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WESTERN BALKANS REGULAR ECONOMIC REPORT

Toward Sustainable Growth

No. **24** | Fall 2023

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The cutoff date for the data used in this report was September 28, 2023.

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 report is produced twice a year by a team led by Natasha Rovo, Richard Record, and Christos Kostopoulos (Task Team Leaders). This issue's core team included World Bank staff working on the Western Balkan countries (with additional contributions to specific sections): Natasha Rovo, Richard Record (Growth section), Sanja Madžarević-Šujster, Joana Madjoska (Labor section), Leonardo Ramiro Lucchetti, Alexandru Cojocaru, Carlos Gustavo Ospino Hernandez, Anna Fruttero, Zurab Sajaia (Poverty section), Milan Lakićević, Besart Myderrizi (Fiscal section), Hilda Shijaku, Isolina Rossi, Tim Pionteck (Monetary section), Alper Oguz, Jane Hwang, Holti Banka, Matija Laco (Financial sector section), Sandra Hlivnjak, Tihomir Stučka (External section), Christos Kostopoulos, Lazar Šestović, Marie Albert, Sergiy Kasyanenko, Hrisyana Stefanova Doytchinova (Outlook section), Sergiy Zorya, Fang Zhang, Demetris Psaltopoulos, Goran Zhivkov (Spotlight).

Research assistance was provided by Suzana Jukić. Peter Milne provided assistance in editing, and Budy Wirasmo assistance in typesetting. The cover image was created by Sanja Tanić.

The dissemination of the report and external and media relations are managed by an External Communications team comprised of Filip Kochan, Sanja Tanić, Lundrim Aliu, Anita Božinovska, Ana Gjokutaj, Jasmina Hadžić, Gordana Filipovic, and Mirjana Popović.

The team is grateful to Xiaoqing Yu (Regional Director for the Western Balkans); Asad Alam (Regional Director, Equitable Growth, Finance and Institutions); Jasmin Chakeri (Practice Manager, Macroeconomics, Trade, and Investment Global Practice); Frauke Jungbluth (Practice Manager, Agriculture & Food 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/.

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Abbreviations

AE	Advanced Economies
AFOLU	Agriculture, Forestry and Other Land Use
AKIS	Agricultural Knowledge and Innovation System
CAD	Current Account Deficit
CAP	Common Agricultural Policy
CESEE	Central, Eastern and Southeastern Europe
CO2	Carbon Dioxide
CPI	Consumer Price Index
CSA	Climate-Smart Agriculture
EAFRD	European Agricultural Fund for Rural Development
EC	European Commission
ECA	Europe and Central Asia
ECB	European Central Bank
EGD	European Green Deal
EIP	European Innovation Partnership
EMDEs	Emerging Markets and Developing Economies
EU	European Union
EU DG AGRI	European Commission's Directorate General for Agriculture and Rural Development
F2F	Farm to Fork
FAO	Food and Agriculture Organization
FAOSTAT	Food and Agriculture Organization Corporate Statistical Database
FAS	Farm Advisory Systems
FBiH	Federation of Bosnia and Herzegovina
FDI	Foreign Direct Investment
FPS	Fast Payment Systems
GDP	Gross Domestic Product
GHG	Greenhouse Gas
H1	First Half
H2	Second Half
ha	hectare
HBS	Household Budget Survey
HICP	Harmonized Index of Consumer Prices
ICT	Information and Communications Technology
IFC	International Finance Corporation
ILO	International Labour Organization
IMF	International Monetary Fund
IPARD	Instrument for Pre-Accession Assistance for Rural Development
IPPU	Industrial Processes and Product Use
KYC	Know-Your-Customer
LCU	Local Currency Unit
LEADER	Liaison Entre Actions de Développement de l'Économie Rurale (Links between activities for the development of rural economy)
lhs	left-hand scale
MTRS	Medium-Term Revenue Strategy
NEET	Not in Employment, Education or Training
NPLs	Non-Performing Loans
PMI	Purchasing Managers Index
PPG	Public and Publicly Guaranteed
PPP	Purchasing Power Parity
Q1	First Quarter
Q2	Second Quarter
Q3	Third Quarter
Q4	Fourth Quarter
R&D	Research and Development
rhs	right-hand scale
RS	Republic of Srpska
SBA	Stand-By Arrangement

