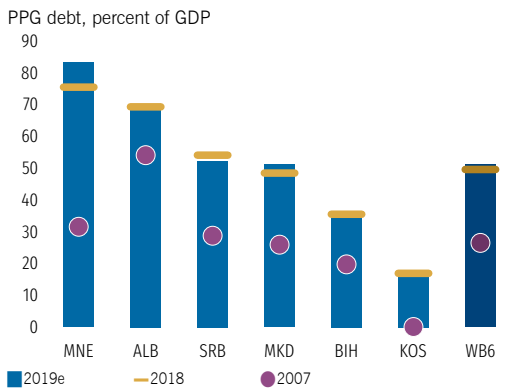
Figure B.4.3. Public Support for Fiscal Rules.

Do you believe that the existing fiscal rules in your country contribute to more prudent budgeting, improve government fiscal performance and accountability? Percent



References: World Bank. 2019. "Fiscal Rules for the Western Balkans". World Bank, Washington DC.

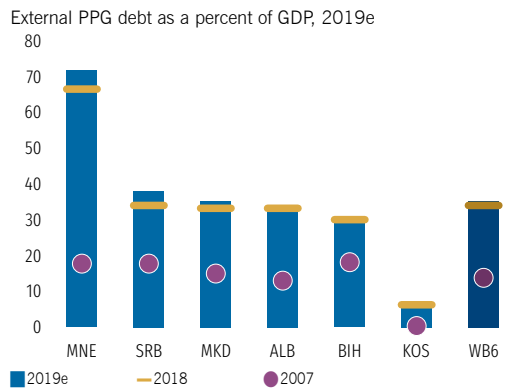
Figure 4.5. Public and publicly guaranteed debt (PPG) rises in Montenegro, North Macedonia, and Kosovo...



Source: National statistics offices and World Bank staff estimates.

Still-high public debt in some countries coupled with fiscal risks and depleted fiscal buffers make the Western Balkan countries highly vulnerable to rising external uncertainties. Successful fiscal consolidation programs and more prudent fiscal management have allowed Serbia to reduce PPG debt as a share of GDP to 52.1 percent and Albania to reduce its PPG debt to 68.4 percent (Figure 4.5). Albania achieved its reduction by careful spending, clearance of arrears, and currency appreciation; but mounting off-balance risks, including from a rapid buildup in PPPs, are now a major concern. In Bosnia and Herzegovina, PPG debt has been stable in nominal terms and has declined a bit as a percentage of GDP; much of its debt is long-term, at favorable rates. However, the country must also deal with fiscal risks emanating from its highly leveraged state-owned enterprises (SOEs) and from sizable expenditure arrears. Kosovo's PPG debt is projected to go up slightly, to 17.7 percent, as capital investments (mainly financed by privatization proceeds) are expected to pick up later in the year. North Macedonia will see an increase in PPG debt, due mainly to higher government borrowing,

Figure 4.6. ...and external PPG debt is expected to go up in Montenegro, Serbia, and North Macedonia.



Source: National statistics offices and World Bank staff estimates.

but also because public investment is due to accelerate. Montenegro's PPG debt is projected to reach a high of 83 percent of GDP by yearend following the government's issuance of €500 million in Eurobonds to service debt due in 2020, and an expected intensification of highway construction later this year.

The fact that current market conditions allow for cheap external financing is an opportunity if it is accompanied by prudent fiscal management (Box 4.2). The window of opportunity should be used to either refinance current external debt at a lower rate and extend maturities or build up foreign exchange reserves as a buffer against liquidity shocks. However, because uncertainties in global markets are rising, such conditions may be short lived. Furthermore, cheap external financing should not be used to delay much-needed reforms. By the end of 2019, the recent issuance of 500 million in Eurobonds is projected push Montenegro's external PPG debt to an estimated 72 percent of GDP (Figure 4.6). In July, Serbia issued its first Eurobond in six years and the first denominated in euros, raising €1 billion at a rate of 1.6 percent with a 10-

Box 4.2. Recent Eurobond Developments in the Western Balkans.

In 2018 and the first half of 2019, with continued favorable conditions on the Eurobond market, in a range of landmark deals countries in the Western Balkans have successfully accessed international markets. Public bond issues on the Euro market by the governments of Albania, Montenegro, North Macedonia, and Serbia have all been successful—as is also true for issues in the Europe and Central Asia region and emerging markets globally (Table B.4.1).

Table B.4.1. Recent Eurobond issuances in the Western Balkans.

| Issuer | Pricing date | Tranche Face Value (bn USD) | Currency | Coupon | Maturity |
|-----------------|--------------|-----------------------------|----------|--------|----------|
| North Macedonia | 1/11/2018 | 0.6 | Euro | 2.8 | 7 |
| Montenegro | 4/12/2018 | 0.6 | Euro | 3.4 | 7 |
| Albania | 10/2/2018 | 0.6 | Euro | 3.5 | 7 |
| Serbia | 6/19/2019 | 1.1 | Euro | 1.5 | 10 |
| Montenegro | 9/26/2019 | 0.6 | Euro | 2.6 | 10 |

Source: Dealogic database.

With yields low in advanced countries, investors are turning to emerging market debt as an alternative asset class. Policymakers in the advanced economies have actively sought to lower interest rates in the hope of reviving moribund trends in the real economy, but confronted by considerable economic uncertainty,¹ global investors have shifted into the safer fixed-income assets of advanced economies, thus accepting low yields on debt securities—yields are now negative on more than \$16 trillion. Those investors in search of higher yields are now turning to emerging-market debt as an alternative.²

For the Western Balkans, the continued benign conditions for access to international capital markets could be an opportunity. Governments and large corporations can selectively use external borrowing to raise financing for carefully identified high-payoff investments that in the short term cannot be funded out of revenues. This may also be an opportunity for them to refinance existing external debt at a lower rate and extend maturities while bolstering foreign exchange reserves. By deepening their presence in Eurobond markets, extending their yield curve, and building a track record of successful issues, borrowers can also hope to access international markets in the future on more favorable terms. As governments and large corporations turn to foreign financing, to the extent that there is crowding out, it may also free the domestic financial sector to serve other private sector players. Exposure to international markets can also discipline domestic reform efforts.

However, continued fiscal discipline is crucial. Even though access to Eurobond markets comes with greater market scrutiny, there is nevertheless the risk that countries may take on excessive debt and delay necessary fiscal consolidation. They may then be caught off-guard if the lending environment suddenly changes, debt servicing costs shoot up, and markets refuse refinancing. For example, a major international default could lead investors to re-evaluate default risks and flee emerging markets. It is therefore vital that international markets are accessed responsibly, with careful weighing of costs as well as benefits.

1 Numerous factors are weighing on the global economy, among them international trade tensions, the risk of a disorderly Brexit, and continued weakness in investment and productivity growth.

2 For European insurance companies, the challenge of low yields on traditional debt investments is compounded by the tighter regulatory requirements of the Solvency II regime now coming into force, raising the cost of doing business. Finally, frontier-market bonds are increasingly integrated into bond indexes, increasing demand from institutional investors who track those indexes.

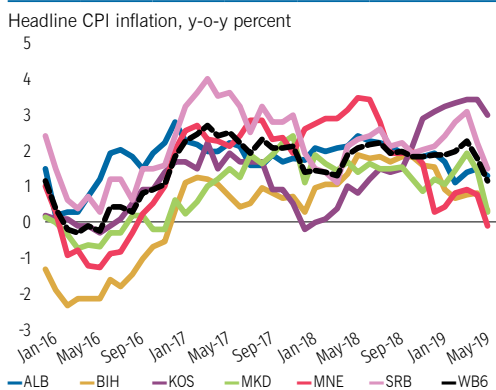
year maturity; it used the proceeds to buy back US\$-denominated Eurobonds that had been issued earlier at a higher rate. Improvements in the execution of foreign-financed capital projects have also pushed up Serbia's external PPG debt to an estimated 38.1 percent of GDP. North Macedonia's intensified borrowing and the acceleration of foreign-financed public investments are projected to push external PPG debt above 35 percent of GDP. Kosovo's

external PPG debt is expected to hold at about 6 percent of GDP because execution of capital projects financed by IFI loans has been minimal. On the other hand, external PPG debt as a percent of GDP is expected to decline slightly in Bosnia and Herzegovina and Albania. Currency appreciation and more careful fiscal management are expected to bring Albania's external PPG debt down to 32.4 percent of GDP.

5. Positive credit growth is driven by household lending

As global growth and prices slow, inflation in the region has declined. Since the end of 2018 inflation dynamics have softened, thanks to low inflation in trading partners and lighter domestic demand pressures (Figure 5.1). In June 2019 inflation in the Western Balkans averaged 1.17 percent, down from 2.1 percent (year-on-year). With generally lower global prices for key commodities, inflation dynamics have largely reflected a decline in imported inflation, augmented by the pass-through effects of appreciating currencies in countries with floating exchange rate regimes. Low and stable core inflation suggests that long-term inflationary pressures remain contained (Figure 5.2). Inflation was highest in Kosovo, driven by a hike in food prices from its imposition of a 100 percent tariff on imports from Serbia. In Bosnia and Herzegovina, inflation stabilized throughout the first part of 2019 as transport prices softened. In Montenegro inflation fell to 0.5 percent, thanks to falling prices for clothing, transportation, alcohol, and tobacco.

Figure 5.1. Inflation is trending down, tracking global food and oil prices.



Source: Central Banks and World Bank estimates.

Note: Food and energy prices are included in headline but not core price indexes.

Monetary policy has been eased to support credit growth. In Serbia and North Macedonia, policy interest rates were reduced, and Serbia intervened in the foreign exchange market to ease short-term currency fluctuations and related impacts on inflation (Figures 5.3 and 5.4). In Serbia, as inflation hovered in the lower half of the inflation tolerance band, in August the policy rate was brought down to 2.5 percent. To mitigate excessive short-term volatility of the dinar against the euro, the National Bank of Serbia intervened in the foreign exchange market. In Albania, lower-than expected inflation associated with exchange rate appreciation has prompted the central bank to hold the policy rate at 1 percent since June 2018; the bank has announced that it will start normalizing monetary policy in the second half of 2020. In North Macedonia, at the beginning of 2019 the central bank lowered the key interest rate by 25 bps, to a historic low of 2.25 percent. With monetary policy accommodative for the past year, the pass

Figure 5.2. Core inflation remains subdued.

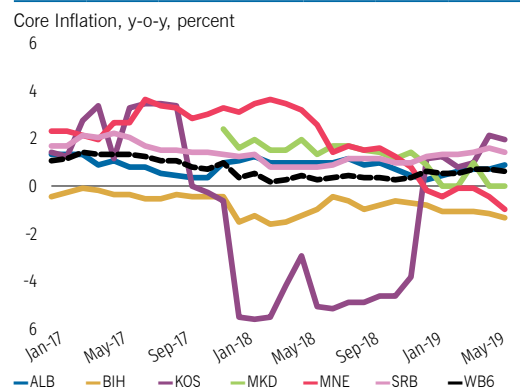
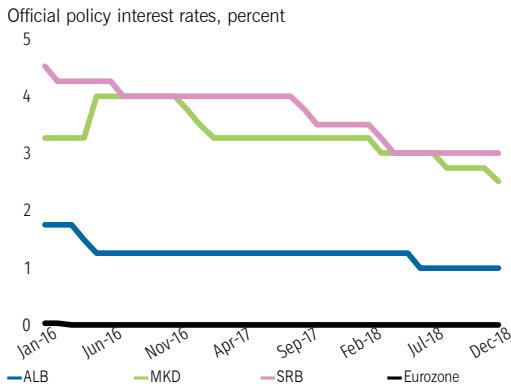
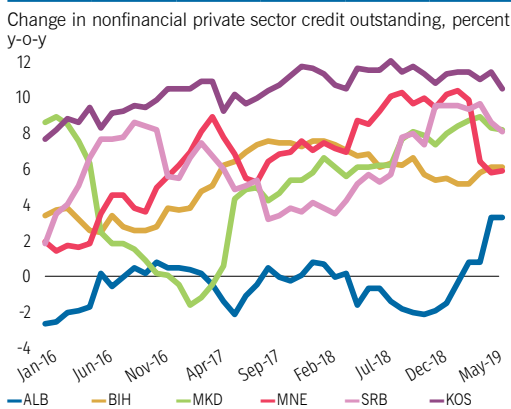


Figure 5.3. Central banks in North Macedonia and Serbia further lowered policy rates...



Source: Central bank and ECB estimates.

Figure 5.5. Credit outstanding continued to be positive throughout the region.



Source: IMF IFS, Central banks.

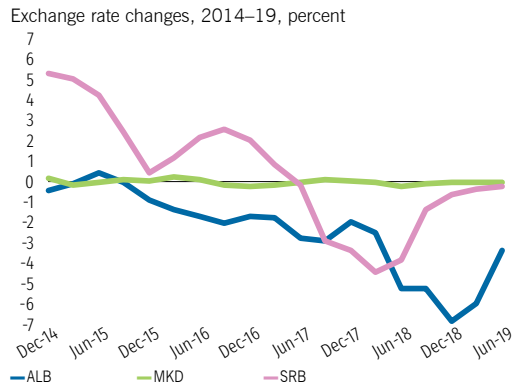
Note: Consistent data on private sector credit growth in Albania, Bosnia and Herzegovina, Republic of North Macedonia, and Serbia are from IMF *International Financial Statistics* (IFS). Data on household and corporate credit are from national central banks. Other depository corporations surveyed are expressed in local currency (euros for Kosovo). Data for Montenegro are based on central bank statistics for credit to residents but not to governments and financial institutions.

through of the lower policy rate to commercial banks deposit and lending rates has intensified in North Macedonia, and credit growth appears to be reviving.

In all Western Balkan countries, credit growth² has been positive, but in most, lending to households is growing faster than lending to businesses. Kosovo saw the

2 Credit here refers to the stock of nonfinancial private sector credit outstanding. Its growth reflects changes in both new credit (positive effect) and NPL write-offs (negative).

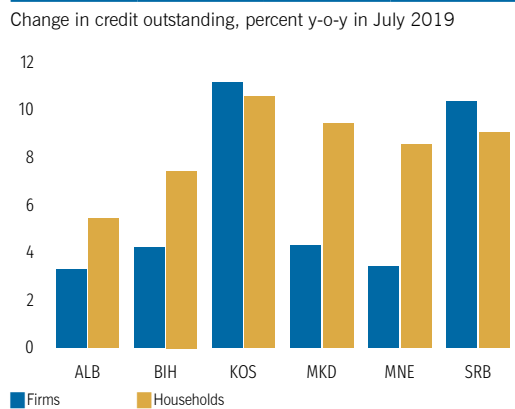
Figure 5.4. ...and Serbia intervened in foreign exchange markets.



Source: Central bank estimates.

Note: Increase indicates depreciation.

Figure 5.6. Credit to households grew consistently, but not credit to firms.

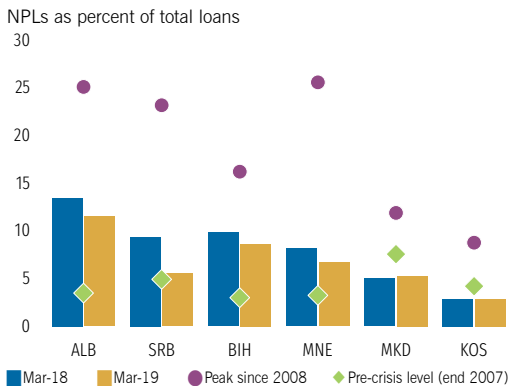


Source: Central banks.

strongest growth of credit to the private sector, reaching about 10.5 percent in June (y-o-y) as credit standards eased; followed by North Macedonia and Serbia at about 8 percent each (Figure 5.5) as credit demand grew. At 5–7 percent, lending was also robust in Bosnia and Herzegovina and Montenegro. In Albania credit growth has been recovering (3 percent) as demand gradually improves, but credit conditions have not caught up with demand.³

3 CESEE Bank Lending Survey for H1 2019.

Figure 5.7. Nonperforming loans are declining.

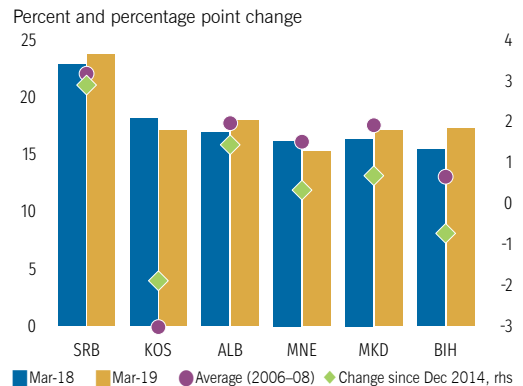


Source: IMF FSIs, National central banks.

Region-wide, lending to households—mainly consumer loans—grew consistently, but credit to firms has been subdued, in part due to the limited range of financing instruments available (Figure 5.6). According to a recent survey by the European Commission,⁴ an average of 15 percent of the firms in the region consider access to finance to be their most important problem, more than double the 7 percent in the EU28. The World Bank, with support from authorities in the region, has developed a practical guide for capital market development in small economies (Box 5.1).

With NPLs decreasing in all countries, credit is gradually becoming less constrained. As of March 2019, the regional NPL average was 6.6 percent of total loans, down 2 pp from the end of 2017 (Figure 5.7). In Albania, though by June NPLs had steadily declined from over 20 to 11.2 percent, they are still the highest in the region; at 2.5 percent, Kosovo’s NPLs are the lowest. Recent reforms have helped reduce NPLs considerably as Albania, Montenegro, and Serbia continue to write off and sell old NPLs. New insolvency laws are in place in Albania, the Bosnia and Herzegovina entity

Figure 5.8. Banks are adequately capitalized.



Source: IMF FSIs, National central banks.

Republika Srpska, and Kosovo. In July the Bank of Albania adopted a framework for voluntary bank out-of-court restructuring of large NPLs. Montenegro has expanded coverage of the credit registry to enhance the capacity of lenders to assess credit risk and has amended its credit risk management regulation to align it with European Banking Authority standards.

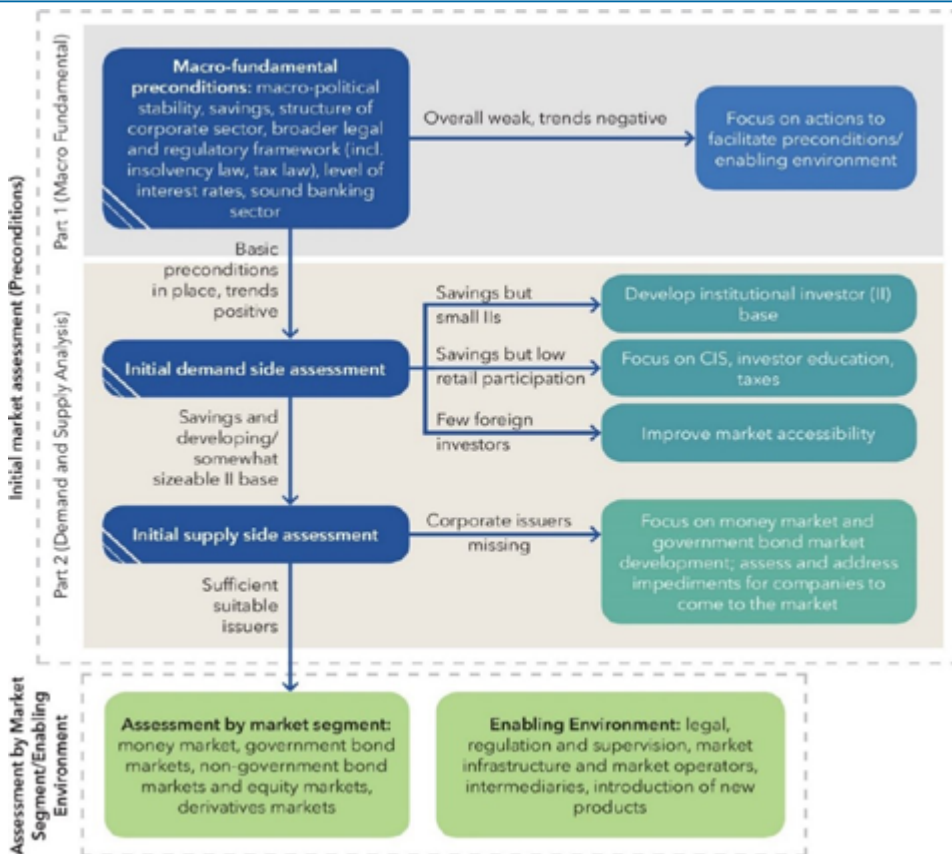
Western Balkans are well-capitalized and have benefited from consolidation. As of March, bank capital adequacy averaged 18 percent (Figure 5.8), though profitability, as measured by the return on assets, remains low at 1.3 percent. As for consolidation, in Albania, since Fall 2018 the number of banks has dropped from 16 to 12 due to mergers and license removal of a small non-operational bank, while in Montenegro two undercapitalized banks have been liquidated. However, the vulnerabilities of domestic and state-owned banks still raise concerns about asset quality and the health of specific banks. Considering the size of Western Balkan economies and their financial sectors, there is room for further consolidation, entry of reputable players, and gains in banking efficiency.