SEPA	Single European Payments Area
SILC	Survey of Income and Living Conditions
SMEs	Small and Medium Enterprises
SOE	State-Owned Enterprise
SWG	Standing Working Group
TARGET	Trans-European Automated Real-time Gross settlement Express Transfer system
TIPS	TARGET Instant Payment Settlement
UAA	Utilised Agricultural Area
UNWTO	United Nations World Tourism Organization
WDI	World Development Indicators
yoy	year-on-year

Western Balkan Country Abbreviations

ALB	Albania
BiH	Bosnia and Herzegovina
KOS	Kosovo
MKD	North Macedonia
MNE	Montenegro
SRB	Serbia
WB6	Western Balkans 6

Note: All comparisons are year on year unless otherwise stated.

Toward Sustainable Growth

1. Overview

In the context of weakening global demand, growth in the Western Balkans decelerated over the course of 2022 and into 2023. Against the background of the lasting effects of shocks from Russia's invasion of Ukraine, sticky inflation, and tighter financial conditions, global demand has been weakening, and this has a divergent impact across the Western Balkans (WB6). On the one hand, the slowdown in global demand contributed to weaker-than-expected performance of industrial production in the whole European Union (EU) region and in the WB6. On the other hand, global demand has proved more resilient in services and, in particular for travel, with twice as many people traveling globally during Q1 2023 as in the same period in 2022 (UNWTO). This has particularly benefited Albania, Kosovo, and Montenegro, where services exports have reached new record highs. In contrast, weakening global demand for goods has weighed on Bosnia and Herzegovina (BiH), North Macedonia and Serbia. On the demand side, private consumption remained in general an important growth driver, despite rising price pressures.

The WB6 region's labor market continued strengthening in 2023, against all odds, but cooling is under way in some countries. The average employment rate for the Western Balkans reached a historical high of 47.8 percent in June 2023. On a regional level, all sectors except agriculture contributed to the job market recovery. In fact, in 2023, labor shortages continued to be among top concerns raised by businesses in the Western Balkans. Unemployment declined in all Western Balkan countries, except in Serbia but, in some cases, the decline is attributable to increased inactivity. The recovery in the labor market also benefited vulnerable groups—youth and women—with youth unemployment declining to 22.7 percent in mid-2023, the lowest on record. This still compares poorly with 14.3 percent in the EU27 in June 2023, but the gap is narrowing. Similarly, the female labor force participation rate has also increased in four out of the six WB6 countries. Wage pressures, combined with growth headwinds, are likely to slow the pace of hiring by firms in the future.

Structural factors that contribute to low labor force participation, coupled with significant gender gaps, are constraining further poverty reduction. With inflation remaining at historical highs through 2023, poverty rates in the region are estimated to continue their downward trend, but at a slower pace. Moreover, despite some improvements over time, and recent momentum in the post-pandemic years, labor force participation rates in Western Balkans continue to lag other countries with similar levels of economic development. Similarly, the gender disparities in the labor market persist in all countries, despite a gradual increase in female labor force participation.

All WB6 countries continue also to experience strong year-on-year (yoy) nominal revenue growth, but notable country variation in expenditure trends shows signs of renewed pressures. Despite persistent external volatility, all Western Balkan countries in 2023 are expected to continue running fiscal deficits below or close to their 2021 levels. While maintaining elevated social protection spending, all WB6 countries will continue spending more on public wages during 2023. To the extent that revenue increases came mostly from inflation, and less from the expansion of the revenue base, WB6 countries may face higher budget rigidity and less room for maneuver to reprioritize their budgets, as fiscal space is being eroded by a parallel increase in rigid (inflation-driven) spending, such as pensions and wages. Moreover, most WB6 countries have become increasingly reliant on external financing over the past few years and are vulnerable to the rising costs of financing resulting from monetary policy tightening.

Inflation pressures in the WB6 region are easing, although price pressures persist. After peaking in October 2022 at 15 percent, average consumer price inflation in the WB6 countries has been on a downward trend, reaching 8.4 percent in July 2023. As of July 2023, core inflation also remains high, at above 5 percent. Its persistence reflects, depending on the economy considered, strong domestic demand, a high pass-through of past shocks to headline inflation into core inflation, the lagged effects of crisis response programs, and the strength of labor markets and wage growth, the latter especially since H2 2022. In countries with independent monetary policy, authorities increased key monetary policy rates throughout H1 2023. Despite the monetary tightening, real policy rates remained negative.