⁴ European Commission, *Survey on the Access to Finance of Enterprises – Analytical Report*, 2018.

Box 5.1. The Assessment Framework on Preconditions and Capital Market Development^a

When small economies consider developing capital markets, an overarching principle is that such markets should be adapted to the requirements of the domestic economy, companies, and investors based on current levels of activity and the needs of market participants. There is no one-size-fits-all solution; the roadmap for development will be based on the unique circumstances of the specific economy. Markets have a certain structure for a variety of reasons, among them the macroeconomic environment, tax environment, and, more often than not, the political and economic path that led to a current makeup of the corporate economy. There is, however, a general sequence that can be followed.

Figure B.5.1. Preconditions and Capital Markets Assessment Framework.



When considering the potential for developing capital markets, first, macro-fundamental preconditions should be assessed (Figure B.5.1). Otherwise, it will be extremely difficult to build deep, liquid, and orderly securities markets in the medium term. Among factors to be considered are the stability of the macroeconomic environment, gross domestic savings, inflation, and interest rates. The soundness of the banking sector should also be considered. If the preconditions are inadequate, policymakers and regulators must focus on making progress in establishing a suitably conducive macroeconomic environment for a capital market. Once macroeconomic fundamentals have been

Box 5.1 continued

assessed, the condition of supportive institutions and the broader legal and institutional environment should be evaluated. Characteristics of a supportive environment for issuers and investors would be efficient contract enforcement, procedures for incorporation and insolvency, accounting and auditing rules, fair competition, and tax policies. If the macroeconomic fundamentals are in place, such institutional and regulatory factors can be addressed in conjunction with other aspects of the capital market.

With basic preconditions in place and trends generally positive, an analysis of supply and demand is recommended to identify causes of underdevelopment. On the demand side, to achieve depth and liquidity capital markets depend on a diversified investor base with varying investment time horizons and differing market views. An assessment of the investor base covering types and size of domestic institutional investors, retail investors, and foreign investors is also needed to identify weaknesses to be addressed to grow the investor base.

In addition to demand for capital market products, it is important to explore the supply side—the pipeline of potential issuers. A supply-side assessment should start with analysis of financial and corporate issuers: the magnitude of the equity and corporate debt markets and the number of potential issuers. If the pipeline of corporate issuers is limited, it should be ascertained whether this is due to the structure of the corporate sector (i.e., size and number of companies) or to technical issues that discourage companies from issuing stocks and bonds. Structural constraints can be addressed over time by first facilitating development of the private sector, and of private equity and venture capital to incubate firms for later listing. In parallel, reform efforts should target the development of money and government bond markets, which can occur regardless of the level of capital market development in a country and is typically viewed as the first step in capital market development.

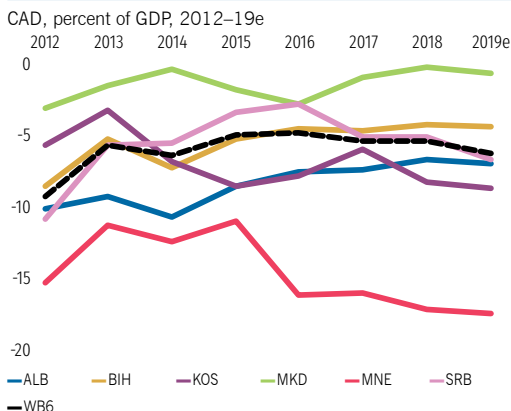
If conditions on both supply and demand sides are conducive, further analysis could assess specific market segments to get a clearer picture of cross-cutting issues and guide the design of reforms. The Assessment Framework contains building blocks on all market segments with indicative topics for discussion as part of a diagnostic: money, government bond, non-government bond, equity and derivatives markets; and aspects of the enabling environment: laws, regulation and supervision, market infrastructure, the investor base, and regional integration.

a <http://documents.worldbank.org/curated/en/397831562046607724/Practical-Guide-on-the-Potential-of-Capital-Markets-Development-in-Small-Economies>.

6. Exports slow amid rising international trade tensions

In 2019 the current account deficit (CAD) is expected to go up in all Western Balkan countries, largely due to a pick-up in imports and a slow-down in export growth. Serbia experienced by far the steepest rise: its CAD rose by 1.5 pp of GDP. The leading cause was the country’s deteriorating trade deficit as imports rose by 2.5 pp and the net services surplus dropped by 1.5 pp. The CAD increase in the other four countries ranged from 0.2 to 0.4 pp and was largely related to rising imports, with exports slowing as a percent of GDP. Montenegro’s CAD is projected to hit 17.4 percent in 2019 due to the high import-dependency of its investments. Montenegro had solid growth of exports in the first half of 2019 led by tourism, but since the import volume is double the export volume, the trade deficit increased despite somewhat lower import growth. Thus, the regional CAD is expected to widen from 5.4 to 6.3 percent of GDP (Figure 6.1).

Figure 6.1. By yearend-2019, the CAD is expected to widen slightly for the region...

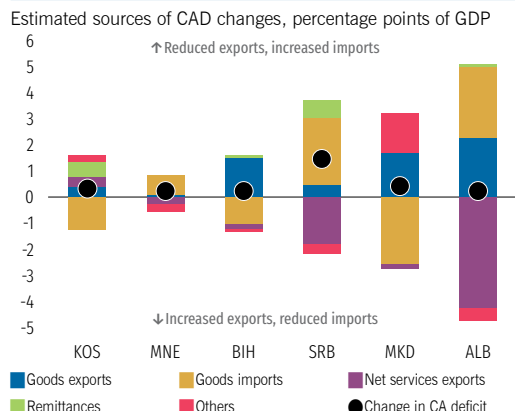


Source: National authorities and World Bank staff calculations.

Imports are rising mainly due to large infrastructure investment projects that have pushed up demand for capital and intermediate goods and raw materials. Imports are expected to rise in response to the needs of public investments in Bosnia and Herzegovina and Kosovo, and of the needs of infrastructure projects and tourism investments in Montenegro (Figure 6.2). In North Macedonia, rising imports of intermediate goods are a result of the high import content of FDI operations in the country, coupled with increased investment activity and road construction. In most countries in the region growing consumption has also stimulated imports of consumption goods and worsened most trade deficits.

Export growth in the Western Balkans is projected to slow by 1 percent in 2019, mainly because of falling demand from EU trade partners and deteriorating trade relations among some CEFTA countries after Kosovo

Figure 6.2. ...mainly because of rising imports for infrastructure projects.



in November 2018 imposed a 100 percent tariff on the import of goods from Bosnia and Herzegovina and Serbia (see Box 6.1). As trade wars and regional trade disputes persist, growth in goods exports is expected to slow. These developments may also affect economic growth throughout the Western Balkans and slow the expected recovery in global prices of base metals.

However, an increase in net services exports is partly compensating for the slowdown in goods exports. Recently, all Western Balkan countries have seen service inflows rise, especially in tourism. The increasing service exports are a welcomed development; they help to diversify exports and act as a counterweight to slowing goods exports.

Box 6.1. The Central European Free Trade Agreement (CEFTA)

CEFTA is a trade agreement between countries not yet members of the European Union (EU) that was founded in 1992 by Hungary, Poland, and the Czech and Slovak republics, all of which have since left to become EU members. Other former parties are Bulgaria, Croatia, Romania, and Slovenia. The current CEFTA members are Albania, Bosnia and Herzegovina, Moldova, Montenegro, North Macedonia, Serbia, and the United Nations Interim Administration Mission in Kosovo on behalf of Kosovo. All CEFTA members except Moldova have also signed the EU Stabilization and Association Agreement. CEFTA thus functions as preparation for full EU membership.

As of 2006, the CEFTA agreement covers 16 policy areas, some of which go beyond tariff reforms. It is thus deeper than most other trade agreements between CEFTA countries, which cover on average 10 areas (see note to box). However, except for tariffs on agricultural and manufacturing goods, all CEFTA policy areas require consensus in settling disputes, which makes it hard to enforce CEFTA requirements. In 2018, CEFTA was deepened by an additional protocol on trade facilitation. A protocol on services liberalization is planned for 2019 and a protocol on dispute settlement should be ready for adoption by 2020.

The agreement has been very effective in eliminating tariffs for all industrial goods within a short phase-out period, and in substantially reducing tariffs for a large number of agricultural goods. Despite that the estimated increases in trade for CEFTA member countries are relatively modest: they vary between 0.02 and 7.4 percent, the positive welfare impact is between 0 and 3.7 percent.

In 2018, CEFTA came under stress when as a consequence of recent tensions Kosovo imposed a 100 percent tariff on Serbia and Bosnia and Herzegovina. This has deeply affected their exports to Kosovo, especially food products. The planned strengthening of CEFTA seems unlikely as long as the conflict endures.

Despite recent tensions, a further deepening of CEFTA could have a substantial beneficial impact on trade. Estimates indicate that improvements in terms of dispute settlement mechanisms could increase CEFTA members' trade and real GDP by around 2 percent in the long-term. If CEFTA were to be further expanded with provisions on movement of capital, consumer protection, labor market regulation, and environmental laws, growth in trade and real GDP would rise by an estimated 2.5 percent. A 6.7 percent gain could be achieved if the countries deepened their commitment to the level of those between EU members.

Source: Alen Mulabdic and Michele Ruta, May 2018, Effects of a Deeper CEFTA, World Bank, Washington, DC.

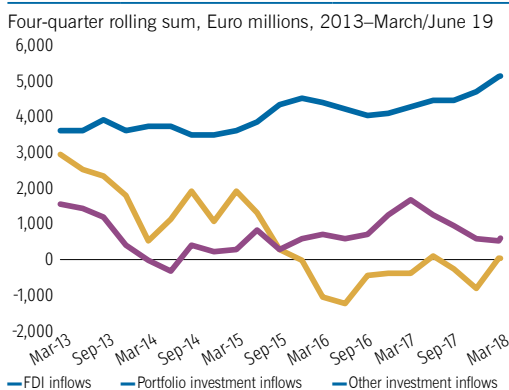
Note: Calculated using the World Bank Content of Deep Agreements Database. It is important to remember, though that the information on the content of CEFTA in the database is based on the text of the 2006 agreement as submitted to the World Trade Organization. It is likely that currently CEFTA covers more areas due to additional protocols negotiated since.

Stable FDI and remittances have helped finance external imbalances in 2019. At an average of 6 percent of GDP, the contribution of remittances to financing trade deficits remains robust in the Western Balkans, especially in Albania, Bosnia and Herzegovina, Serbia, and Kosovo, where they are expected to remain an essential source of trade deficit financing. The primary sources of remittances are Austria, Germany, Greece, Italy, and Switzerland. Total FDI for the region is expected to reach 5.2 percent of GDP, slightly less than in 2018 because Albania, North Macedonia, and Serbia had smaller inflows as a percent of GDP than a year ago (Figure 6.3). FDI in North Macedonia and Serbia has fallen following unusually high levels in 2018 (the highest since 2009 in North Macedonia and since 2011 in Serbia). The expected inflows for 2019 remain above the averages for the past five years. In Kosovo, net FDI improved to 4.1 percent of GDP, covering about 45 percent of the CAD financing. In Bosnia and Herzegovina and Montenegro, FDI is enough to finance about 50 percent of the CAD, and in Albania, North Macedonia, and Serbia it can cover the entire CAD (Figure 6.4). Although FDI has supported growth in the Western Balkan countries, current investment

levels are too low to sustain growth over the long term. Moreover, while greenfield investment peaked in 2018, a substantial share of FDI has gone into non-tradable sectors such as real estate and retailing, which do not contribute directly to exports.

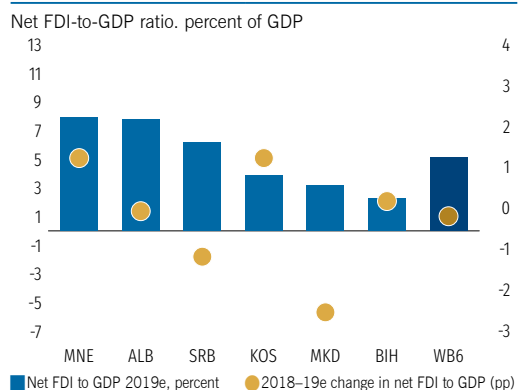
The rise in external debt in 2019 suggests that some countries in the Western Balkans still depend on external financing. The external debt-to-GDP ratio for the region is projected to remain high at 79.5 percent of GDP. While FDI currently finances a considerable part of the region's CADs, there are risks associated with continuing high CADs, especially when external debt-to-GDP ratios are not only high but worsening. A sudden stop in foreign investments, continued decline in exports because of global trade wars and regional disputes, or an increasing reliance on imports, especially for consumption goods, would amplify dependence on external financing and could jeopardize foreign currency reserves. In 2019, however, all Western Balkan countries are projected to keep reserves at above 4 months of imports.

Figure 6.3. Total FDI inflows to the region were generally steady in 2019...



Source: National authorities and World Bank staff calculations.

Figure 6.4. ...but net FDI inflows fell in North Macedonia and Serbia.



7. The outlook is positive but vulnerable to rising external risks

After slowing in 2019, medium-term growth prospects for the Western Balkans are rather positive, with annual growth projected to increase to 3.6 percent in 2020 and 3.8 percent in 2021 (Table 7.1). The benign outlook applies to all countries except Montenegro where the phasing-out of an investment cycle is expected to dampen activity, with growth falling to 2.8 percent in 2020 and 2.7 percent in 2021. But in several countries the positive growth outlook is supported by one-time factors and masks the region’s exposures to downside risks. In Albania, energy production is expected to rebound as rainfall is assumed to return to historical averages. In Kosovo, several large public investment projects in transport are expected to advance. And in Serbia, consumption is expected to remain robust in 2020 as increases in public sector wages and pensions materialize. Overall, economic growth in the region is projected to be stronger than in the EU and the Central and Eastern Europe region through 2021.

Table 7.1. Growth Rates in the Western Balkans, 2017–21f

| | 2017 | 2018e | 2019f | 2020f | 2021f |
|------------------------|------|-------|-------|-------|-------|
| Albania | 3.8 | 4.1 | 2.9 | 3.4 | 3.6 |
| Bosnia and Herzegovina | 3.2 | 3.6 | 3.1 | 3.4 | 3.9 |
| Kosovo | 4.2 | 3.8 | 4.0 | 4.2 | 4.1 |
| North Macedonia | 0.2 | 2.7 | 3.1 | 3.2 | 3.3 |
| Montenegro | 4.7 | 4.9 | 3.0 | 2.8 | 2.7 |
| Serbia | 2.0 | 4.2 | 3.3 | 3.9 | 4.0 |
| Western Balkans | 2.6 | 3.9 | 3.2 | 3.6 | 3.8 |
| EU28 | 2.5 | 2.0 | 1.4 | 1.3 | 1.4 |

Source: World Bank (Global Economic Prospects) working assumptions, national statistical offices, World Bank estimates.

The positive outlook is driven by consumption while the contribution of investment to GDP growth is expected to slow. The contribution of investment to regional growth is expected to slip slightly, from 1.3 pp in 2019 to 1.1 pp in 2020 and 1 pp in 2021; but that is still slightly above the 2012–18 average of 0.7 percent. In North Macedonia, growth will be supported by contributions from investment and household consumption, boosted by more people being in work and higher wages. Labor income gains will also fuel growth in Albania, mainly based on private consumption. Private consumption will also push up growth in Bosnia and Herzegovina and in Serbia. In Serbia, a drop in the negative contribution from net exports is also expected. At the same time, foreign investment in the Western Balkans is increasing. In 2018, the region recorded its highest greenfield FDI inflows in a decade, and FDI net inflows are expected to hold steady at about 5.2 percent of GDP through 2021.

The positive outlook is, however, vulnerable to external and domestic risks that could affect growth, job creation, and poverty reduction. High fiscal and current account deficits in several countries, as well as dependence on external financing and remittances, expose countries in the region to external economic shocks. The major external risks are economic slowdowns in international trade partners, in particular the European Union (EU), which is by far the region’s largest trading partner. The high degree of openness to trade and capital flows and the presence of major commodity exporters thus expose the

region to global shocks, deceleration in the economies of trading partners, and an escalation of trade tensions, especially for specific sectors like automobiles (see Box 7.1 on external risks). The recent slowdown of the German industry, especially of car production which reached 2009 levels (mostly driven by a fall in demand for diesel cars), translates into a downside risk for the economies with strong automotive and automotive parts industries, such as Bosnia and Herzegovina, North Macedonia, and Serbia. Domestically, positive growth outlooks in some Western Balkan countries are particularly fragile given their underpinning on one-time factors, mainly the execution of large capital projects, which could greatly undermine growth if they don't materialize or if delays continue to plague execution. Political uncertainty, credit conditions, and macroeconomic stability are other key domestic risk concerns, as well as weather shocks, which affect both agriculture and energy production, both of which are vital to the economies of the region.

Medium- and long-term patterns of economic development in the region depend heavily on the pace of structural reforms. The Western Balkans continue to suffer from numerous structural deficiencies, among them skills mismatches, low youth employment rates, high informality, low productivity and innovation, limited access to financing, and weak business environments. The severe inefficiency and low productivity that characterize the region's economies translate into a sizable gap in each country between actual and potential output—what could be achieved given the available input and technology. Boosting productivity growth requires reinforcing the state institutions that protect the rule of law and safeguarding private sector competition. Both will strengthen anti-corruption mechanisms and level the playing field between firms. Higher productivity also requires improving public services to boost human capital while preserving macro-fiscal and financial stability. Together, these structural reforms would help unlock stronger,

Box 7.1. Emerging Global Risks

The global economy continues to show signs of marked deceleration. The pace of industrial production growth has nearly halved since the start of 2019 and business confidence continues to fall. Tracking a decline in consumer confidence, the services sector has also begun to slow. Since June the realization of certain downside risks—including re-escalation of trade and geopolitical tensions—has darkened the global growth outlook and generated substantial commodities market volatility. Market expectations of GDP growth have deteriorated in response, with average forecasts for growth edging down globally by 0.1 pp and for Emerging Market and Developing Economies (EMDE) growth by 0.2 pp (Figure B.7.1). Given current working assumptions, worldwide more than half of the economies are expected to slow in 2019, with global growth anticipated to drop to 2.5 percent in both 2019 and 2020.

Cyclical headwinds and persistent policy uncertainty continue to dampen growth in global trade. Trade tensions have been rising throughout 2019, most notably between the United States and China. Growth in the volume of global goods traded has plunged, and the sustained contraction in new export orders suggests that the slide will continue (Figure B.7.2). The working assumption for global trade growth in 2019 has been slashed since the start of the year, to 1.9 percent, the worst pace since the global financial crisis. By yearend, tariffs will cover nearly all U.S. imports from China and more than two-thirds of Chinese imports from the U.S.