The financial sector in the Western Balkans has remained stable and resilient despite the increasing risks, testing financial stability. Non-performing loans (NPLs) continued to follow a downward trend, declining to a historical low (3.9 percent) in June 2023, while profitability exceeded pre-pandemic levels and capital buffers were preserved. Current financial sector performance demonstrates the strong resilience of the sector thanks to the robust financial position of banks achieved by decisive reforms and restructuring over the past decade (following the global financial crisis) and strong support from governments during the COVID-19 pandemic. Nevertheless, asset quality resilience remains under stress—as demonstrated by the widening gap between stage 2 and stage 3 loans, driven by the increase in the share of loans which may potentially become non-performing.

After a temporary spike in 2022, the average current account deficit (CAD) is expected to improve in the Western Balkans over the course of 2023, even though merchandise trade deficits remain elevated. Some pressure on the merchandise deficit has been released with the sharp deceleration in aggregate demand and import prices that started trending downward. Meanwhile, the marginal decline in exports of goods for the WB6 region was a combination of a reduction observed in the range between 0.2 and 1.7 percentage points in North Macedonia, Montenegro, Albania, Serbia, and Kosovo, together with an improvement of 1.5 percentage points in BiH. Net services and remittances play an increasing role in mitigating structural merchandise trade deficits. Moreover, since 2021, net foreign direct investment (FDI) inflows have continued to play a crucial role in funding CADs, with FDI inflows in Albania, Kosovo, and Serbia expected to fully finance their respective CADs in 2023.

Growth is expected to decelerate across WB6 countries in 2023 and then to gradually recover over the medium term, but risks remain tilted to the downside. Growth rates in Europe are expected to be below the pre-pandemic five-year average, suggesting that the recovery is still weak, while the persistence of inflation suggests that monetary tightening is expected to continue. In this context, after the strong post-COVID-19 recovery in 2021, the WB6 countries are expected to witness slower growth in 2023, primarily owing to weaker consumption and exports, reflecting weaker EU performance. Growth for the WB6 region is expected at 2.5 percent in 2023, a slight downgrade by 0.1 percent with respect to the spring 2023 projections. The forecast for Albania and Montenegro has been upgraded, with 2023 growth at 3.6 and 4.8 percent, respectively. Meanwhile, the forecasts for BiH, Kosovo, North Macedonia, and Serbia, have been downgraded, with 2023 growth at 2.2, 3.2, 1.8, and 2.0, respectively. But risks to this growth outlook are tilted to the downside. A prolonged slowdown in the EU, as well as internal structural bottlenecks, could lead to even further downward revisions to growth projections. In addition, if inflation is not brought back to long-term averages as planned, this may further hurt domestic demand.

Reforms are needed to consolidate the recovery toward sustainable growth, while negotiations with the EU hold the potential to bolster prospects in the Western Balkans. The energy crisis has highlighted the need to accelerate the green transition across Europe, including in the Western Balkans, and with a focus on key sectors, such as agriculture. It has also highlighted the importance of promoting diversification of energy sources toward renewables and energy efficiency. Reforms aiming at increasing market competition, attracting higher quality investments, and addressing barriers that limit labor force participation (especially among women), also hold the potential to boost economic growth in the region. Accelerating regional integration would also help accelerate income convergence.

As the WB6 agriculture sector is undergoing a major structural transformation, efforts to green agriculture are also important to ensure access to the EU market and for the competitiveness of agriculture, rural development, and food and nutrition security. Most WB6 countries have recently included agriculture greening in their development strategies. Historically, the environmental footprint of the WB6 agriculture sector has been relatively low. But this has been more an unintended outcome of still high rurality and low farming intensity rather than a result of public policy and expenditure choices. Agricultural public expenditures, while substantial in terms of amounts and adequate to influence agricultural production, have not yet prioritized financing of greening and climate-smart agriculture. It is important for the WB6 countries to accelerate greening of their agriculture by learning from the EU's green transition and better utilization of the existing public funds available for agricultural development.