Box 7.1 continued

Figure B.7.1. Forecasts of Growth, 4/28–8/19

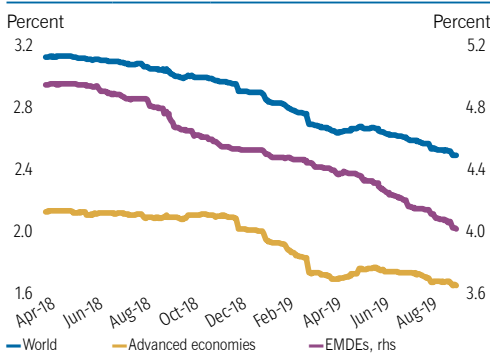
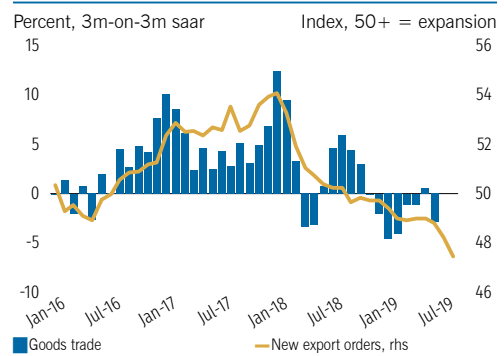


Figure B.7.2. Growth in the Volume of Global Goods Trade and New Export Orders, 1/16–7/18



Emerging data in major economies point to a somewhat abrupt slowdown in activity as the global trade slowdown takes its toll. In the Euro Area, political uncertainty, stemming from concerns about a perhaps disorderly Brexit and debt sustainability in Italy, is also denting confidence: preliminary estimates suggest that in 2020 growth in the Euro Area will decelerate to 1.1 percent rather than firming up to 1.4 percent as was expected. Growth in China has continued to ebb amid heightened trade tensions with the United States, with policy support only partially offsetting the negative impact of higher tariffs.

Risks to global growth are definitely to the downside. Among downside risks are an intensification of trade tensions or other policy uncertainties, which could weigh on investment and worsen financial and commodity market volatility; sudden slowdowns in major economies that could generate substantial spillover effects for EMDEs; and new EMDE financial stress episodes, amplified by rising debt, corporate sector vulnerabilities, and heightened refinancing pressures. The probability of growth in 2020 being at least 1 pp below current projections is estimated at close to [20] percent—comparable to the 2001 global downturn.

A further escalation of trade tensions between the U.S. and China could mean significant economic losses for exporters of products targeted, with trade costs cascading into other sectors. Similarly, a deterioration in U.S.–Europe trade relations, particularly with respect to auto tariffs, could bring major disruptions in tightly integrated value chains. A disorderly Brexit from the EU would cause uncertainty to spike and further block trade flows, causing dislocating shifts in financial markets. A sharper-than-expected deceleration in major economies—such as the Euro Area, the U.S., or China—would seriously jeopardize global and EMDE growth.

A worsening slowdown in the Euro Area could generate adverse spillovers to Europe’s EMDEs. The Europe and Central Asia (ECA) region is generally open to trade and capital flows given its increasing integration with the EU and the presence of several large commodity-exporting economies, which leaves the region vulnerable to growth shocks originating from outside ECA. Global spillovers to ECA are estimated to be larger than spillovers from Russia or Turkey, the region’s two largest economies. Over two years a 1 pp decline in growth in the rest of the world subtracts 1.7 pp from growth in ECA economies (World Bank 2016). A substantial deceleration in China would push down commodity prices worldwide, with a disproportionately large impact on ECA commodity exporters (World Bank 2019).

Box 7.1 continued

The Euro Area is a vital trading partner and source of financial flows to ECA—a worse than expected slowdown could have spillovers to ECA through trade, remittances, and banking system channels (Figure B.7.3). The Western Balkans is no exception—the EU is its single largest trading partner and an important export destination, as well as a substantial source of the region's FDI and remittances (Figure B.7.4). Weaker economies in key trading partners could dampen external demand for exports from the Western Balkans. Among major export destinations for the Western Balkans, for instance, are Italy and Germany, where fragile growth outlooks could depress export growth in the region. Furthermore, an escalation of trade tensions between the United States and Europe that affects automobiles could disrupt tightly integrated value chains in the Western Balkans, especially in North Macedonia and Serbia (World Bank 2019).

Figure B.7.3. Goods Exports by Destination, 2017

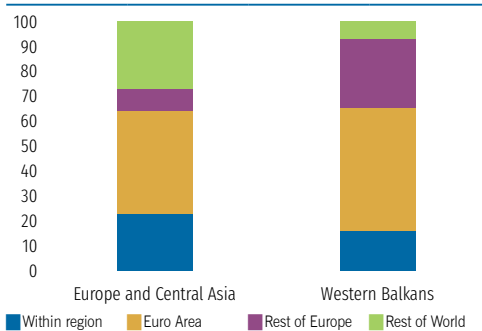
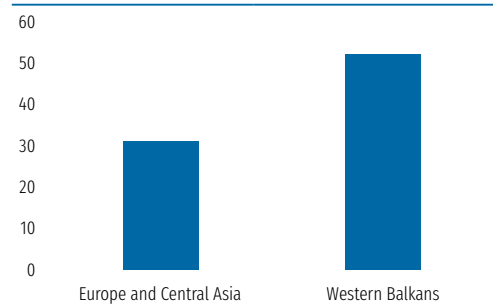


Figure B.7.4. Remittances from the EU, Percent



Source: Bloomberg, Consensus Economics, CPB Bureau for Economic Policy Analysis, Haver Analytics, International Monetary Fund, World Bank.

more equitable, and more sustainable growth, ensuring faster convergence with EU income levels.

Political tensions continue to be an obstacle to internal stability and regional integration.

They also make it difficult for each country to pursue much-needed structural reforms—and the tensions may build as general elections approach: Elections are planned for 2020 in North Macedonia, Montenegro, and Serbia; and 2021 in Albania and municipal elections in Bosnia and Herzegovina. A government is yet to be formed in Bosnia and Herzegovina, where the last general election was held in October 2018. Besides domestic political disputes, poor regional cooperation, expressed in trade barriers imposed against each other, constitutes

a risk for regional integration and economic development.

Aspirations to EU candidacy and accession, however, are an important incentive to overcome internal dissension and push for reforms. For Bosnia and Herzegovina, the aspiration to become an EU candidate may help overcome internal differences and be a force for reform. All countries in the region should focus their efforts on the critical areas of the rule of law and fundamental rights to advance accession within the 2018 Western Balkans Strategy (EU Commission 2019). Achieving more trade integration, both regionally and internationally, will help firms in Western Balkan countries reach larger markets and benefit from economies of scale and thus productivity growth.

Country Notes

Albania

- With lower rainfall slashing energy production, growth is projected to slow to 2.9 percent in 2019.
- The labor market continued to improve, and unemployment reached a new low of 11.5 percent in June 2019.
- Contained spending and clearance of arrears helped bring down public debt, but off-balance risks, e.g., from public-private partnerships, are mounting.
- In the medium term, growth is expected to rise to about 3.5 percent backed by domestic demand.
- Fiscal consolidation, more efficient public spending efficiency, and structural reforms are critical for sustainable and equitable growth.

Recent Economic Developments

After expanding by 4.1 percent in 2018, annual growth for 2019 is projected to slow to 2.9 percent. A drastic decline in rainfall in the first half of the year (H1) cut hydroelectric power production in half and lowered GDP growth by more than half percentage point (pp). Services and construction led growth. Despite growing political tensions, domestic demand heightened. Net exports reduced growth by -0.4 pp as stagnant growth in trade partners limited exports of traditional goods, and energy exports declined. Improving employment, higher wages, and growth in consumer credit drove private consumption, which contributed 2.1 pp to GDP growth. Meanwhile, better credit conditions and government infrastructure spending pushed up investment, contributing 0.5 pp. In H2, as the energy shock abates, Albania's economic growth is expected to improve.

Despite lower growth job creation strengthened and unemployment declined. Growth in jobs increased to 3.4 percent in the second quarter of 2019 after a slight deceleration in the first quarter. New jobs were created in services industry and agriculture. At the end

of the second quarter, labor force participation rose by 1.24 pp year-on-year (y-o-y), but the gap between male and female participation remains large. In Q2 unemployment reached a record low of 11.5 percent. Real wages increased on average by 3.4 percent, mostly in services (trade and transport, and tourism).

Inflation has declined since 2018, reversing the recent trend. Average inflation through July fell from 2.1 percent in 2018 to 1.5 percent, where it is forecast to end the year. Low imported inflation from trade partners and appreciation of the lek were the main factors. Domestic inflation pressures were also weak because of continued underutilization of production capacities; the estimated output gap is -0.9 percent. The drop in inflation tracked the one in food inflation, mirroring what was happening in Albania's main trading partners. Consistent with its price-stability objective, and to lessen the impact of the lek appreciation on domestic prices, the Bank of Albania (BoA) has held its policy rate at a record low of 1 percent since June 2018. The change has been transmitted to short-term government securities and deposit and lending rates. During H1, the real effective exchange rate appreciated by 4.5 percent as the nominal

appreciation effect dominated the negative inflation differential with trading partners.

The banking sector is well-capitalized and profitable. All banks exceeded the Basel III required minimum capital-adequacy ratio of 12 percent, with the sector averaging 18.5 percent in June; the liquidity ratio was adequate at 21 percent. Loan portfolios improved as the BoA continued to restructure the nonperforming loans (NPLs) of large borrowers, which with mandatory write-offs, helped reduce NPLs to 11.2 percent of total loans by June, down from 25.0 percent y-o-y in 2008.¹ Reducing the NPL ratio is a BoA priority. A new insolvency law was adopted in 2016, and the BoA is preparing a framework for banks to use in voluntary, out-of-court settlements to resolve large NPLs.

Monetary easing and improvements in the loan portfolio are beginning to affect growth in credit to the private sector. In H1 loans to the private sector grew by 6.8, pushing the credit-to-GDP ratio to 35.9 percent from 35.3 at the end of 2018. In particular, lower interest rates on loans in leks have stimulated demand for domestic currency loans, which grew by 7.9 percent in H1. Credit to businesses for investment has also improved, unlike previous trends.² However, corporate lending is still limited and would be encouraged by a wider range of financing instruments. Since bank assets account for over 90 percent of total financial sector assets, sector diversification and enhanced business access to finance would benefit from policies to create new mechanisms for leasing, factoring, venture

capital, private equity, insurance, mutual funds, and microfinance, especially with support from better supervision of the financial sector and smooth operation of government bond markets.

While Albania's debt-to-GDP declined in 2019, risks generated by contingent liabilities and SOEs remain high. The revenues-to-GDP ratio has dropped from 27.6 percent of GDP in 2018 to an estimated 27.3 percent. Revenue growth in 2019 was limited by lower GDP growth and by accelerated repayment of VAT-refund arrears. Personal income tax revenue and social security contributions rose slightly, supported by higher wages and efforts to reduce informality. Meanwhile, tighter controls on social transfers and subsidies curbed current spending. Due to lower than projected revenues, capital spending relative to GDP fell by 0.1 pp. The government has recently increased the use of public-private partnerships (PPPs) to finance infrastructure, health care, and education projects. Budgetary arrears (e.g., VAT refunds and local-government transfers) amounted to about 1.5 percent of GDP in 2018. The budget deficit is expected to widen in 2019 to 2.2 percent of GDP as the government reduces VAT arrears to the private sector; and public debt, including guarantees and arrears, is expected to fall to 68.4 percent of GDP. In August, Moody's confirmed its long-term sovereign credit ratings for Albania at B+.

The energy shock and lower foreign demand have exposed external vulnerabilities for Albania. The current account deficit (CAD) is highly sensitive to commodity prices and rainfall, which largely determines energy production. Thus, the CAD is expected to widen from 6.7 percent of GDP in 2018 to 7 percent. Foreign direct investment (FDI)

1 Source: BoA Monetary Policy Report August 2019. The figures refer to the change in credit outstanding after NPL write-off effects.

2 In June 2019, credit to businesses grew by an annualized 7 percent.

is expected to remain unchanged as the investment phase for large projects in energy and gas transmission ends. Since 2016 foreign exchange reserves have held steady at over six months of goods and services import coverage. Large reserves help mitigate the risks posed by high external debt, which is projected to reach 65.7 percent of GDP in 2019.

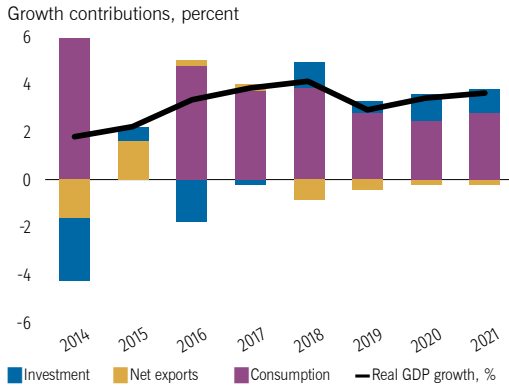
Outlook and Risks

Growth is projected to accelerate to about 3.5 percent in 2020–21 as increased economic dynamism gradually closes the output gap. Growth will increasingly depend on labor income gains fueling private consumption. In the short term, a return of the energy balance to a more normal level will alleviate the trade balance and net exports. Beyond the short term, recent positive trends in Albanian exports stemming from expanding markets, will moderate, in reflection of stagnant growth in the global economy. Investment will also contribute to growth, fueled by public projects and private investment, assuming continued progress on structural reforms in, e.g., the justice system and the financial sector. As the economy grows and capacity utilization recovers, long-term trends are expected to push inflation close to its historical averages in the second half of 2021.

By 2021 the fiscal deficit is expected to fall to 1.7 percent of GDP. The medium-term fiscal plan calls for fiscal consolidation to continue until 2022, which should generate savings on the wage bill, goods, and services and on transfers to social insurance beneficiaries and local governments. Sustained capital spending on infrastructure is planned at 4.8 percent of GDP. And gradual fiscal consolidation combined with continued economic growth is forecast to lower the debt-to-GDP ratio to 60 percent.

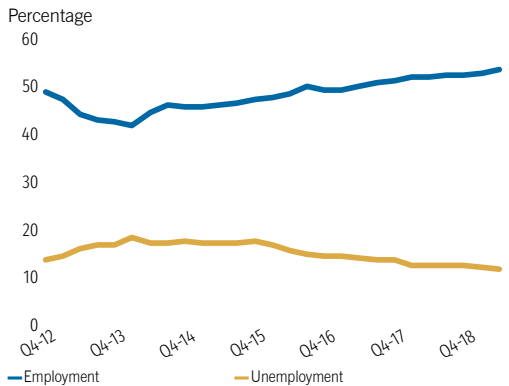
The country's economic prospects are vulnerable to significant downside risks. Lower demand from foreign trade partners could constrain growth in the short to medium term, worsen labor market conditions, and expose the country to further external vulnerability. Preserving macro-fiscal stability is crucial to support sustainable growth; that calls for further streamlining of spending, maximizing tax revenues by expanding the tax base, and improving revenue administration, and for managing fiscal risks from PPPs and SOEs. Fostering inclusive growth also requires better conditions for private sector development, such as improving the business environment, and enhancing financial access, energy security, and human capital.

Investment and recovery in consumption are expected to drive growth in 2019.



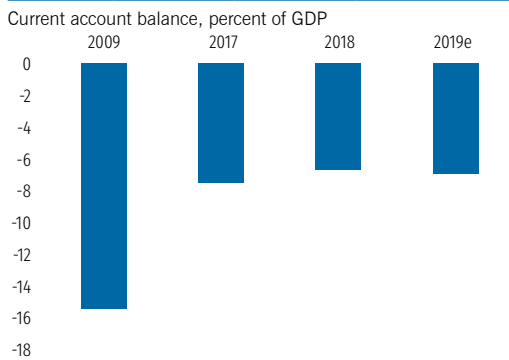
Source: Instat and World Bank.

Labor markets improved, though at a slower pace.



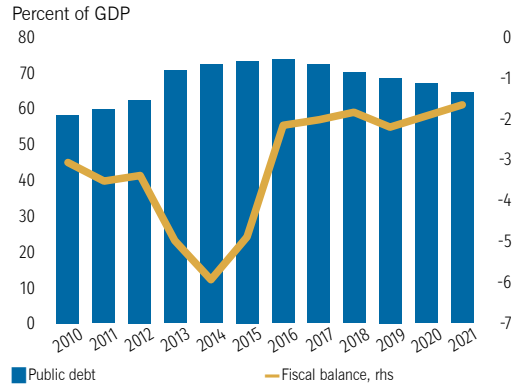
Source: Instat.

The energy shock and a drop in foreign demand have exposed the country's external vulnerabilities.



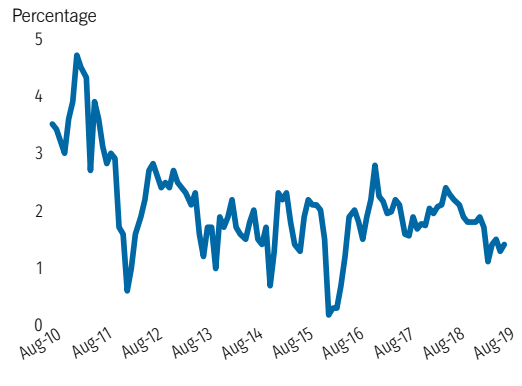
Source: Central Bank and World Bank.

Public debt is declining but fiscal consolidation was lower than in the past.



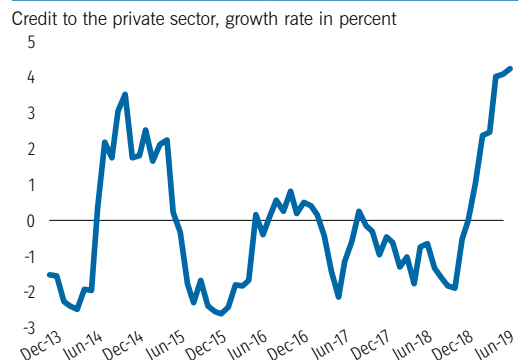
Source: Ministry of Finance and World Bank.

Imported goods inflation and exchange rate appreciation kept inflation outside the 3 ± 1 percent target band, and monetary policy was again accommodative.



Source: Instat.

As asset quality improved, monetary stimulus was transmitted into private sector credit growth.



Source: Central Bank and World Bank.

| ALBANIA | 2014 | 2015 | 2016 | 2017 | 2018 | 2019e | 2020f | 2021f |
|---|-------------|-------------|-------------|-------------|-------------|--------------|--------------|--------------|
| Real GDP growth (percent) | 1.8 | 2.2 | 3.3 | 3.8 | 4.1 | 2.9 | 3.4 | 3.6 |
| Composition (percentage points): | | | | | | | | |
| Consumption | 5.9 | 0.0 | 4.8 | 3.7 | 3.9 | 2.8 | 2.5 | 2.8 |
| Investment | -2.6 | 0.6 | -1.7 | -0.2 | 1.0 | 0.5 | 1.1 | 1.0 |
| Net exports | -1.6 | 1.6 | 0.2 | 0.3 | -0.8 | -0.4 | -0.2 | -0.2 |
| Exports | 0.3 | 0.3 | 3.3 | 4.0 | 1.0 | 0.6 | 1.4 | 1.4 |
| Imports (-) | 1.9 | -1.3 | 3.1 | 3.7 | 1.8 | 1.0 | 1.6 | 1.6 |
| Consumer price inflation (percent, period average) | 1.6 | 1.9 | 1.3 | 2.0 | 2.1 | 1.5 | 2.7 | 2.9 |
| Public revenues (percent of GDP) | 26.3 | 26.4 | 27.4 | 27.7 | 27.6 | 27.3 | 27.4 | 27.5 |
| Public expenditures (percent of GDP) | 32.3 | 30.9 | 29.6 | 29.8 | 29.3 | 29.6 | 29.4 | 29.2 |
| Of which: | | | | | | | | |
| Wage bill (percent of GDP) | 5.1 | 5.1 | 4.6 | 4.7 | 4.5 | 4.5 | 4.5 | 4.5 |
| Social benefits (percent of GDP) | 9.9 | 9.9 | 10.3 | 10.4 | 10.2 | 10.4 | 10.3 | 10.2 |
| Capital expenditures (percent of GDP) | 4.3 | 4.4 | 4.0 | 4.4 | 4.8 | 4.7 | 4.8 | 4.8 |
| Fiscal balance (percent of GDP) | -6.0 | -4.9 | -1.8 | -2.0 | -1.8 | -2.2 | -2.0 | -1.7 |
| Primary fiscal balance (percent of GDP) | -3.1 | -2.2 | 0.5 | 0.0 | 0.4 | 0.0 | 0.2 | 0.4 |
| Public debt (percent of GDP) | 66.1 | 69.1 | 68.7 | 67.8 | 64.6 | 63.0 | 62.1 | 59.6 |
| Public and publicly guaranteed debt (percent of GDP) | 72.0 | 72.7 | 72.3 | 71.9 | 69.7 | 68.4 | 66.6 | 64.3 |
| Of which: External (percent of GDP) | 29.6 | 34.2 | 32.6 | 32.6 | 32.9 | 32.4 | 32.6 | 30.7 |
| Goods exports (percent of GDP) | 9.3 | 7.5 | 6.7 | 6.9 | 7.7 | 5.5 | 5.7 | 5.9 |
| Goods imports (percent of GDP) | 31.6 | 29.9 | 30.9 | 31.3 | 30.2 | 32.9 | 33.5 | 34.0 |
| Net services exports (percent of GDP) | 3.2 | 5.1 | 7.4 | 9.4 | 8.6 | 12.9 | 13.4 | 14.2 |
| Trade balance (percent of GDP) | -19.0 | -17.3 | -16.8 | -15.1 | -13.8 | -14.5 | -14.4 | -14.9 |
| Remittance inflows (percent of GDP) | 5.9 | 5.8 | 5.7 | 5.5 | 5.2 | 5.2 | 4.9 | 4.8 |
| Current account balance (percent of GDP) | -10.8 | -8.6 | -7.6 | -7.5 | -6.7 | -7.0 | -6.4 | -6.1 |
| Net foreign direct investment inflows (percent of GDP) | 8.1 | 8.0 | 8.7 | 8.6 | 8.0 | 7.8 | 7.5 | 6.9 |
| External debt (percent of GDP) | 69.5 | 74.4 | 73.5 | 68.7 | 62.9 | 60.6 | 59.9 | 56.3 |
| Real private credit growth (percent, period average) | -1.3 | -1.8 | -2.1 | -2.3 | -3.0 | n.a. | n.a. | n.a. |
| Nonperforming loans (percent of gross loans, end of period) | 22.4 | 18.2 | 18.3 | 13.2 | 11.1 | n.a. | n.a. | n.a. |
| Unemployment rate (percent, period average) | 17.5 | 17.1 | 15.2 | 13.7 | 12.3 | 11.5 | n.a. | 0.0 |
| Youth unemployment rate (percent, period average) | 32.5 | 33.2 | 28.9 | 25.9 | 23.1 | n.a. | n.a. | n.a. |
| Labor force participation rate (percent, period average) | 53.7 | 55.7 | 57.5 | 58.3 | 59.4 | n.a. | n.a. | n.a. |
| GDP per capita, PPP (current international \$) | 10,645 | 10,926 | 11,276 | 11,693 | n.a. | n.a. | n.a. | n.a. |

Sources: Country authorities, World Bank estimates and projections.

Note: Youth unemployment rate is for labor force aged 15–29. Statistical discrepancy contribution is divided at the ratio of 80 percent and 20 percent between Consumption and Investment respectively. Change in inventories is included in Investments.

Bosnia and Herzegovina

- Having exceeded expectations by reaching 3.6 percent in 2018, economic growth is expected to down-shift slightly in 2019.
- In the medium term, with a fully operational government in place and the implementation of structural reforms motivated by BiH aspiration to gain EU candidate status, growth is likely to pick up again.
- Because of a planned increase in public investments and a rise in transfers and wages, the fiscal stance is expected to deteriorate this year but then improve gradually as fiscal tightening resumes.
- Risks to the outlook are fairly balanced: Externally, slow growth in BiH's main trading partner, the EU, is the main downside risk. Domestically, further delays in government formation since the October 2018 general election and municipal elections in 2020 could slow both reform and growth.

Recent Economic Developments

Growth is expected to slow to 3.1 percent in 2019, down from 3.6 percent in 2018.

Softening growth is to a large extent the result of a slow-down in net exports. Owing to continuing global trade wars and regional trade disputes, the trade balance figures weakened in the first half of 2019 and are expected to worsen in the short term and offset BiH growth momentum. In the first half of 2019, external demand slowed, affecting both exports (–5.7 percent year-on-year [y/y]) and imports (–3.5 percent y/y). The slowdown in external demand, is estimated to be counterbalanced by growth in consumption (2.6 percentage points [pp]) and investment (0.4 pp). Economic activity is still supported by robust, though moderating, growth in private consumption owing to a steady inflow of remittances, growth in consumer credit, and rising real wages. The drivers of production remain the same with services contributing 2.4 pp, industry 0.5pp, and agriculture 0.2 pp.

Unemployment is at its lowest in over a decade.

The unemployment rate declined from 18.4 percent in 2018 to 15.7 percent in 2019, driven by a slight rise in demand for labor and a likely reduction in the working-age population.³ Employment rate has risen from 34.3 to 35.5 percent this year, with industry and services creating the majority of jobs. But despite the improvements in the labor market, and recent stable economic growth, gains in employment are modest; today by regional standards employment in BiH is still low. Addressing structural rigidities will be crucial if BiH is to accelerate gains in job creation.

Prices continue trending downward this year.

Higher prices of transport, tobacco, and rental housing pushed up consumer prices by an average of 1.4 percent in 2018. Because food and transport are the two largest components of the consumer price index, the global decline in food and energy prices has eased inflationary pressures. In June 2019 consumer prices rose by 0.3 percent y/y. down from 1.5 percent y/y in January. Significantly, improvement in the

³ 2019 Labor Force Survey.

labor market (lower unemployment and higher wages) had no impact on inflation, which is largely determined by such supply-side factors as less inflation in the euro area and the region and the effect of oil and food prices on the world market.

In 2019, the fiscal balance is expected to turn to deficit. The latest consolidated data estimate there was a 2.2 percent of GDP surplus in 2018.⁴ The 2018 fiscal outcome is expected because of the combined effect of stronger collection of indirect taxes, sluggish capital spending reflecting implementation delays due to lack of government formation in the Federation of BiH (FBiH) and state institutions, and higher current spending on, e.g., veteran benefits in FBiH, and higher wages in Republika Srpska. In 2019, the surplus position is expected to be reversed as current spending continues to rise and public investment picks up. Total public debt, which is still moderate, is projected to decline to 34.6 percent of GDP after 2019. In March, Standard & Poor's confirmed its long-term B sovereign credit rating for BiH and raised its outlook from stable to positive—the first improvement in the country's outlook since 2012.

Having narrowed slightly in 2018, the current account deficit (CAD) is expected to widen to 4.3 percent in 2019 as exports decline by 0.9 percent and imports rise slowly by 2.2 percent. Exports have been weighed down by the slowdown in economic growth in the EU, a significant trading partner for BiH; lower global prices for aluminum, a major BiH export; and loss of markets for some commodities due to regional trade disputes. For instance, export of milk to Kosovo, one

of BiH's main markets for milk, slowed when in violation of the CEFTA agreement Kosovo imposed a 100 percent tariff on the import of goods from BiH. Introduction of the tariff has affected all BiH exports to Kosovo but especially dietary products like milk. Other components of the CAD, such as the services surplus arising from construction, transport, travel, and remittances, were almost unchanged and have been sufficient to finance a significant part of the CAD, supported by FDI and other investment. It is estimated that in 2019 FDI will cover 50 percent of the CAD, with the balance financed by new borrowing. For 2019 total BiH external debt-to-GDP is projected to stay below 66 percent.

The banking sector is liquid and well-capitalized. System-wide, the nonperforming loan (NPL) ratio is heading down. At the end of the first quarter, the share of NPLs in commercial bank portfolios had gone down from 8.8 percent of total loans at the end of 2018 to 8.5 percent. Profitability is also on the rise—in the first quarter return on average equity was 12 percent, up from 9.6 percent at the end of 2018. The capital-to-assets ratio has risen from 13.2 percent in 2018 to 13.5 percent. Capital buffers are within regulatory requirements.

Outlook and Risks

By 2021, supported primarily by consumption and to some extent by public investment, economic growth is projected to strengthen to 3.9 percent. BiH's commitment to gaining EU candidate status is seen as a key reason to advance the country's structural reform agenda. As and when a new government is formed and structural reforms are launched, a moderate rise in growth is expected, with higher

⁴ See Consolidated CBBiH data, available at the CBBiH Panorama web portal.

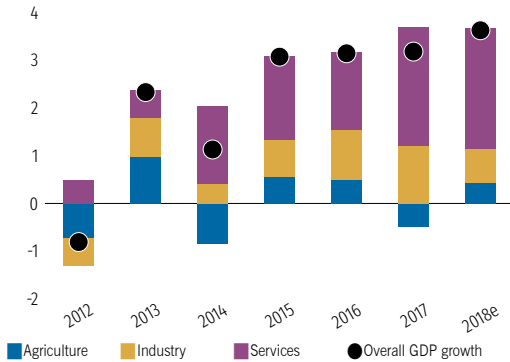
investment in infrastructure. In the medium term, external deficits are expected to persist, mostly owing to the trade balance, which will move in line with global oil and aluminum prices. Remittances are likely to hold steady and will continue to support consumption, which will remain a major driver of growth in the medium term. In the medium term, too, labor market improvements should strengthen as investments in energy, construction, and tourism support job creation. Real GDP growth is therefore projected to build gradually to 3.9 percent by 2021.

Unleashing the potential of the private sector is still a major challenge for BiH and will continue to preclude heightened growth over the medium term. Private sector growth is lackluster and insufficient to improve labor market outcomes. It continues to be restricted by a high tax burden on labor, a poor business environment, skills gaps, and a large public sector. Moreover, despite good fiscal outcomes in earlier years, public finances today are still characterized by arrears accumulation, structural rigidities on the spending side manifested in high current spending, and poor targeting of social assistance benefits.

Notable risks, both domestic and external, persist. The main domestic risk is the challenging political environment, which makes advancement of structural reform difficult and will continue to delay EU integration. Externally, slow growth in the EU and rising regional and global trade tensions are the main downside risks.

GDP growth strengthened in 2018, but momentum has since softened.

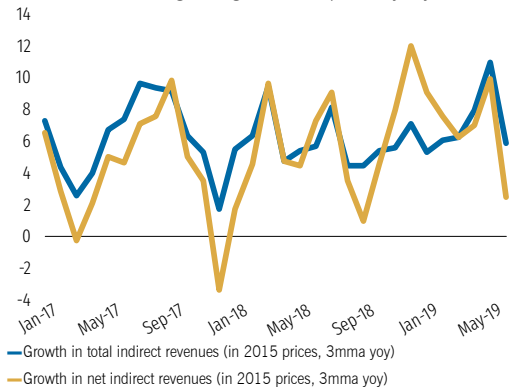
Contributions to growth, percentage points of GDP



Source: BiH Agency for Statistics, World Bank.

Indirect tax revenues continue to rise...

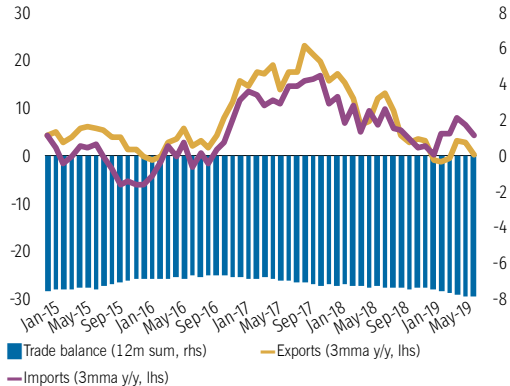
Real 3 months moving average (3mma), percent y-o-y



Source: BiH Indirect Tax Office, World Bank.

The deficit in the goods trade continues to widen.

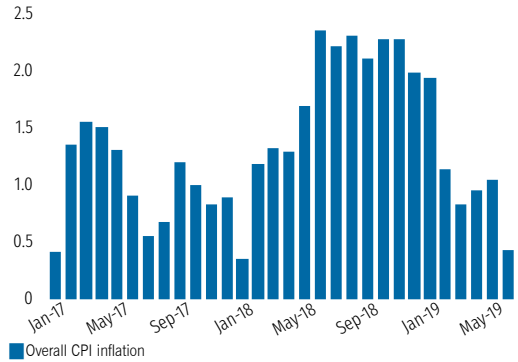
3 mma, percent y-o-y, and the goods trade balance in KM billions



Source: BiH Agency for Statistics, World Bank.

Inflation remains low and price pressures eased in the first half of 2019.

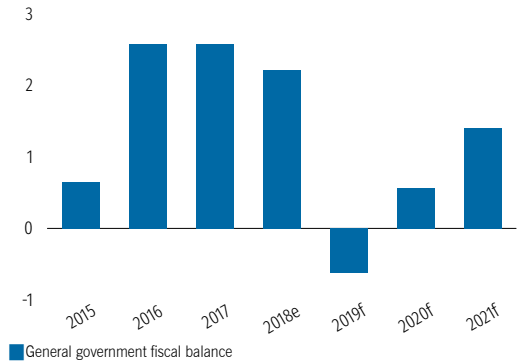
Percent y-o-y



Source: BiH Agency for Statistics, World Bank.

...but higher public spending is expected to put the fiscal balance in a deficit position.

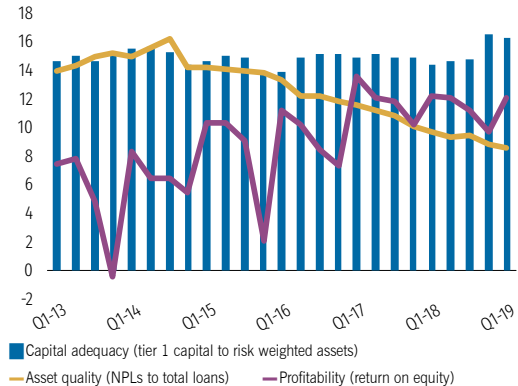
Percent of GDP



Source: Fiscal authorities, World Bank estimates.

Nonperforming loans in commercial bank portfolios are declining but still high.

Percent



Source: Central Bank of BiH, World Bank calculations.

| BOSNIA AND HERZEGOVINA | 2014 | 2015 | 2016 | 2017f | 2018 | 2019e | 2020f | 2021f |
|---|-------------|-------------|-------------|--------------|-------------|--------------|--------------|--------------|
| Real GDP growth (percent) | 1.1 | 3.1 | 3.1 | 3.2 | 3.6 | 3.1 | 3.4 | 3.9 |
| Composition (percentage points): | | | | | | | | |
| Consumption | n.a. | n.a. | n.a. | n.a. | n.a. | 2.6 | 3.1 | 2.9 |
| Investment | n.a. | n.a. | n.a. | n.a. | n.a. | 0.4 | 0.4 | 0.9 |
| Net exports | n.a. | n.a. | n.a. | n.a. | n.a. | 0.0 | -0.1 | 0.1 |
| Exports | n.a. | n.a. | n.a. | n.a. | n.a. | 0.4 | 0.6 | 1.1 |
| Imports (-) | n.a. | n.a. | n.a. | n.a. | n.a. | 0.4 | 0.6 | 1.1 |
| Consumer price inflation (percent, period average) | -0.9 | 0.0 | -1.6 | 0.8 | 1.4 | 0.8 | 0.8 | 0.6 |
| Public revenues (percent of GDP) | 43.7 | 43.1 | 42.7 | 43.0 | 42.8 | 41.8 | 42.0 | 41.7 |
| Public expenditures (percent of GDP) | 45.8 | 42.5 | 41.5 | 40.4 | 40.6 | 42.4 | 41.4 | 40.3 |
| Of which: | | | | | | | | |
| Wage bill (percent of GDP) | 11.9 | 11.5 | 11.0 | 10.6 | 10.3 | 10.2 | 10.0 | 9.6 |
| Social benefits (percent of GDP) | 17.0 | 16.5 | 15.9 | 15.2 | 15.3 | 17.0 | 16.8 | 16.6 |
| Capital expenditures (percent of GDP) | 4.3 | 2.0 | 2.4 | 2.4 | 2.8 | 2.5 | 2.3 | 2.1 |
| Fiscal balance (percent of GDP) | -2.0 | 0.7 | 1.2 | 2.6 | 2.2 | -0.6 | 0.6 | 1.4 |
| Primary fiscal balance (percent of GDP) | -1.2 | 1.6 | 2.9 | 2.9 | 2.9 | 0.2 | 1.4 | 2.2 |
| Public debt (percent of GDP) | 41.6 | 41.9 | 42.3 | 36.1 | 34.1 | 33.2 | 32.3 | 31.4 |
| Public and publicly guaranteed debt (percent of GDP) | 43.4 | 43.6 | 42.1 | 37.7 | 35.6 | 34.6 | 33.7 | 32.7 |
| Of which: External (percent of GDP) | 34.3 | 35.0 | 34.3 | 30.6 | 29.8 | 28.9 | 28.3 | 27.6 |
| Goods exports (percent of GDP) | 25.0 | 25.2 | 25.7 | 29.8 | 30.2 | 28.7 | 28.7 | 28.5 |
| Goods imports (percent of GDP) | 53.8 | 50.3 | 49.4 | 53.3 | 52.7 | 51.6 | 52.3 | 53.1 |
| Net services exports (percent of GDP) | 6.1 | 6.7 | 7.0 | 7.2 | 7.4 | 7.5 | 7.4 | 7.5 |
| Trade balance (percent of GDP) | -28.8 | -25.2 | -23.6 | -23.5 | -22.5 | -23.0 | -23.7 | -24.6 |
| Remittance inflows (percent of GDP) | 8.4 | 8.3 | 8.2 | 8.4 | 8.1 | 8.0 | 7.7 | 8.0 |
| Current account balance (percent of GDP) | -7.5 | -5.3 | -4.7 | -4.7 | -4.3 | -4.5 | -5.3 | -6.0 |
| Foreign direct investment inflows (percent of GDP) | 2.9 | 1.8 | 1.7 | 2.1 | 2.2 | 2.3 | 2.3 | 2.4 |
| External debt (percent of GDP) | 76.3 | 72.2 | 72.2 | 68.5 | 66.1 | 65.8 | 65.8 | 65.5 |
| Real private credit growth (percent, period average) | 3.1 | 1.1 | 3.1 | 6.2 | 6.8 | 5.8 | n.a. | n.a. |
| Nonperforming loans (percent of gross loans, end of period) | 14.2 | 13.7 | 11.8 | 10.0 | 8.8 | 8.5 | n.a. | n.a. |
| Unemployment rate (percent, period average) | 27.5 | 27.7 | 25.4 | 20.5 | 18.4 | 15.7 | n.a. | n.a. |
| Youth unemployment rate (percent, period average) | 62.9 | 62.3 | 54.3 | 45.8 | 38.8 | 33.8 | n.a. | n.a. |
| Labor force participation rate (percent, period average) | 43.7 | 44.1 | 43.1 | 42.7 | 42.1 | 42.1 | n.a. | n.a. |
| GDP per capita, PPP (current international \$) | 11,164 | 11,526 | 12,173 | 12,875 | 13,200 | 13,775 | 14,258 | 14,550 |

Sources: Country authorities, World Bank estimates and projections.

Note: Nonperforming loans show year-to-date actuals.

Kosovo⁵

- For 2019 growth is projected to reach 4 percent, up from 3.8 percent, driven by consumption, service exports, and investment.
- The overall budget deficit is expected to stay just below 3 percent of GDP, and within the 2 percent fiscal rule limit which excludes capital spending financed by privatization proceeds and international financial institutions. Slight underperformance in revenue, compared to the plan, will be overcompensated with a significant under execution of capital projects.
- Poorly targeted social protection spending remains high and continues to limit fiscal space.
- The outlook is positive, with growth averaging 4.2 percent for 2020–21, but there are downside risks related to domestic and regional politics dynamics, possible delays in investment plans due to upcoming elections, higher than projected cost of the new law on public salaries, and the stability of international metals prices.

Recent Economic Developments

Growth is expected to edge up to 4 percent in 2019, from 3.8 percent in 2018. For the year, private consumption is expected to add 2.9 pp to growth, thanks to higher consumer lending, remittances, and public wages; and public consumption is expected to add another 1.6 pp. The contribution of investment to growth is projected to be only 1.1 pp because late approval of the budget law led to delays in the execution of public investment plans. Elections in 2019 may further delay execution of the capital budget. Despite strong growth in services exports, net exports are expected to subtract 1.4 pp from growth.