Table 1.1. Western Balkans Outlook, 2020–25

	2020	2021	2022	2023e	2024f	2025f
Real GDP Growth (percent)						
Albania	-3.3	8.9	4.8	3.6	3.2	3.2
Bosnia and Herzegovina	-3.0	7.4	3.9	2.2	2.8	3.4
Kosovo	-5.3	10.7	5.2	3.2	3.9	4.0
North Macedonia	-4.7	3.9	2.1	1.8	2.5	2.9
Montenegro	-15.3	13.0	6.4	4.8	3.2	3.1
Serbia	-0.9	7.5	2.3	2.0	3.0	3.8
WB6	***-3.0***	***7.8***	***3.3***	***2.5***	***3.0***	***3.5***
Real GDP Components Growth (percent)						
Consumption			3.6	1.3	2.0	2.6
Investment			2.4	0.4	0.6	1.2
Net exports			-2.7	0.7	0.4	-0.3
Exports			7.7	2.9	2.7	3.5
Imports (-)			10.4	2.2	2.3	3.8
Consumer Price Inflation (percent, period average)	***1.0***	***3.2***	***11.8***	***9.1***	***4.1***	***2.7***
External Sector (percent of GDP)						
Goods exports	21.4	25.3	28.5	27.8	28.0	28.2
Trade balance	-19.5	-16.9	-18.8	-16.1	-15.8	-15.6
Current account balance	-8.6	-5.9	-7.8	-5.8	-5.7	-5.7
Foreign direct investment	5.3	5.8	6.9	5.9	5.7	5.6
External debt	88.9	83.9	77.3	73.1	71.6	70.2
Public Sector (percent of GDP)						
Public revenues	34.7	36.0	34.9	36.0	35.5	35.7
Public expenditures	42.5	38.9	37.6	38.1	37.9	37.8
Fiscal balance	-7.9	-2.9	-2.7	-2.2	-2.4	-2.0
Public and publicly guaranteed debt	60.2	56.6	50.6	48.5	49.0	47.9

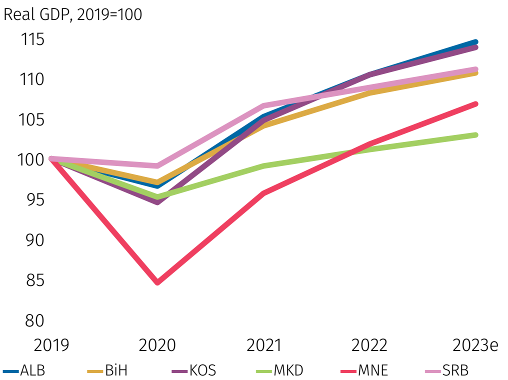
Sources: National statistical offices; Ministries of Finance; central banks; World Bank staff estimates.
Note: e = estimate; f = forecast.

2. Recovery and convergence are occurring at different speeds across the Western Balkans

Against the background of continued shocks from Russia's invasion of Ukraine, sticky inflation, and tighter financial conditions, growth in the Western Balkans decelerated over the course of 2022 and into 2023. In 2022, the Western Balkans experienced strong economic growth, eventually reaching pre-pandemic levels also in North Macedonia and Montenegro (Figure 2.1). However, growth had already started to moderate throughout 2022 in the case of BiH and since early 2023 in Albania, North Macedonia, and Serbia, mostly due to a slowdown in global demand, which adversely affected industrial output. Macroeconomic conditions remained favorable during H1 2023 in Kosovo and Montenegro, despite persistent external volatility, thanks to record growth in exports of services, mostly of diaspora-related travel services in Kosovo, as well as ICT services.

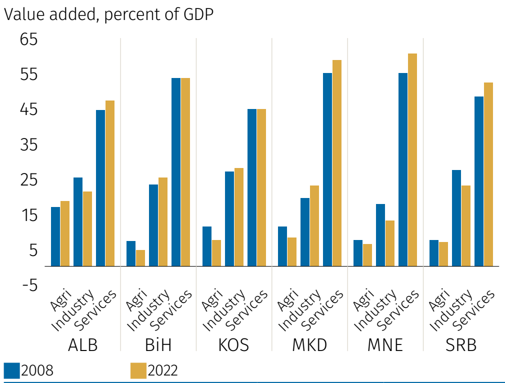
Weakening global demand has had a diverse impact across the Western Balkans. On the one hand, the slowdown in global demand contributed to weaker-than-expected performance of industrial production in the whole EU region and in the Western Balkans. In BiH, industrial production, which accounted for 25 percent of GDP (Figure 2.2), dropped by 3.9 percent during the period January to July 2023, largely driven by a decline in sales on foreign markets totaling 11 percent, whereas turnover in the domestic market declined by 2 percent. The COVID-19 pandemic and the energy shock are still negatively affecting the performance of the industrial sector (Figure 2.3). This is due to the low geographical trade diversification (Figure 2.4), with a majority of goods exports from Albania, BiH, North Macedonia and Serbia going to advanced economies (AEs) in Europe and Central Asia (ECA), coupled with the structural challenges facing the sector, related to the green transition, value-chain disruptions, and diversification. On the other hand, global demand has continuously shown impetus for services and, in particular, travel services, with twice as many people traveling globally during Q1 2023 as