Labor force participation continues to be low, despite the chronically high unemployment. In 2019 Q2 unemployment went down, by 4.1 pp, from the same period last year, due to higher employment but also lower labor force participation. Employment rate increased by 1.3 pp y-o-y to 29.8 percent. Youth

unemployment eased to 49.1 percent, down by 5.9 pp y-o-y. However, the share of NEET youth (the percentage of young people that are not in training, education, or employment) are high at 31.7 percent.

The 2019 overall fiscal deficit is expected to be 2.9 percent, driven by higher capital investment—financed in part by privatization proceeds—and higher untargeted social protection spending. Total spending is projected to grow by 10 percent, based on a 12 percent growth in current spending and 4 percent higher capital spending. Social protection spending will exceed the budgeted amount; as payments for war veterans are likely to be higher than planned because amendments to the law to contain the costs were not implemented. Total revenues are expected to rise by 10.9 percent y-o-y, supported by higher economic growth and better collection of tax debt. VAT collection should grow by 11 percent; CIT by 6.7 percent; and PIT by 10.9 percent, excise revenues by 6.4 percent, while customs duties will slightly decrease. A slight underperformance in revenue, compared to the plan, is expected, which will however

⁵ Statistical discrepancy is distributed between consumption and investment, while contribution from inventories are included in investment.

be overcompensated with a significant under execution of capital investment plans. The overall fiscal balance according to the fiscal rule definition will be below the deficit ceiling of 2 percent of GDP, as it excludes PAK-financed (privatization proceeds) capital spending and the investment clause. By year end, public and publicly guaranteed debt is projected at 17.7 percent of GDP.

Credit growth continues to be robust because of high liquidity. As in 2018, better market conditions and lower interest rates led to higher private credit by end July. Corporate loans grew by 11 percent, particularly to such services as wholesale and trade and construction and 11.9 percent to manufacturing; loans to households continued to grow fast at 10.5 percent y-o-y at end July. The new loans to industry grew by 20 percent at end August. As July ended, NPLs remained low at 2.5 percent of total loans.

Consumer price inflation accelerated early in the year but eased to 2.7 percent y-o-y by August. The main cause was rising food prices, followed by a rise in the prices of alcoholic drinks and tobacco. The increase in import prices helped to push consumer price inflation, with an average y-o-y increase of 4.5 percent in Q1. Tariffs imposed on goods imports from Serbia and Bosnia and Herzegovina may have contributed to the rise in consumer price inflation.

The current account deficit (CAD) is expected at 8.7 percent in 2019. Travel services, net FDI (foreign direct investment) and remittances continue to finance the trade deficit. Net FDI rose by 50 percent y-o-y in the first half (H1) of 2019. However, most FDI continued to go to real estate (83 percent), which will not

contribute to GDP beyond the construction period; the second prime destination for FDI was construction (12 percent).⁶ The main origin of FDI was Germany, Switzerland, and the United States. Net remittances also grew by 8.1 percent in H1 compared to the same period last year. By July 2019 goods exports had grown by 10.5 percent y-o-y and net service exports by 17.3 percent, mainly driven by travel services to Kosovo's diaspora. Imports of goods also grew strongly at 4.9 percent y-o-y.

Outlook and Risks

In the medium-term economic growth in Kosovo is projected at about 4.2 percent, propelled by higher capital spending and consumption. Several large public investment projects are expected to advance, notably railway and regional road projects financed by international financial institutions (IFIs). In 2020 higher public wages, remittances, and consumer lending are expected to support higher consumption. Private investment is expected to increase, driven by favorable lending conditions and by FDI in energy and real estate. However, given the large number of new entrants into the labor market, higher public spending alone will not be sufficient to significantly reduce the chronically high unemployment.

The positive outlook is vulnerable to domestic political uncertainty, lower than projected IFI-financed public investment, lower base metal prices than projected, slower growth in the EU, and higher global uncertainty. Moreover, the expansion of public investment—the main driver of medium-term

⁶ The data on BoP is based on the data available at the time of the preparation of the reports, as of September 30, 2019.

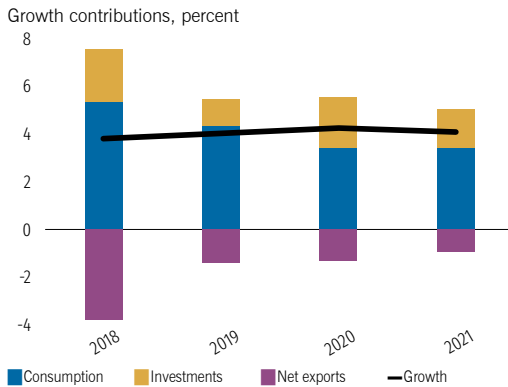
growth—may be limited by inadequate capacity to carry out the investment program which can result in the under-execution of spending.

Headline fiscal policy is expected to be sustainable as long as fiscal risks are contained.

The new law on public salaries, if not regulated through prudent secondary legislation, could result in higher deficits, a breach of the fiscal rule on public wage growth, and a deterioration in the composition of public spending. Similarly, if public employment is not contained through the 2020 could result in further increases in compensation of public employees. Because the law on public wages comes into force only at the end of 2019, the full impact will not be felt until 2020. Higher public sector wages can also put pressure on private sector wages, which could undermine the competitiveness of Kosovar exporters. Additional fiscal risks might arise from higher untargeted social protection spending, unproductive capital spending, and potentially lower performance of publicly owned enterprises

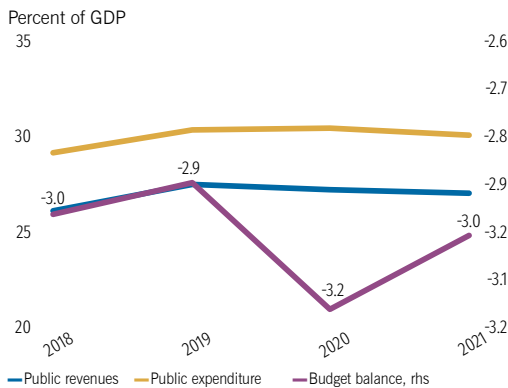
To counterbalance the risks, reforms should be directed to improving the quality of fiscal spending and stability; better targeting of social protection programs; investing more in education and health to realize the benefits of the demographic dividend and improve skills; engaging and employing youth and women by reducing disincentives to their participation in the labor market; heightening productivity by addressing the regulatory burden on businesses and improving the judicial system; addressing corruption; and building up environmental sustainability.

Consumption is expected to be the main driver of growth in 2019.



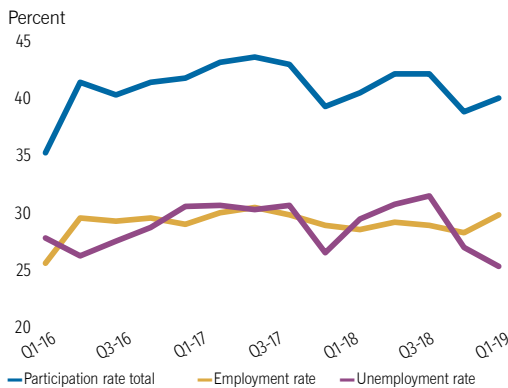
Source: Statistics Agency of Kosovo and World Bank.

Higher public investment through IFI and privatization proceeds-financed projects, and transfers will raise budget deficits.



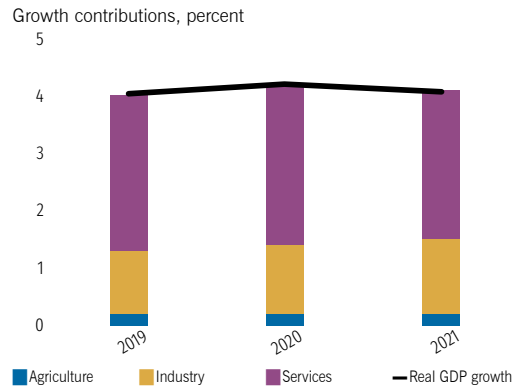
Source: Ministry of Finance and World Bank.

Labor force participation continues to be low.



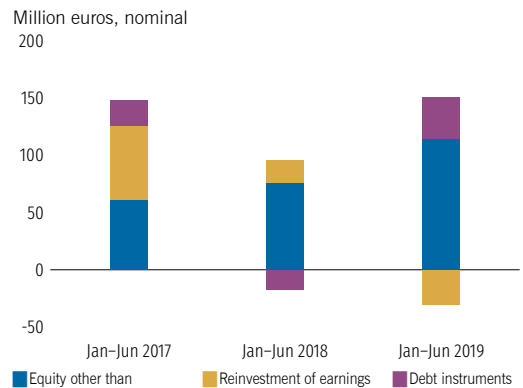
Source: Statistics Agency of Kosovo, LFS.

Services should continue to be a major contributor to growth on the production side in 2019, and beyond.



Source: Statistics Agency of Kosovo and World Bank.

Net FDI increased in the first half of 2019, in comparison to the same period last year especially in real estate and construction.



Source: Central Bank and World Bank.

Consumer price inflation went up in the first half but is now slowing.



Source: Central Bank.

| KOSOVO | 2014 | 2015 | 2016 | 2017 | 2018 | 2019e | 2020f | 2021f |
|---|-------------|-------------|-------------|-------------|-------------|--------------|--------------|--------------|
| Real GDP growth (percent) | 1.2 | 4.1 | 4.1 | 4.2 | 3.8 | 4.0 | 4.2 | 4.1 |
| Composition (percentage points): | | | | | | | | |
| Consumption | 3.8 | 2.5 | 4.7 | 1.5 | 5.7 | 3.8 | 5.0 | 4.6 |
| Investment | -1.4 | 2.9 | 2.1 | 1.5 | 2.1 | 1.1 | 2.1 | 1.6 |
| Net exports | -1.2 | -1.3 | -2.7 | 1.2 | -3.8 | -1.4 | -1.3 | -0.9 |
| Exports | 2.9 | 0.5 | 0.5 | 4.0 | 1.0 | 1.1 | 1.1 | 1.5 |
| Imports (-) | 4.1 | 1.8 | 3.2 | 2.8 | 4.8 | 2.5 | 2.5 | 2.4 |
| Consumer price inflation (percent, period average) | 0.4 | -0.5 | 0.3 | 1.5 | 1.1 | 2.8 | 1.8 | 1.5 |
| Public revenues (percent of GDP) | 24.0 | 25.1 | 26.3 | 26.4 | 26.1 | 27.4 | 27.2 | 27.0 |
| Public expenditures (percent of GDP) | 26.6 | 27.1 | 27.7 | 27.6 | 29.1 | 30.3 | 30.4 | 30.0 |
| Of which: | | | | | | | | |
| Wage bill (percent of GDP) | 8.7 | 9.0 | 9.0 | 8.6 | 8.8 | 8.7 | 8.7 | 8.7 |
| Social benefits (percent of GDP) | 5.0 | 5.4 | 6.1 | 6.1 | 6.2 | 6.4 | 6.2 | 6.3 |
| Capital expenditures (percent of GDP) | 7.4 | 7.0 | 7.2 | 7.3 | 7.9 | 7.8 | 8.4 | 8.6 |
| Fiscal balance (percent of GDP) | -2.6 | -2.0 | -1.4 | -1.2 | -3.0 | -2.9 | -3.2 | -3.0 |
| Primary fiscal balance (percent of GDP) | -2.4 | -1.7 | -1.1 | -0.9 | -2.7 | -2.5 | -2.9 | -2.7 |
| Public debt (percent of GDP) | 10.4 | 12.7 | 14.1 | 15.6 | 16.3 | 17.1 | 17.2 | 18.8 |
| Public and publicly guaranteed debt (percent of GDP) | 10.6 | 12.8 | 14.4 | 16.3 | 16.9 | 17.7 | 17.7 | 19.3 |
| Of which: External (percent of GDP) | 5.8 | 6.2 | 6.2 | 6.6 | 6.2 | 6.1 | 6.0 | 6.1 |
| Goods exports (percent of GDP) | 5.8 | 5.6 | 5.1 | 5.9 | 5.6 | 5.2 | 5.4 | 5.4 |
| Goods imports (percent of GDP) | 42.8 | 41.9 | 42.8 | 44.3 | 46.2 | 44.9 | 44.7 | 43.9 |
| Net services exports (percent of GDP) | 8.3 | 7.9 | 10.5 | 12.4 | 11.6 | 11.2 | 11.6 | 11.7 |
| Trade balance (percent of GDP) | -28.7 | -28.5 | -27.2 | -26.1 | -29.0 | -28.6 | -27.8 | -26.8 |
| Remittance inflows (percent of GDP) | 11.2 | 11.5 | 11.4 | 11.8 | 10.7 | 10.2 | 9.9 | 9.9 |
| Current account balance (percent of GDP) | -6.9 | -8.6 | -7.9 | -6.0 | -8.0 | -8.7 | -8.3 | -7.4 |
| Net foreign direct investment inflows (percent of GDP) | 2.2 | 4.7 | 2.9 | 3.4 | 2.8 | 3.8 | 4.1 | 4.2 |
| External debt (percent of GDP) | 31.2 | 33.3 | 33.2 | 32.6 | 33.7 | 33.8 | 34.5 | 34.2 |
| Real private credit growth (percent, period average) | 3.3 | 7.8 | 8.7 | 8.8 | 10.1 | n.a. | n.a. | n.a. |
| Nonperforming loans (percent of gross loans, end of period) | 8.5 | 6.2 | 4.9 | 3.1 | 2.7 | n.a. | n.a. | n.a. |
| Unemployment rate (percent, period average) | 35.3 | 32.9 | 27.5 | 30.5 | 29.5 | n.a. | n.a. | .. |
| Youth unemployment rate (percent, period average) | 61.0 | 57.7 | 52.4 | 52.7 | 55.3 | n.a. | n.a. | n.a. |
| Labor force participation rate (percent, period average) | 41.6 | 37.6 | 38.7 | 42.8 | 40.9 | n.a. | n.a. | n.a. |
| GDP per capita (US\$) | 4,055 | 3,745 | 3,692 | 3,818 | 4,312 | 4,377 | 4,667 | 4,934 |
| Poverty rate at US\$5/day, PPP (percent of population) | 25.3 | 21.4 | 20.37 | 21.6 | 19.8 | 18.0 | 16.4 | 15.3 |

Sources: Country authorities, World Bank estimates and projections. Data on BOP payments if of September 30, 2019.

Montenegro

- After reaching 4.9 percent in 2018, the highest rate in 10 years, growth is expected to moderate in the near term as a large public investment cycle phases out.⁷
- Labor market developments remain positive, with employment rising and poverty declining.
- Fiscal consolidation reduced the budget deficit but current spending was higher than planned.
- Accelerating structural reforms and maintaining a prudent approach to public spending is critical because of limited fiscal space and rising global uncertainties.

Recent Economic Developments

Growth is expected to moderate as investment levels off. After reaching 4.9 percent in 2018, the fastest rate in a decade, for 2019 economic growth is estimated at 3 percent. Growth slowed in the first quarter because of less investment and a decline in industrial production. It is projected, however, that private consumption—supported by favorable labor market developments, increased lending, and booming tourism—will add 2.9 percentage points (pp) to economic growth. After delays in public projects early in the year and a high base in 2018, investments are projected to contribute 1.9 pp to growth in 2019. Because those investments are import-dependent, the volume of imports is outpacing the solid growth of exports. As a result, in 2019 net exports are projected to subtract 1.8 pp from growth. Recent economic activity indicators are mixed: By June, retail trade had grown by 5.3 percent year-on-year (y-o-y) and tourist overnight stays were up 12.5 percent. However, industrial production shrank by 12.2 percent as unfavorable hydrological conditions early in the year impeded energy production. Manufacturing growth also declined by 3.5 percent, led by a contraction

in production of metal and mineral goods. In the first six months, recent construction growth decelerated somewhat, to 12.3 percent y-o-y, the lowest since March 2016.

Employment is again rising steadily. Supported by buoyant economic activity, the positive trend in employment growth continued, mostly in construction, tourism, and other services. The survey-based unemployment rate declined from 14.4 percent in Q2 2018 to 14.3 percent in Q2 2019; it is projected to average 14.9 percent for the year. Youth unemployment fell from 23.9 percent in Q2 2018 to a historic low of 20.7 percent in Q1 2019. There were also record highs in the survey-based participation rate of 57.8 percent and the employment rate of 49.5 percent. Yet long-term unemployment is still high: 79 percent of unemployed workers have been job-hunting for more than a year. As of July 1, the government increased the net monthly minimum wage from €193 to €222. At the same time, the health contribution paid by employers was reduced from 4.3 to 2.3 percent to prevent a rise in unit labor costs and thus a potential adverse effect on employment. To avoid employment losses, any further increase in the minimum wage should be aligned with increases in labor productivity.

⁷ When this report was sent to print, the Statistical office of Montenegro published the final 2018 National Account data, according to which the rate of real GDP growth was 5.1 percent.

Inflation eased in the first half. Consumer price inflation was just 0.5 percent, driven by declining prices for clothing, transportation, alcohol, and tobacco, though producer prices rose by 2.4 percent, mainly driven by higher prices for coal and mineral goods manufactures. Consumer price inflation is projected to be 1 percent for the full year. In the first six months, nominal wages increased by 0.6 percent, but real wages were flat.

The current account deficit (CAD) is projected to hit 17.4 percent in 2019. Solid growth of exports in the first half was led by tourism and transport services, but merchandise exports stalled because of lower aluminum and electricity exports. Import growth was somewhat lower, driven by electricity, minerals, and medical products; but since import volume is double export volume, the trade deficit increased. Income accounts moderated due to interest and dividend payments. Net FDI picked up to 8.3 percent of GDP, financing about half of the CAD, the rest being covered by portfolio investment and by loans. By June, foreign exchange reserves had slipped to €0.8 billion, covering 3.9 months of merchandise imports.

Since two banks were liquidated, the financial sector has been resilient. In the first half of 2019, deposits fell by 2.7 percent y-o-y while credits grew by 0.6 percent, driven by 8.9 percent growth in lending to households. Liquidity is ample—the loan-to-deposit ratio is 90 percent. Continued credit growth helped to reduce non-performing loans to 5.3 percent of total loans. The June average capital adequacy ratio of 19.5 percent exceeded the regulatory minimum. The banking sector is moderately profitable, but profits are unevenly distributed among banks.

Despite strong revenue growth, high current spending resulted in a higher-than-planned fiscal deficit. By June recent economic activity and higher tax compliance supported 8 percent growth in central government revenues, and under-execution of capital spending by 50 percent, also helped cut the deficit. Nevertheless, current spending rose because of a 4 percent y-o-y increase in spending on wages, in part due to a delay in reform of the public administration, and a 12 percent increase in transfers, primarily for spending on health. High current spending delays the goal of balancing the budget.

The government is actively managing public debt, but liabilities remain high. Over the next two years debt amounting to €800 million is coming due. In September, the government issued a Eurobond of €500 million with an interest rate of 2.55 percent and a ten-year maturity. The record-low interest rate and a record-long maturity are the results of fiscal consolidation efforts undertaken, but also of the current favorable market conditions. Nevertheless, in the view of increasingly uncertain environment, the government must remain committed to fiscal consolidation and avoid any policy reversal. The government plans to use the 2019 Eurobond proceedings to cover its financing needs for 2020, which includes repayment of Eurobonds due in March. The Eurobonds will push public debt to an estimated 78.6 percent and public and publicly guaranteed (PPG) debt to an estimated 83 percent by year-end.

Outlook and Risks

The outlook is positive, but the uncertainty of the external environment is a major risk.

The economy is expected to average 2.8 percent growth through 2021. The phasing-out of the investment cycle that has driven growth for three years is likely to continue to slow growth somewhat, to 2.8 percent in 2020 and 2.7 percent in 2021. Completion of large public infrastructure projects should reduce the CAD and the fiscal deficit, which is expected to turn to surplus in 2021. Thus in 2021 public debt is forecasted to decline to 62.3 percent of GDP and PPG debt to 66.6 percent. Private investment is expected to remain high, mostly driven by energy and tourism, but investment sentiment could be affected by falling business confidence and uncertainties in external markets. Unless there is a faster slowdown in EU demand, exports are expected to strengthen due to new energy and tourism capacities. An unexpectedly strong global slowdown and the associated uncertainties would weigh on growth and could limit the scope for robust improvements in the labor market and welfare.

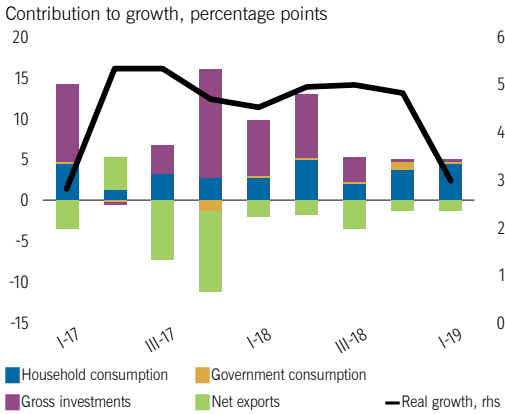
The domestic risks are mixed. Construction of the remaining phases of the Bar-Boljare highway within the forecast period would support growth but could also compromise fiscal consolidation. Financing through public-private partnerships, for example, can carry high contingent liabilities, which would push up PPG debt and narrow the fiscal space. Delay in optimizing the public administration could further undermine fiscal consolidation. However, completion of the airport concessions within the forecast period would result in additional one-time revenues, as would the

launch of the economic citizenship program.⁸ Other financial sector vulnerabilities stem from ailing second-tier banks.

A firm commitment to structural reforms is critical. With global prospects uncertain and fiscal buffers limited, it is imperative for Montenegro to remain fully committed to fiscal consolidation, improvement in governance, and acceleration of structural reforms. In this context, it is necessary to increase the efficiency of public spending, especially in administration, health, and infrastructure. This necessitates resolving the unsustainability of the operations of Montenegro Airlines, which has been granted significant state aid; in 2018, its accumulated losses reached €90 million, exceeding its capital. At the same time, fighting corruption and reinforcing the state institutions that protect the rule of law and private sector competition would help unlock stronger, more equitable, and more sustainable growth, ensuring faster convergence with EU income levels.

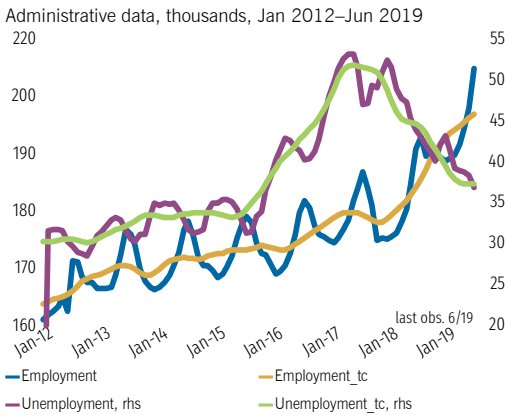
⁸ Since the airport concession agreement and the economic citizenship program are surrounded by uncertainty, these are considered an upside risk and are not included in the projections.

Growth slowed in the first quarter of 2019...



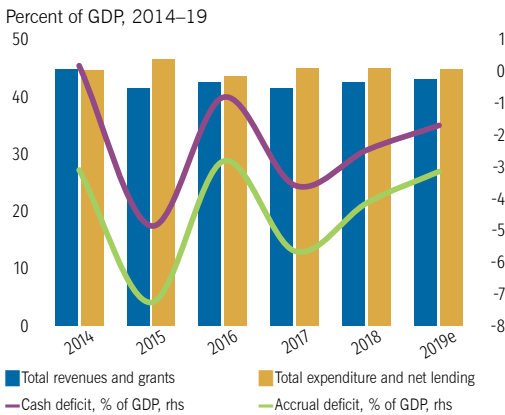
Source: MONSTAT data, World Bank staff calculations.

Employment growth remained strong...



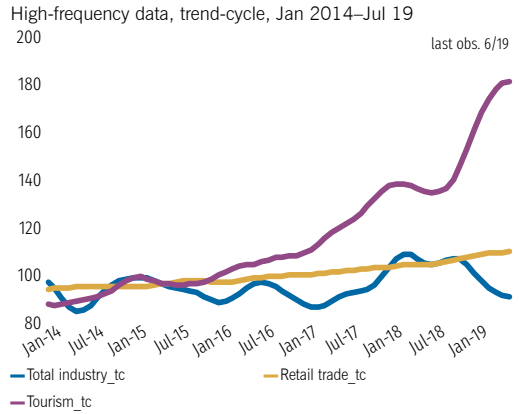
Source: MONSTAT data, tc = trend cycle.

In 2019 the fiscal deficit is projected to be more than 3 percent of GDP in 2019...



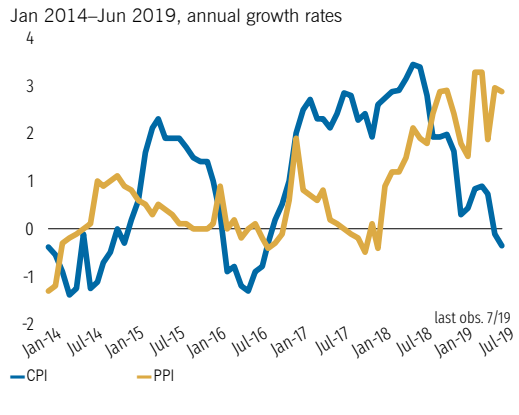
Source: MoF and MONSTAT data.

...partly driven by base effect and a decline in industrial production.



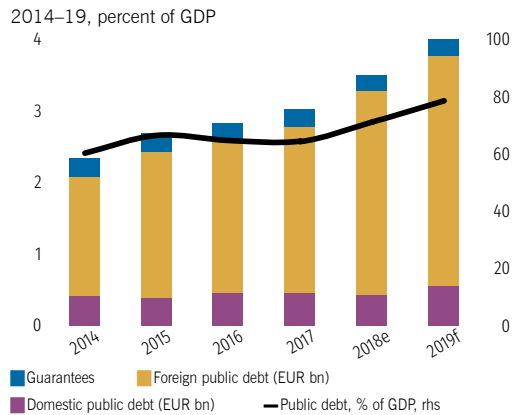
Source: MONSTAT. Tc = Trend cycle.

...and inflationary pressures eased.



Source: MONSTAT data.

...with public debt estimated at about 78 percent of GDP.



Source: MoF, CBCG, and MONSTAT data.

| MONTENEGRO | 2014 | 2015 | 2016 | 2017 | 2018 | 2019e | 2020f | 2021f |
|---|-------------|-------------|-------------|-------------|-------------|--------------|--------------|--------------|
| Real GDP growth (percent) | 1.8 | 3.4 | 2.9 | 4.7 | 4.9 | 3.0 | 2.8 | 2.7 |
| Composition (percentage points): | | | | | | | | |
| Consumption | 2.7 | 2.3 | 4.8 | 3.2 | 4.4 | 2.9 | 2.4 | 2.5 |
| Investment | 0.6 | 1.7 | 7.2 | 8.0 | 4.2 | 1.9 | -0.4 | -2.0 |
| Net exports | -1.6 | -0.6 | -9.1 | -6.5 | -3.7 | -1.8 | 0.7 | 2.2 |
| Exports | -0.4 | 2.8 | 2.9 | 0.9 | 4.7 | 2.2 | 2.0 | 2.1 |
| Imports (-) | 1.2 | 3.4 | 12.0 | 7.4 | 8.4 | 4.0 | 1.3 | -0.1 |
| Consumer price inflation (percent, period average) | -0.7 | 1.5 | -0.3 | 2.4 | 2.6 | 1.0 | 1.6 | 1.8 |
| Public revenues (percent of GDP) | 44.6 | 41.5 | 42.5 | 41.4 | 42.4 | 43.0 | 42.5 | 41.3 |
| Public expenditures (percent of GDP) | 47.7 | 48.8 | 45.3 | 47.0 | 46.5 | 46.2 | 43.5 | 39.8 |
| Of which: | | | | | | | | |
| Wage bill (percent of GDP) | 12.7 | 12.3 | 12.2 | 11.8 | 11.3 | 11.3 | 10.8 | 10.4 |
| Social benefits (percent of GDP) | 14.2 | 13.3 | 14.1 | 12.5 | 11.8 | 11.6 | 11.4 | 11.2 |
| Capital expenditures (percent of GDP) | 5.3 | 8.1 | 3.7 | 7.8 | 8.6 | 8.5 | 6.8 | 4.4 |
| Fiscal balance (percent of GDP) | -3.1 | -7.3 | -2.8 | -5.7 | -4.1 | -3.2 | -1.0 | 1.5 |
| Primary fiscal balance (percent of GDP) | -0.8 | -4.9 | -0.7 | -3.3 | -1.9 | -1.1 | 1.1 | 3.5 |
| Public debt (percent of GDP) | 59.9 | 66.2 | 64.4 | 64.2 | 70.8 | 78.6 | 71.2 | 62.3 |
| Public and publicly guaranteed debt (percent of GDP) | 67.1 | 73.7 | 71.4 | 70.0 | 75.7 | 83.3 | 75.7 | 66.6 |
| Of which: External (percent of GDP) | 47.0 | 54.9 | 59.5 | 58.8 | 66.1 | 71.5 | 66.3 | 57.6 |
| Goods exports (percent of GDP) | 10.3 | 9.1 | 8.9 | 8.9 | 9.4 | 9.3 | 9.5 | 9.8 |
| Goods imports (percent of GDP) | 50.1 | 49.5 | 50.8 | 52.2 | 53.8 | 54.5 | 52.5 | 49.0 |
| Net services exports (percent of GDP) | 20.0 | 21.8 | 19.4 | 19.8 | 20.3 | 20.5 | 21.1 | 20.6 |
| Trade and services balance (percent of GDP) | -19.8 | -18.6 | -22.5 | -23.5 | -24.1 | -24.7 | -21.9 | -18.6 |
| Remittance inflows (percent of GDP) | 4.7 | 4.4 | 4.0 | 3.9 | 4.1 | 4.1 | 4.0 | 3.9 |
| Current account balance (percent of GDP) | -12.4 | -11.1 | -16.2 | -16.1 | -17.2 | -17.4 | -15.3 | -11.9 |
| Net foreign direct investment inflows (percent of GDP) | 10.2 | 17.1 | 9.4 | 11.3 | 7.0 | 8.0 | 8.0 | 8.0 |
| External debt (percent of GDP) | 162.9 | 169.4 | 162.6 | 160.6 | 164.4 | 180.0 | 178.5 | 175.6 |
| Real private credit growth (percent, period average) | -1.5 | 0.3 | 3.5 | 4.4 | 5.9 | n.a. | n.a. | n.a. |
| Nonperforming loans (percent of gross loans, end of period) | 16.8 | 13.4 | 11.1 | 8.0 | 7.7 | n.a. | n.a. | n.a. |
| Unemployment rate (percent, period average) | 18.0 | 17.6 | 17.7 | 16.1 | 15.2 | 14.9 | 14.7 | 14.8 |
| Youth unemployment rate (percent, period average) | 35.8 | 37.6 | 35.9 | 31.7 | 29.4 | n.a. | n.a. | n.a. |
| Labor force participation rate (percent, period average) | 52.7 | 53.7 | 54.5 | 54.7 | 56.0 | n.a. | n.a. | n.a. |
| GDP per capita, PPP (current international \$) | 15,371 | 16,337 | 17,867 | 19,355 | 21,071 | 21,914 | 23,015 | 24,010 |
| Poverty rate at US\$5.5/day, PPP (percent of population) | 4.8 | 4.6 | 4.2 | 4.4 | 4.7 | 4.5 | 4.3 | 4.2 |

Sources: Country authorities, World Bank estimates and projections.

Note: Nonperforming loans show year-to-date actuals (including interest and accruals).

North Macedonia

- Growth is firming up in 2019 and is projected to reach 3.1 percent by year-end, driven by rising investments and consumption.
- Unemployment fell to a historic low and wage pressure continues, which may affect the competitiveness of the economy as unit labor costs rise.
- Public debt and the fiscal deficit widened in 2019 as current spending increased due to rising wages, pensions, and subsidies amid moderate growth in revenues.
- Staying on course with structural reforms that reignite competitiveness, improve governance, and public sector performance will help accelerate the process of income convergence with the EU.

Recent Economic Developments

Growth is firming up in 2019. Economic growth strengthened in the first half of 2019 to 3.6 percent, its fastest rate since 2016. Wholesale and retail trade were the main driver of growth, accounting for 1.5 pp. Agriculture contributed 0.5 pp contributions, while industry contributed 0.4 pp despite a slowdown in manufacturing, evident in Q2 2019. Construction also added 0.1 pp, but this is expected to be temporary as surveys for the sector point to positive expectations from companies in terms of contracts, prices and employment. On the demand side, the main contributors to growth in the first half of 2019 were investment and private consumption, the latter spurred by rising wages, pensions, and household lending. Net exports subtracted from growth for the second consecutive quarter: rising exports were not enough to compensate for the growing imports of intermediate, capital, and consumer goods. While private consumption is expected to moderate by year-end, investments will strengthen, partly due to acceleration of public investments. However, net exports are expected to continue subtracting from growth because rising exports will not be enough to compensate for a surge in imports, mainly capital and intermediary goods. Growth

for 2019 is expected to reach 3.1 percent, up from 2.7 percent in 2018.

The labor market has continued improving. Employment went up by 5.2 percent y-o-y in H1, after averaging 2.5 percent in 2018. Most of the new jobs were in manufacturing, transport and storage, administrative services and entertainment. The employment rate improved to 47 percent—up an annualized 2.3 pp. Unemployment fell to 17.7 percent in H1, a historic low, and the participation rate stayed at 57.1 percent. It is estimated that for 2019 as a whole, unemployment will decline to 19.4 percent.

Wage pressures again increased in 2019. By June real net wages were up over 2 percent y-o-y, partly because the minimum wage increased in both July 2018 and April 2019, and some public servants were given a raise in early 2019. The highest wage increases were in health, education, and social protection, transport, construction, and agriculture. The continued trend of wage growth, particularly in labor-intensive industries, coupled with a decline in labor productivity in most sectors, is jeopardizing the competitiveness of the economy as the unit cost of labor goes up. Using the US\$5.5/day (2011 PPP) poverty

line, it is projected that poverty is falling below 21 percent for 2019, continuing a decreasing trend that began in 2009. Using the \$11/day (2005 PPP) line, the middle class increased from approximately 30 percent in 2009 to about 41 percent in 2015.

The external imbalance somewhat widened in 2019. The current account deficit (CAD) is expected to broaden to 0.7 percent of GDP, compared to 0.2 percent at year end 2018. In June, it stood at 1 percent of GDP (on a four-quarter rolling basis). The solid export performance of FDI-related industries like automobile parts and electrical machinery continued and is being supplemented by exports of iron and steel, largely because of favorable terms of trade, and furniture and tobacco product exports. Despite rising imports of intermediary and capital goods and of consumption goods, the trade deficit is expected to decline to less than 15 percent of GDP. The surplus in net services exports is expected to increase somewhat, to 3.5 percent of GDP, which with lower surpluses in transfers and income is expected to result in a slightly higher CAD. FDI in the first half of 2019 dropped as profits were repatriated but is expected to rebound in H2 to reach 3.2 percent of GDP for the full year. Gross foreign currency reserves will hold steady at above 4 months of imports. For the year, external debt is projected to rise above 78 percent of GDP in 2019, due to the rise in public external debt.

Credit continued its robust growth in 2019 with a rise in corporate lending. Overall, credit growth in July was 6.8 percent y-o-y, down from 7.3 percent at the end of 2018. Growth in household credit remained robust at 9.4 percent y-o-y, accounting for 60 percent of total growth in credit. Corporate, non-public,

credits also picked up by 4.4 percent, led by longer-term investment lending, indicating a pick-up in corporate activity. Despite credit growth, nonperforming loans (NPLs) by July decreased slightly to 4.7 percent, with corporate NPLs at 7.5 percent. At 10.1 percent deposits continued to rise y-o-y, resulting in a loan-to-deposit ratio of 82.5 percent. The survey of credit activity indicates a continued rise in lending, based on higher demand and easing of credit requirements.

Monetary policy was further relaxed. In early 2019, the central bank lowered the key interest rate by 25 bps, to a historic low of 2.25 percent, based on favorable developments in the foreign exchange market, moderate inflation, continued solid deposit growth, and a negative output gap. Inflation for the year is expected to average 1.6 percent y-o-y because of higher food prices.

Despite a rise in tax and contribution rates, the fiscal deficit widened in 2019. In H1 government revenues went up 6 percent y-o-y: higher rates for social contributions were introduced in January, the personal income tax higher statutory rate was introduced, while exemptions were reduced, and tobacco excises were increased. However, spending went up by 8.4 percent y-o-y due to rising pensions, wages, subsidies, and health spending. Capital spending, although rising, is still vastly under-executed. The revised General Government 2019 deficit is projected at 2.5 percent of GDP (the World Bank estimate stands at 2.4 percent), up from 1.1 percent in 2018; when combined with the deficit of the Public Enterprise for State Roads, the total deficit estimate is 2.7 percent. The budget revision led to a further increase in subsidies for social contribution payments to incentivize formalization of wages paid in cash;

subsidies to agriculture; and a 15-percent paid VAT refund to citizens, upon submission of tax receipts to strengthen tax compliance. Public and publicly guaranteed debt is expected to rise from 48.5 percent in 2018 to 51 percent, as government borrowing intensifies to meet coming obligations and guaranteed debt also goes up as public investment in roads accelerates.

Outlook and Risks

The outlook for the economy is moderately positive, with annual average growth predicted to be about 3.2 percent through 2021. Investment (e.g., public investment in the highway, and private investment in energy and tourism) will be the main driver of growth. It will be supported by personal consumption as employment picks up and wages continue to grow, propelled by a higher minimum wage that will mostly affect private sector employees. Net-exports are expected to subtract from growth as external demand weakens somewhat. This baseline scenario is accompanied by rising risks, in particular external, as there are increasing signs of a slowdown in the EU and the global economy, affected by the trade dispute between the US and China, the Brexit uncertainty, tensions between US and Iran, crises in emerging economies like Argentina etc.

Fiscal consolidation is expected to continue, even though more slowly due to new spending programs. The government has introduced two programs to fight informality, which is estimated at 30–40 percent of GDP, the annual cost of which is estimated at 0.8 percent of GDP. While these programs have been accommodated within the 2019 planned deficit

due to lower capital spending, for the medium term they should be offset with other spending or revenue measures to avoid increasing fiscal vulnerabilities. While these efforts are intended to tackle informality, which is a major drag on the economy, they are unlikely to be successful unless they are accompanied by strengthening of the tax administration, greater inspection efficiency, and improvements in the delivery of public services and in laws affecting the business environment.

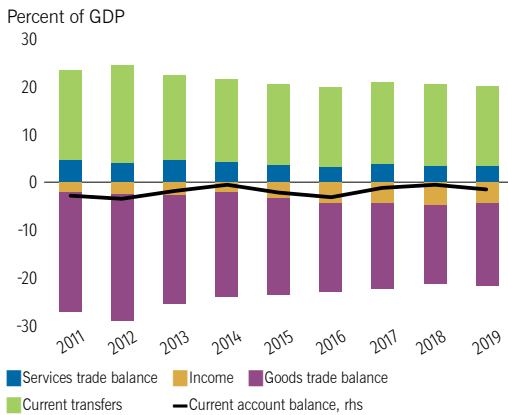
Although 2019 is a pre-election year, possible opening of EU accession negotiations requires that North Macedonia stay the course on structural reforms to reignite competitiveness, improve governance, and enhance public sector performance. Invigorating competition policy and rationalizing state aid would promote both growth and fiscal sustainability.

Economic growth accelerated in 2019...



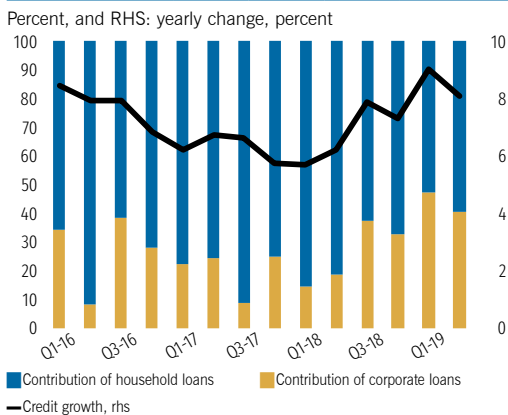
Source: State Statistics Office.