Figure 2.1. Real GDP growth in 2022 was stronger than expected, but decelerated over the course of 2022 and in 2023...



Source: National statistical offices; World Bank staff.

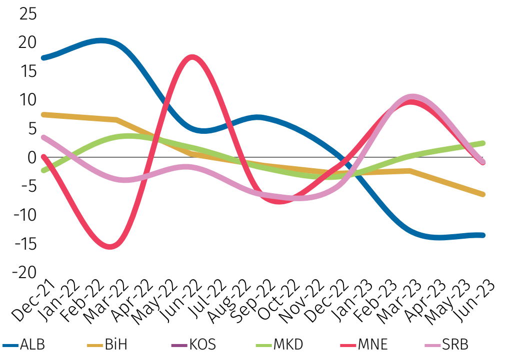
Figure 2.2. ...as weakening global demand has a diverse impact across the WB6, due to their different economic structures



Source: National statistical offices; World Bank staff.

Figure 2.3. Industrial production continues decelerating…

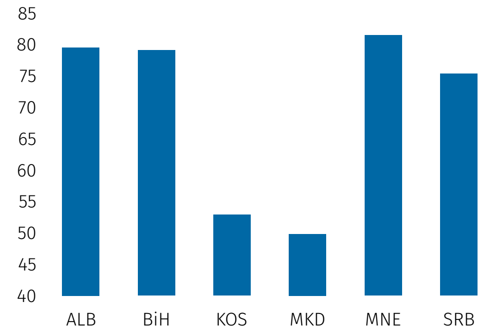
Change in industrial production, percent, 3-month moving average yoy



Source: National statistical offices; World Bank staff.

Figure 2.4. …as exports are highly concentrated toward advanced economies in ECA

Percent of total goods exports, 2019



Source: WDI.

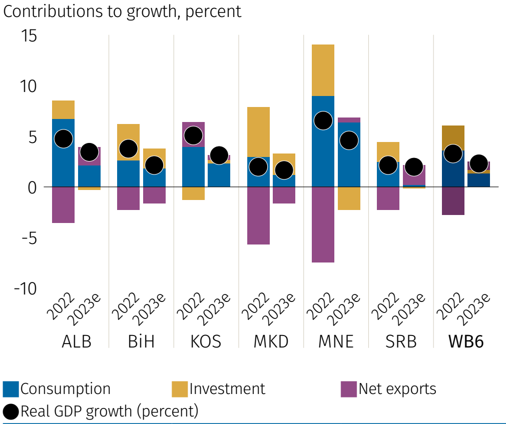
in the same period in 2022 (UNWTO). This has particularly benefited Albania, Kosovo, and Montenegro, where services exports have experienced new record highs.

On the demand side, private consumption remained in general an important growth driver, but rising price pressures have started putting a dent into households' purchasing power (Figure 2.5). In Albania, private consumption grew by 3 percent in Q1 2023 (yoy), supported by increasing employment and wages, strong consumer confidence, relatively low interest rates and benign credit conditions, despite monetary policy normalization. Increased income from employment, credit growth, business and consumer sentiment indicators, and strong tax revenues, suggest an increasing contribution to growth from consumption, as well as investment and net exports, in Q2 and Q3 2023. In BiH, private consumption contracted in Q1 2023, as remittance inflows dropped by 4.8 percent in real terms; nonetheless, it is expected to pick up in Q2 and Q3 of 2023, supported by an average after-tax real wage increase of 17 percent during the period January to June 2023. In Kosovo, monthly indicators, including those on the external sector, firms' sales and international travel data show that the impact from consumption as well as service exports on growth was strong throughout the first three quarters of 2023. In Montenegro, GDP expanded by 6.6 percent[1] in H1, driven by personal consumption, which grew by 10.4 percent in real terms, underpinned by an increase in public sector wages, employment gains, and household borrowing. In North Macedonia, consumption eased to 1.6 percent (down by 1.1 percentage points from Q4 2022) as continued high inflation put a dent on the household purchasing power. Conversely, in Serbia, consumption, together with investment, made negative contributions to growth in H1 2023.