The external deficit widened but remained low.



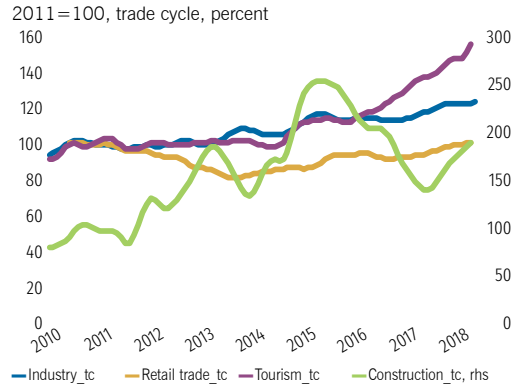
Source: National Bank.

Lending to corporations rose as monetary policy relaxed...



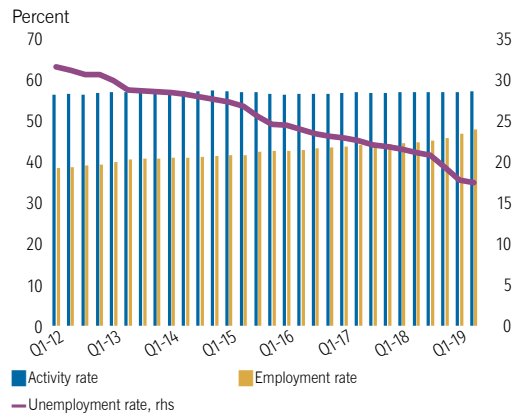
Source: National Bank.

...although with signs of moderation by mid-year.



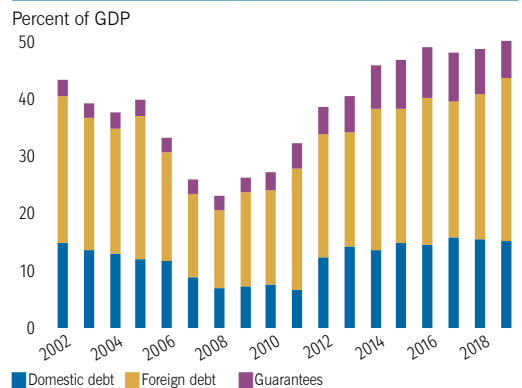
Source: State Statistics Office and World Bank calculations.

Solid growth reduced unemployment to a historic low.



Source: State Statistics Office.

...and public debt is projected to increase as the fiscal deficit widened.



Source: Ministry of Finance and World Bank estimates.

| NORTH MACEDONIA | 2014 | 2015 | 2016 | 2017 | 2018 | 2019e | 2020f | 2021f |
|--|-------------|-------------|-------------|-------------|-------------|--------------|--------------|--------------|
| Real GDP growth (percent) | 3.6 | 3.9 | 2.8 | 0.2 | 2.7 | 3.1 | 3.2 | 3.3 |
| Composition (percentage points): | | | | | | | | |
| Consumption | 2.1 | 3.5 | 2.0 | 0.1 | 3.2 | 2.0 | 1.9 | 1.8 |
| Investment | 2.8 | 2.9 | 3.9 | 0.7 | -2.2 | 1.2 | 1.5 | 1.7 |
| Net exports | -1.3 | -2.5 | -3.2 | -0.5 | 1.7 | -0.1 | -0.2 | -0.2 |
| Exports | 7.3 | 4.2 | 4.7 | 4.5 | 9.1 | 5.4 | 5.6 | 6.0 |
| Imports (-) | 8.6 | 6.7 | 7.9 | 5.0 | 7.4 | 5.5 | 5.8 | 6.2 |
| Consumer price inflation (percent, period average) | -0.2 | -0.3 | -0.2 | 1.3 | 1.4 | 1.6 | 1.8 | 2.0 |
| Public revenues (percent of GDP) | 29.7 | 31.0 | 30.6 | 31.0 | 30.4 | 32.0 | 32.0 | 32.0 |
| Public expenditures (percent of GDP) | 33.9 | 34.4 | 33.2 | 33.9 | 31.5 | 34.4 | 34.8 | 34.4 |
| Of which: | | | | | | | | |
| Wage bill (percent of GDP) | 7.0 | 7.0 | 6.8 | 6.6 | 6.3 | 6.5 | 6.4 | 6.1 |
| Social benefits (percent of GDP) | 14.9 | 14.8 | 15.0 | 15.4 | 15.2 | 15.6 | 15.7 | 15.4 |
| Capital expenditures (percent of GDP) | 4.2 | 4.2 | 3.8 | 4.2 | 2.5 | 3.5 | 4.0 | 4.1 |
| Fiscal balance (percent of GDP) | -4.2 | -3.4 | -2.7 | -2.7 | -1.1 | -2.4 | -2.8 | -2.4 |
| Overall Fiscal Balance with the Public Enterprise for State Roads* | -5.3 | -4.1 | -3.8 | -3.5 | -1.7 | -2.7 | -3.4 | -2.7 |
| Primary fiscal balance (percent of GDP) | -3.2 | -2.3 | -1.5 | -1.5 | 0.1 | -1.1 | -1.6 | -1.1 |
| Public debt (percent of GDP) | 38.1 | 38.1 | 39.9 | 39.5 | 40.5 | 43.4 | 44.5 | 43.8 |
| Public and publicly guaranteed debt (percent of GDP) | 45.8 | 46.6 | 48.8 | 47.8 | 48.5 | 51.1 | 52.4 | 52.2 |
| Of which: External (percent of GDP) | 32.1 | 31.6 | 34.2 | 32.0 | 32.9 | 35.1 | 36.6 | 34.9 |
| Goods exports (percent of GDP) | 25.7 | 26.8 | 35.1 | 38.1 | 43.2 | 41.6 | 45.4 | 47.3 |
| Goods imports (percent of GDP) | 42.9 | 42.9 | 53.1 | 54.9 | 58.6 | 56.1 | 60.8 | 62.3 |
| Net services exports (percent of GDP) | 4.5 | 3.8 | 3.5 | 3.8 | 3.3 | 3.5 | 3.8 | 4.1 |
| Trade balance (percent of GDP) | -12.7 | -12.2 | -14.5 | -13.0 | -12.1 | -11.0 | -11.6 | -10.9 |
| Remittance inflows (percent of GDP) | 2.4 | 2.3 | 2.0 | 1.9 | 1.9 | 1.9 | 1.9 | 1.9 |
| Current account balance (percent of GDP) | -0.5 | -2.0 | -2.9 | -1.0 | -0.3 | -0.7 | -1.2 | -1.0 |
| Net foreign direct investment inflows (percent of GDP) | 2.3 | 2.2 | 3.3 | 1.8 | 5.8 | 3.2 | 3.7 | 4.0 |
| External debt (percent of GDP) | 70.0 | 69.3 | 74.7 | 73.6 | 73.7 | 78.1 | 78.7 | 77.4 |
| Real private credit growth (percent, period average) | 8.6 | 9.5 | 4.3 | 1.2 | 5.1 | n.a. | n.a. | n.a. |
| Nonperforming loans (percent of gross loans, end of period) | 10.8 | 10.3 | 6.3 | 6.1 | 5.1 | n.a. | n.a. | n.a. |
| Unemployment rate (percent, period average) | 28.0 | 26.1 | 23.7 | 22.4 | 20.7 | 19.4 | 18.0 | 17.0 |
| Youth unemployment rate (percent, period average) | 53.1 | 47.3 | 48.2 | 46.7 | 45.4 | n.a. | n.a. | n.a. |
| Labor force participation rate (percent, period average) | 57.3 | 57.0 | 56.5 | 56.8 | 56.9 | n.a. | n.a. | n.a. |
| GDP per capita, PPP (current international \$) | 22,002 | 22,514 | 22,998 | 23,493 | 23,998 | 24,514 | 25,041 | 25,579 |
| Poverty rate at US\$5/day, PPP (percent of population) | 24.8 | 23.2 | 21.9 | 21.0 | 20.7 | 20.5 | 20.5 | 20.2 |

Sources: Country authorities, World Bank estimates and projections.

Note: Poverty rates are based on North Macedonia survey on income and living conditions (SILC).

Serbia

- Growth in 2019 is currently projected at 3.3 percent, lower than expected due to the unfavorable external situation.
- External imbalances are widening: The CAD is projected to reach 6.7 percent of GDP in 2019 as momentum softens in Serbia's main trading partners.
- A surplus of 0.3 percent of GDP in the general government budget in the first half of 2019 helped to reduce public debt and could lead to the projected deficit being revised to a small surplus.
- The recent slowdown of the economy could be exacerbated if external conditions for emerging markets tighten, EU growth slows, and local and regional political uncertainty worsens.

Recent Economic Developments

The Serbian economy expanded by 2.8 percent in the first half of 2019 (H1), which makes difficult to reach originally projected annual growth of 3.5 percent. Based on the latest estimates by the Statistics Office year-on-year (y/y) growth was below expectations at 2.7 percent in Q1 and 2.9 percent in Q2. As a result, the growth projection for the year has been lowered to 3.3 percent. Consumption and investment, though strong, will not be sufficient to compensate for an increasing negative contribution of net exports to growth, as exports slows down. Higher consumption, both public and private, is to a large extent being met by increased imports. In H1 imports of goods and services rose 12.2 percent (in euro terms), a development expected to continue till yearend. Investment has remained high, driven by general government investment, which rose by 31 percent in nominal terms. This year's lower-than-expected growth to date is mainly a result of export growth slowing as economic activity moderated in Serbia's major trading partners, particularly Italy and to some extent in Germany.

The performance of industry was disappointing, and early indicators also suggest a modest agricultural season.

Industrial output fell by 2 percent in H1—manufacturing alone saw output fall by 2.8 percent. The decrease in industrial output was broad-based, occurring in 17 of 29 sectors. As for agriculture, production of wheat could be down around 14 percent from last year, as well as of fruit: in H1 production of raspberries and cherries was significantly smaller. On the other hand, production of corn and other important products turned out to be better than previously expected. It is now estimated that agriculture would have a zero contribution to growth in 2019 (unlike previously projected negative contribution). In addition, services have been performing briskly. Retail trade turnover was 8.5 percent higher in real terms in H1 than a year earlier. Tourism saw a 4.3 percent rise in arrivals, and transport of goods went up 3.3 percent,⁹ primarily because more goods travelled by road.

Labor market improvement continues, but more slowly. According to Labor Force Survey data, in H1 unemployment again fell, to an estimated 11.2 percent. Official data (based

⁹ The first quarter data.

on the Central Registry of Mandatory Social Insurance and National Employment Services registries) confirm improvements in the labor market. Thus, registered employment rose by 2.4 percent in H1 (y/y) and average wages also went up, in nominal terms by 9.9 percent and in real terms by 7.2 percent.¹⁰ Wage growth was higher in the private sector (10.7 percent) than in the public sector (9.5 percent), but the public sector wage premium remains: In H1 the average net wage in the public sector was 60,839 dinars, but just 51,145 dinars in the private sector.

The consolidated general government budget showed a surplus of 0.3 percent of GDP in H1, y/y. Total revenues went up by 7.6 percent in nominal terms. The main sources of higher public revenues were VAT and social contributions. VAT revenues were up by 8.9 percent in nominal terms primarily because of higher collection of VAT from imports, which went up significantly in 2019. Social security contributions rose by 8.1 percent because of the wage increase and the move to more formal employment. Budgetary spending rose by 9.6 percent in nominal terms, equal to 1.7 percent of annual GDP. The main drivers of higher spending were social transfers (including pensions), up by 6.6 percent; capital investments, up 30.7 percent; and the wage bill, up 8.3 percent. The fiscal surplus reached 0.3 percent of annual GDP—half what it was in the same period of 2018. Throughout H1, the surplus and GDP growth helped to keep public and publicly guaranteed debt broadly stable at around 54 percent of GDP.¹¹

¹⁰ Data available through May only.

¹¹ Total public debt includes nonguaranteed debt of local governments.

Inflation has been declining in recent months, after peaking in April at 3.1 percent y/y. The main driver of inflation in H1 was food prices, which peaked in April at 6.1 percent y/y. With inflationary pressures low and the inflation outlook stable, to boost growth NBS, the central bank, lowered its policy rate to 2.75 percent in July and to 2.5 percent in August—its lowest level since inflation targeting was introduced. In 2019, the dinar continued to appreciate gradually. In nominal terms, since 2018 it has appreciated by 0.4 percent against the euro.¹² To smooth excessive short-term exchange rate volatility, the NBS intervenes regularly in the foreign exchange market. So far this year it has been a net purchaser of foreign currency, buying EUR 1.6 billion, which by August helped to bring Serbia's foreign currency reserves to a record high of EUR 13.1 billion, up EUR 1.8 billion since December 2018. Reserves currently cover about six months of imports.

Credit activity continues to be strong, but its structure is somewhat unfavorable. Overall, through July credit grew by 6.9 percent y/y, primarily because of loans to businesses (up 10.3 percent y/y). While loans to private businesses were up by (a still strong) 8.4 percent, loans to state-owned enterprises (SOEs) increased by 32.8 percent, although from a low base. Loans to households also continued to rise. Many household loans are short-term “cash” loans to individuals; the stock of those loans is 15.8 percent higher in euro terms than a year ago. Another factor raising questions about loan portfolio structure is that loans to private enterprises were just 4 percent higher than loans to households. Finally, 47 percent of the new loans were for liquidity purposes (current assets) and only 35 percent for investment.

¹² Data as of end-August.

Moreover, in H1 local banks provided no loans for export purposes. And 61.5 percent of the new loans went to SMEs.

The banking system is performing well.

Gross nonperforming loans (NPLs) declined considerably, to 5.2 percent in June.¹³ The NPLs of households were even lower at 4.4 percent. NPLs total about EUR 1 billion, of which about EUR 400 million is owed by active businesses and EUR 200 million by enterprises now in bankruptcy proceedings. The value of household NPLs is about EUR 400 million. NPLs are expected to continue to decline over the medium term, although not as fast as in the past two years.

The current account deficit (CAD) went up considerably in 2019.

In euro terms, in H1 the CAD expanded by 51 percent y/y. Most of the rise is explained by the widening of the trade deficit by 16 percent. Exports of goods rose by 8.5 percent, but imports went up by 10.2 percent, and from a much higher base. The surplus in trade in services was lower by 2.4 percent. Net primary income is down by 2.5 percent, y/y, and net secondary income by 7.4 percent, to a large extent because remittances were 4.3 percent lower. Therefore, the projection for the 2019 CAD has risen to 6.7 percent of GDP. Still, the inflow of FDI is strong (€1.8 billion in H1, up 28 percent, y/y), and more than sufficient to finance the CAD. Total external debt has begun to go up in nominal terms, reaching EUR 27.1 billion in Q1, but is declining as a share of GDP, by April reaching an estimated 62.5 percent.¹⁴

Outlook and Risks

Growth of the Serbian economy in 2019 is expected to be slightly lower than previously projected but over the medium term to recover to about 4 percent.

Economic activity is projected to grow by 3.3 percent because external developments are less favorable. Also, a shift to consumption-led growth has pushed up imports, which coupled with lower exports due to economic downturns in major trading partners (Italy in particular) means that the negative contribution to growth of net exports will be higher. Most recently, the announced increase in public sector wages¹⁵, might even more contribute to this unfavorable shift in drivers of growth. In addition, this policy measure will certainly make the effort of keeping fiscal balance unchanged much more difficult and will increase the deficit. Return to more robust growth rates is expected only over the medium-term.

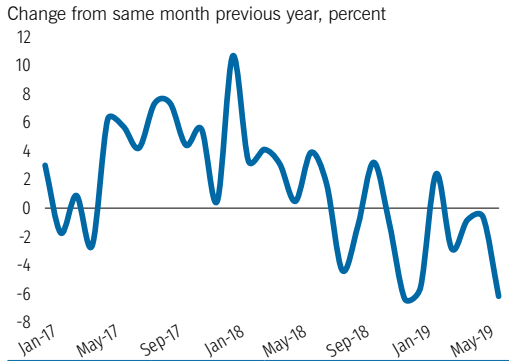
The medium-term growth projections depend heavily on the speed of structural reform.

Serbia has a large unreformed public sector with severe SOE inefficiencies. Also, legal and institutional bottlenecks still prevent faster development of the private sector and discourage higher investment, both foreign and domestic. Among the needed reforms are upgrading regulation of the financial sector as it relates to international capital and financial transactions, leasing and fintech; providing support to SMEs to innovate and integrate into international value chains; relieving cumbersome and nontransparent taxation of SMEs; and trade facilitation, especially border controls. For the short term the main downside risk relates to election campaign and how quickly a new government is formed.

¹³ Preliminary figures.
¹⁴ The latest available data.

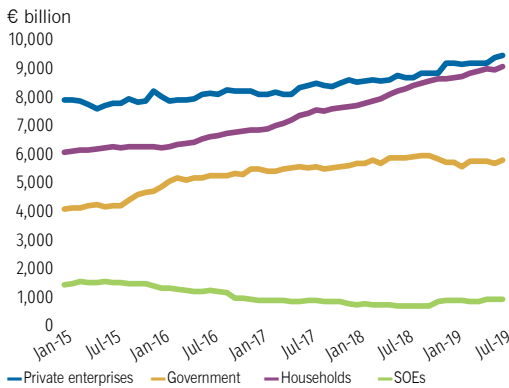
¹⁵ As announced in September 2019.

Growth has begun to slow, as indicated by industrial activity.



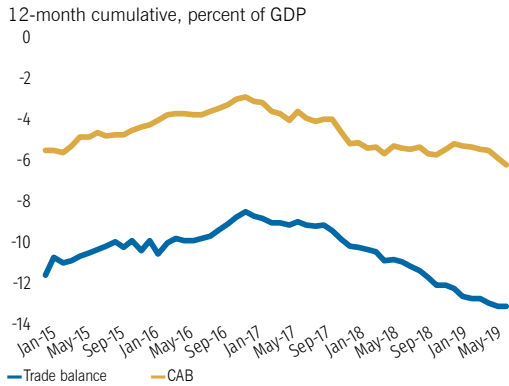
Source: Statistics Office of Serbia.

Credit recovered, mainly because loans to households increased.



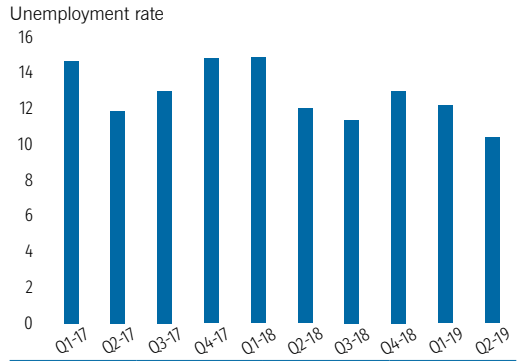
Source: National Bank of Serbia.

The CAD is widening rapidly.



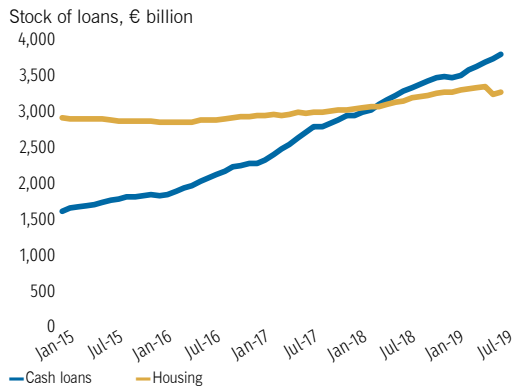
Source: National Bank of Serbia.

However, the labor market has improved.



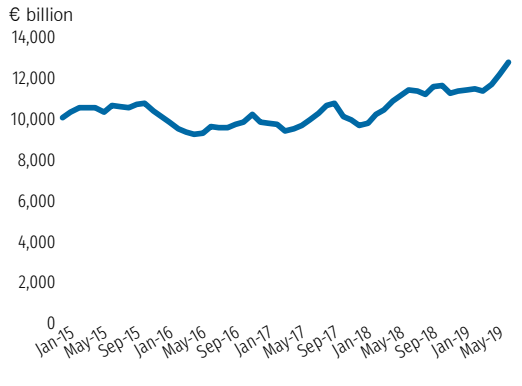
Source: Statistics Office of Serbia.