The negative contribution to growth from net exports in H1 2023—except for Montenegro and Serbia—and from agriculture speaks to the volatility of the growth model. Small economies are subject to a variety of risks, including dependence on imports of essential

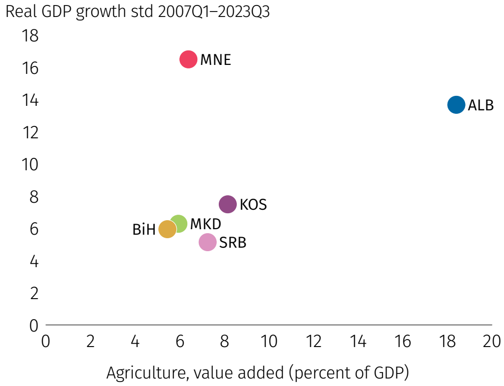
1 All comparisons are year-on-year, unless otherwise indicated.

Figure 2.5. Consumption remains an important growth driver, despite rising price pressures



Source: National statistical offices; World Bank staff.

Figure 2.6. Some countries display more growth volatility than others



Source: National statistical offices; World Bank staff.

goods, vulnerability to external shocks, lack of scale, limited connectivity, highly concentrated economic structures, reliance on external financing, and susceptibility to natural disasters and climate change. This contributes to an uneven convergence pattern across the six countries (see Box 2.1) and translates into very volatile economic growth (Figure 2.6). This is especially the case of Albania, where dependence on climate conditions is high due to the prominent role of sectors such as agriculture and hydro energy production. The Spotlight sheds further light on the role of agriculture for the economic development of the Western Balkans and its contribution to greening their economies.

Box 2.1. Toward income convergence

The Western Balkans countries have made significant progress in terms of income convergence with AEs. Income convergence is typically measured by comparing the per capita income of a country with that of a more prosperous nation, in this case the EU average. For the Western Balkans, this ratio ranged from 27.3 percent in Kosovo to 50 percent in Montenegro in 2022, indicating that the countries' standards of living are between one-quarter and one-half that of the EU average.

However, not all countries have achieved the same level of convergence, nor have they advanced at the same speed. By examining the average convergence velocity, or the rate of change in income convergence per decade, it is evident that Montenegro and Serbia have exhibited positive convergence velocities in recent decades. The other economies have only achieved negative convergence velocity, meaning that the rate of convergence has been

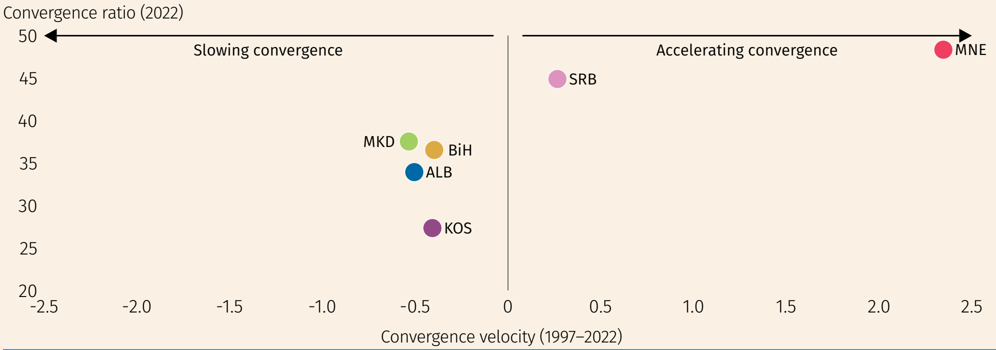
(Box 2.1 continued)

decelerating. For example, the convergence velocity for Albania has decreased from an average of 5 percentage points per decade after 1997 to about 2.7 percentage points per decade more recently.