However, short-term loans may be rising too fast.



Source: National Bank of Serbia.

High FDI fully covers the CAD and is helping to push up reserves.



Source: National Bank of Serbia.

| SERBIA | 2014 | 2015 | 2016 | 2017 | 2018 | 2019e | 2020f | 2021f |
|---|-------------|-------------|-------------|-------------|-------------|--------------|--------------|--------------|
| Real GDP growth (percent) | -1.6 | 1.8 | 3.3 | 2.0 | 4.2 | 3.3 | 3.9 | 4.0 |
| Composition (percentage points): | | | | | | | | |
| Consumption | 0.1 | -1.0 | 1.1 | 1.9 | 2.9 | 4.4 | 5.2 | 2.9 |
| Investment | -0.9 | 0.8 | 0.4 | 2.2 | 3.4 | 1.9 | 1.3 | 1.1 |
| Net exports | -0.8 | 1.9 | 1.9 | -2.1 | -2.0 | -3.1 | -2.7 | -0.1 |
| Exports | 1.7 | 4.0 | 5.4 | 4.0 | 4.6 | 2.2 | 2.1 | 4.9 |
| Imports (-) | 2.5 | 2.0 | 3.5 | 6.1 | 6.6 | 5.2 | 4.8 | 5.0 |
| Consumer price inflation (percent, period average) | 2.1 | 1.4 | 1.1 | 3.2 | 2.0 | 2.2 | 1.9 | 2.5 |
| Public revenues (percent of GDP) | 39.0 | 39.3 | 40.8 | 41.5 | 41.1 | 40.8 | 40.1 | 39.8 |
| Public expenditures (percent of GDP) | 45.2 | 42.7 | 41.9 | 40.4 | 40.6 | 41.2 | 40.7 | 40.4 |
| Of which: | | | | | | | | |
| Wage bill (percent of GDP) | 11.0 | 9.7 | 9.2 | 9.0 | 9.2 | 9.4 | 9.3 | 9.3 |
| Social benefits (percent of GDP) | 16.7 | 16.5 | 15.8 | 15.1 | 14.7 | 14.6 | 14.4 | 14.3 |
| Capital expenditures (percent of GDP) | 2.3 | 2.7 | 3.1 | 2.8 | 3.6 | 4.2 | 4.3 | 4.2 |
| Fiscal balance (percent of GDP) | -6.2 | -3.4 | -1.2 | 1.1 | 0.5 | -0.4 | -0.5 | -0.5 |
| Primary fiscal balance (percent of GDP) | -3.4 | -0.4 | 1.7 | 3.6 | 2.6 | 1.6 | 1.4 | 1.4 |
| Public debt (percent of GDP) | 58.2 | 64.0 | 62.8 | 55.6 | 50.1 | 49.1 | 46.0 | 43.0 |
| Public and publicly guaranteed debt (percent of GDP) | 65.4 | 70.6 | 68.6 | 58.7 | 54.3 | 52.1 | 49.2 | 46.3 |
| Of which: External (percent of GDP) | 39.0 | 42.4 | 42.7 | 35.5 | 33.6 | 38.1 | 35.9 | 33.8 |
| Goods exports (percent of GDP) | 30.0 | 32.1 | 34.9 | 35.9 | 35.5 | 35.0 | 34.2 | 34.1 |
| Goods imports (percent of GDP) | 41.6 | 42.3 | 43.4 | 46.1 | 47.7 | 50.3 | 51.6 | 49.7 |
| Net services exports (percent of GDP) | 1.3 | 2.0 | 2.5 | 2.4 | 2.5 | 4.3 | 4.8 | 3.9 |
| Trade balance (percent of GDP) | -10.3 | -8.2 | -6.0 | -7.8 | -9.7 | -10.9 | -12.6 | -11.7 |
| Remittance inflows (percent of GDP) | 5.3 | 5.8 | 5.1 | 5.2 | 5.9 | 5.2 | 5.2 | 4.9 |
| Current account balance (percent of GDP) | -5.6 | -3.5 | -2.9 | -5.2 | -5.2 | -6.7 | -8.0 | -7.7 |
| Net foreign direct investment inflows (percent of GDP) | 3.5 | 5.1 | 5.2 | 6.2 | 7.4 | 6.2 | 6.0 | 5.8 |
| External debt (percent of GDP) | 72.4 | 73.5 | 72.1 | 68.9 | 61.3 | 58.7 | 55.6 | 52.4 |
| Real private credit growth (percent, period average) | -3.8 | -1.2 | 5.0 | 1.9 | 3.7 | n.a. | n.a. | n.a. |
| Nonperforming loans (percent of gross loans, end of period) | 21.5 | 21.6 | 17.0 | 9.8 | 5.7 | n.a. | n.a. | n.a. |
| Unemployment rate (percent, period average) | 19.2 | 17.7 | 15.3 | 13.5 | 12.7 | 12.0 | 11.8 | 11.7 |
| Youth unemployment rate (percent, period average) | 47.5 | 43.2 | 34.9 | 31.9 | 29.8 | n.a. | n.a. | n.a. |
| Labor force participation rate (percent, period average) | 51.9 | 51.6 | 53.3 | 54.0 | 54.5 | n.a. | n.a. | n.a. |
| GDP per capita, PPP (current international \$) | 14,435 | 14,925 | 15,674 | 16,386 | 17,555 | 18,567 | 19,792 | 21,096 |
| Poverty rate at US\$5.5/day, PPP (percent of population) | 24.1 | 24.0 | 23.1 | 22.4 | 21.7 | 20.9 | 19.7 | 0.0 |

Sources: Country authorities, World Bank estimates and projections.

Note: Nonperforming loans show year-to-date actuals.

Key Economic Indicators

| Key Economic Indicators | 2014 | 2015 | 2016 | 2017 | 2018 | 2019e | 2020f | 2021f |
|--|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Real GDP growth (percent) | | | | | | | | |
| Albania | 1.8 | 2.2 | 3.3 | 3.8 | 4.1 | 2.9 | 3.4 | 3.6 |
| Bosnia and Herzegovina | 1.1 | 3.1 | 3.1 | 3.2 | 3.6 | 3.1 | 3.4 | 3.9 |
| Kosovo | 1.2 | 4.1 | 4.1 | 4.2 | 3.8 | 4.0 | 4.2 | 4.1 |
| North Macedonia | 3.6 | 3.9 | 2.8 | 0.2 | 2.7 | 3.1 | 3.2 | 3.3 |
| Montenegro | 1.8 | 3.4 | 2.9 | 4.7 | 4.9 | 3.0 | 2.8 | 2.7 |
| Serbia | -1.6 | 1.8 | 3.3 | 2.0 | 4.2 | 3.3 | 3.9 | 4.0 |
| WB6 | 0.4 | 2.6 | 3.3 | 2.6 | 3.9 | 3.2 | 3.6 | 3.8 |
| Consumer price inflation (percent, period average) | | | | | | | | |
| Albania | 1.6 | 1.9 | 1.3 | 2.0 | 2.1 | 1.5 | 2.7 | 2.9 |
| Bosnia and Herzegovina | -0.9 | 0.0 | -1.6 | 0.8 | 1.4 | 0.8 | 0.8 | 0.6 |
| Kosovo | 0.4 | -0.5 | 0.3 | 1.5 | 1.1 | 2.8 | 1.8 | 1.5 |
| North Macedonia | -0.2 | -0.3 | -0.2 | 1.3 | 1.4 | 1.6 | 1.8 | 2.0 |
| Montenegro | -0.7 | 1.5 | -0.3 | 2.4 | 2.6 | 1.0 | 1.6 | 1.8 |
| Serbia | 2.1 | 1.4 | 1.1 | 3.2 | 2.0 | 2.2 | 1.9 | 2.5 |
| WB6 | 1.0 | 0.9 | 0.4 | 2.2 | 1.8 | 1.8 | 1.8 | 2.0 |
| Public expenditures (percent of GDP) | | | | | | | | |
| Albania | 32.3 | 30.9 | 29.6 | 29.8 | 29.4 | 29.6 | 29.4 | 29.2 |
| Bosnia and Herzegovina | 45.8 | 42.5 | 41.5 | 40.4 | 40.6 | 42.4 | 41.4 | 40.3 |
| Kosovo | 26.6 | 27.1 | 27.7 | 27.6 | 29.1 | 30.3 | 30.4 | 30.0 |
| North Macedonia | 33.9 | 34.4 | 33.2 | 33.9 | 31.5 | 34.4 | 34.8 | 34.4 |
| Montenegro | 47.7 | 48.8 | 45.3 | 47.0 | 46.5 | 46.2 | 43.5 | 39.8 |
| Serbia | 45.2 | 42.7 | 41.9 | 40.4 | 40.6 | 41.2 | 40.7 | 40.4 |
| WB6 | 38.6 | 37.7 | 36.5 | 36.5 | 36.3 | 37.4 | 36.7 | 35.7 |
| Public revenues (percent of GDP) | | | | | | | | |
| Albania | 26.3 | 26.4 | 27.6 | 27.7 | 27.6 | 27.3 | 27.4 | 27.5 |
| Bosnia and Herzegovina | 43.7 | 43.1 | 42.7 | 43.0 | 42.8 | 41.8 | 42.0 | 41.7 |
| Kosovo | 24.0 | 25.1 | 26.3 | 26.4 | 26.1 | 27.4 | 27.2 | 27.0 |
| North Macedonia | 29.7 | 31.0 | 30.6 | 31.0 | 30.4 | 32.0 | 32.0 | 32.0 |
| Montenegro | 44.6 | 41.5 | 42.5 | 41.4 | 42.4 | 43.0 | 42.5 | 41.3 |
| Serbia | 39.0 | 39.3 | 40.8 | 41.5 | 41.1 | 40.8 | 40.1 | 39.8 |
| WB6 | 34.5 | 34.4 | 35.1 | 35.2 | 35.1 | 35.4 | 35.2 | 34.9 |

Source: World Bank calculations and projections on data from national authorities and World Economic Outlook (2017)

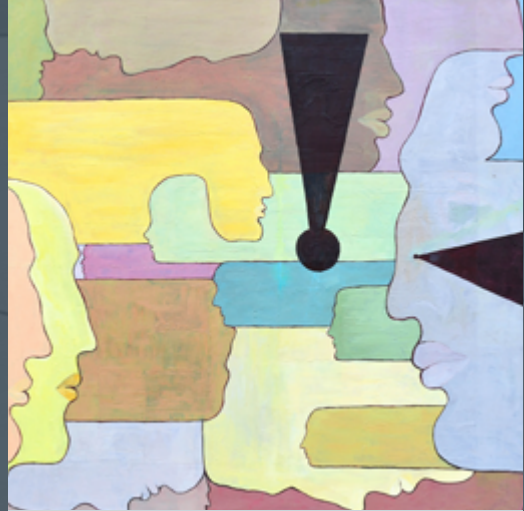
| | 2014 | 2015 | 2016 | 2017 | 2018 | 2019e | 2020f | 2021f |
|--|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Fiscal balance (percent of GDP) | | | | | | | | |
| Albania | -6.0 | -4.5 | -1.8 | -2.0 | -1.8 | -2.2 | -2.0 | -1.7 |
| Bosnia and Herzegovina | -2.0 | 0.7 | 2.6 | 2.6 | 2.2 | -0.6 | 0.6 | 1.4 |
| Kosovo | -2.6 | -2.0 | -1.4 | -1.2 | -3.0 | -2.9 | -3.2 | -3.0 |
| North Macedonia | -4.2 | -3.4 | -2.7 | -2.7 | -1.1 | -2.4 | -2.8 | -2.4 |
| Montenegro | -3.1 | -7.3 | -2.8 | -5.7 | -4.1 | -3.2 | -1.0 | 1.5 |
| Serbia | -6.2 | -3.4 | -1.2 | 1.1 | 0.5 | -0.4 | -0.5 | -0.5 |
| WB6 | -4.0 | -3.3 | -1.2 | -1.3 | -1.2 | -2.0 | -1.5 | -0.8 |
| Public debt (percent of GDP) | | | | | | | | |
| Albania | 66.1 | 69.1 | 68.7 | 67.8 | 64.6 | 63.0 | 62.1 | 59.6 |
| Bosnia and Herzegovina | 41.6 | 41.9 | 42.3 | 36.1 | 34.1 | 33.2 | 32.3 | 31.4 |
| Kosovo | 10.4 | 12.7 | 14.1 | 15.6 | 16.3 | 17.1 | 17.2 | 18.8 |
| North Macedonia | 38.1 | 38.1 | 39.9 | 39.5 | 40.5 | 43.4 | 44.5 | 43.8 |
| Montenegro | 59.9 | 66.2 | 64.4 | 64.2 | 70.8 | 78.6 | 71.2 | 62.3 |
| Serbia | 58.2 | 64.0 | 62.8 | 55.6 | 50.1 | 49.1 | 46.0 | 43.0 |
| WB6 | 45.7 | 48.7 | 48.7 | 46.4 | 46.1 | 47.4 | 45.6 | 43.1 |
| Public and publicly guaranteed debt (percent of GDP) | | | | | | | | |
| Albania | 72.0 | 72.7 | 72.3 | 71.9 | 69.7 | 68.4 | 66.6 | 64.3 |
| Bosnia and Herzegovina | 43.4 | 43.6 | 42.1 | 37.7 | 35.6 | 34.6 | 33.7 | 32.7 |
| Kosovo | 10.6 | 12.8 | 14.4 | 16.3 | 16.9 | 17.7 | 17.7 | 19.3 |
| North Macedonia | 45.8 | 46.6 | 48.8 | 47.8 | 48.5 | 51.1 | 52.4 | 52.2 |
| Montenegro | 67.1 | 73.7 | 71.4 | 70.0 | 75.7 | 83.3 | 75.7 | 66.6 |
| Serbia | 65.4 | 70.6 | 68.6 | 58.7 | 54.3 | 52.1 | 49.2 | 46.3 |
| WB6 | 50.7 | 53.4 | 52.9 | 50.4 | 50.1 | 51.2 | 49.2 | 46.9 |
| Goods exports (percent of GDP) | | | | | | | | |
| Albania | 9.3 | 7.5 | 6.7 | 6.9 | 7.7 | 5.5 | 5.7 | 5.9 |
| Bosnia and Herzegovina | 25.0 | 25.2 | 25.7 | 29.8 | 30.2 | 28.7 | 28.7 | 28.5 |
| Kosovo | 5.8 | 5.6 | 5.1 | 5.9 | 5.6 | 5.2 | 5.4 | 5.4 |
| North Macedonia | 25.7 | 26.8 | 35.1 | 38.1 | 43.2 | 41.6 | 45.4 | 47.3 |
| Montenegro | 10.3 | 9.1 | 8.9 | 8.9 | 9.4 | 9.3 | 9.5 | 9.8 |
| Serbia | 30.0 | 32.1 | 34.9 | 35.9 | 35.5 | 35.0 | 34.2 | 34.1 |
| WB6 | 23.0 | 23.6 | 25.8 | 27.3 | 27.9 | 26.9 | 27.0 | 27.2 |

Source: World Bank calculations and projections on data from national authorities and World Economic Outlook (2017)

| | 2014 | 2015 | 2016 | 2017 | 2018 | 2019e | 2020f | 2021f |
|---|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|
| Trade balance (percent of GDP) | | | | | | | | |
| Albania | -19.0 | -17.3 | -16.8 | -15.1 | -13.8 | -14.5 | -14.4 | -13.9 |
| Bosnia and Herzegovina | -22.7 | -18.5 | -16.7 | -16.3 | -15.2 | -15.4 | -16.2 | -17.1 |
| Kosovo | -28.7 | -28.5 | -27.2 | -26.1 | -29.0 | -28.6 | -27.8 | -26.8 |
| North Macedonia | -12.7 | -12.2 | -14.5 | -13.0 | -12.1 | -11.0 | -11.6 | -10.9 |
| Montenegro | -19.8 | -18.6 | -22.5 | -23.5 | -24.1 | -24.7 | -21.9 | -18.6 |
| Serbia | -10.3 | -8.2 | -6.0 | -7.8 | -9.7 | -10.9 | -12.6 | -11.7 |
| WB6 | -15.8 | -13.8 | -12.9 | -13.2 | -13.7 | -14.3 | -15.0 | -14.4 |
| Current account balance (percent of GDP) | | | | | | | | |
| Albania | -10.8 | -8.6 | -7.6 | -7.5 | -6.7 | -7.0 | -6.4 | -6.1 |
| Bosnia and Herzegovina | -7.3 | -5.3 | -4.7 | -4.7 | -4.3 | -4.5 | -5.3 | -6.0 |
| Kosovo | -6.9 | -8.6 | -7.9 | -6.0 | -8.4 | -8.7 | -8.3 | -7.4 |
| North Macedonia | -0.5 | -2.0 | -2.9 | -1.0 | -0.3 | -0.7 | -1.2 | -1.0 |
| Montenegro | -12.4 | -11.1 | -16.2 | -16.1 | -17.2 | -17.4 | -15.3 | -11.9 |
| Serbia | -5.6 | -3.5 | -2.9 | -5.2 | -5.2 | -6.7 | -8.0 | -7.7 |
| WB6 | -6.4 | -5.1 | -4.9 | -5.5 | -5.4 | -6.3 | -6.8 | -6.5 |
| External debt (percent of GDP) | | | | | | | | |
| Albania | 69.5 | 74.4 | 73.5 | 68.7 | 62.9 | 60.6 | 59.9 | 56.3 |
| Bosnia and Herzegovina | 76.3 | 72.2 | 72.2 | 68.5 | 66.1 | 65.8 | 65.8 | 65.5 |
| Kosovo | 31.2 | 33.3 | 33.2 | 32.6 | 33.7 | 33.8 | 34.5 | 34.2 |
| North Macedonia | 70.0 | 69.3 | 74.7 | 73.6 | 73.7 | 78.1 | 78.7 | 77.4 |
| Montenegro | 162.9 | 169.4 | 162.6 | 160.6 | 164.4 | 180.0 | 178.5 | 175.6 |
| Serbia | 72.4 | 73.5 | 72.1 | 68.9 | 61.3 | 58.7 | 55.6 | 52.4 |
| WB6 | 80.4 | 82.0 | 81.4 | 78.8 | 77.0 | 79.5 | 78.8 | 76.9 |
| Unemployment rate (period average, percent) | | | | | | | | |
| Albania | 17.5 | 17.1 | 15.2 | 13.7 | 12.3 | 11.5 | n.a. | n.a. |
| Bosnia and Herzegovina | 27.5 | 27.7 | 25.4 | 20.5 | 18.4 | 15.7 | n.a. | n.a. |
| Kosovo | 35.3 | 32.9 | 27.5 | 30.5 | 29.5 | n.a. | n.a. | .. |
| North Macedonia | 28.0 | 26.1 | 23.7 | 22.4 | 20.7 | 19.4 | 18.0 | 17.0 |
| Montenegro | 18.0 | 17.6 | 17.7 | 16.1 | 15.2 | 14.9 | 14.7 | 14.8 |
| Serbia | 19.2 | 17.7 | 15.3 | 13.5 | 12.7 | 12.0 | 11.8 | 11.7 |
| WB6 | 24.3 | 23.2 | 20.8 | 19.5 | 18.1 | 14.7 | 14.8 | 14.5 |

Source: World Bank calculations and projections on data from national authorities and World Economic Outlook (2017)

View this report online:
www.worldbank.org/eca/wbrer



Angel Profiles

by Eduart Karaj

Eduart Karaj has fifteen years of experience in painting and sculpting. Karaj graduated at the Academy of Arts in Tirana in 2005. His works have been displayed in a number of personal and collective exhibitions of both genres in Albania and abroad. He also does icon restoration including a multi-year assignment in the Orthodox Christian Church in Tirana. Karaj won Second Prize in the Ikonografi Moderne (Modern Iconography) Exhibition in Tirana in 2018. In a constant effort for enriching his art, Karaj's oeuvre is characterized by a modern spirit, proof of which we can see also see in the painting he submitted to the Art Competition organized by the World Bank Tirana Office in Spring 2019.

People forge ideas, people mold dreams, and people create art. To connect local artists to a broader audience, the cover of this report and following editions will feature art from the Western Balkan countries.