Human capital and firm productivity emerge as the two common avenues for boosting growth and productivity, hence convergence, across the WB6 countries. Other areas concern economic management, reform of state-owned enterprises (SOEs), and institutional strengthening in general. Enhancing the management of public investment is also crucial, as shortcomings in the quantity and quality of infrastructure capital undermine the returns to private investment. Coordinated policies and investments for regional integration can also generate significant economy-wide benefits. For example, reducing waiting times at the border has the same impact on exports as lowering tariffs in the EU market. Finally, the green transition and the need for a sustainable economic model are also seen as opportunities for the WB6 countries.[2]

Figure 2.7. The Western Balkans' standards of living are between one-quarter and one-half that of the EU average, but convergence is moving at different speeds

Change in convergence ratio per decade, 1997–2022, percentage points



Source: WDI; World Bank staff.
Note: Calculations based on GDP per capita, PPP (constant 2017 US$). For Kosovo, data are available starting 2008.

2 See World Bank Country Economic Memorandum (CEM) for Serbia (2020), Albania (2021), Kosovo (2022), Montenegro (2023) and BiH (forthcoming).

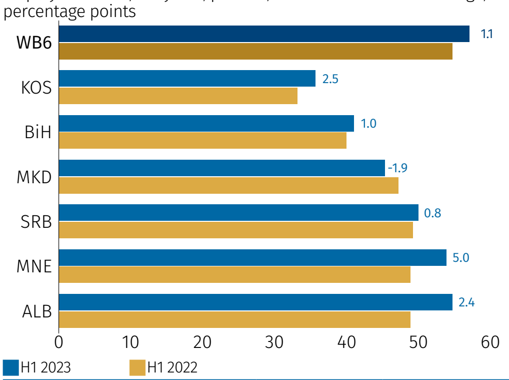
3. The labor market remained strong against all odds, but cooling is underway in some countries[3]

The region's labor market continued strengthening in 2023 and employment levels reached historical highs in several countries (Figure 3.1). The growth recovery in 2022–23 brought employment to new highs: between mid-2022 and mid-2023, an additional 103,000 jobs were created in the region, of which Albania, BiH, and Montenegro showed the strongest gains. This was followed by Kosovo, where the Tax Administration reported that the number of personal income tax payers increased by close to 5 percent in Q2 2023 (yoy), equivalent to about 29,000 jobs being added. However, North Macedonia and Serbia have seen growth in employment levels decelerate in mid-2023 affected by a slowdown in external demand and a struggling manufacturing sector (Figure 3.2). Average annual employment growth in mid-2023 for the region was 1.5 percent.

The average employment rate for the Western Balkans reached a historical high of 47.8 percent in June 2023.[4] Although still lower when compared with an average 54.5 percent for the EU27 in June 2023, this is an increase of 1.6 percentage points since mid-2022, underscoring the continued labor market recovery and convergence with the EU. In fact, in Albania and Montenegro, the employment rate at 57.1 and 55.9 percent, respectively, has already surpassed the EU27 rate. The largest increase in the employment rate was recorded in Montenegro (Figure 3.1). In Kosovo, despite recent gains, only 34 percent of the working-age population is employed. North Macedonia observed a decline in the annual employment rate after the recent methodological changes.

Figure 3.1. The employment rate reached a historical high in the Western Balkans...

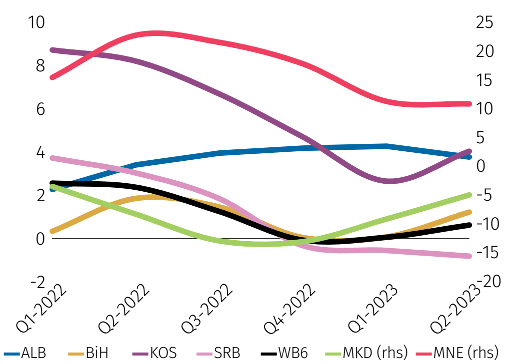
Employment rate, 15+ years, percent, and H1 2023–H1 2022 change, percentage points



Source: National statistics offices; World Bank staff estimates.
Note: 15–64 years for Kosovo.

Figure 3.2. ...but a slowdown is underway in most countries

Change in employment, percent, 3-month moving average yoy



Source: National statistics offices; World Bank staff estimates.

3 This analysis was affected by: (i) delayed publishing of Labor Force Survey (LFS) data in Kosovo and by (ii) a sampling revision in BiH, Montenegro, and North Macedonia that reduced comparability with previous LFS data. Using tax administration data, and unemployment data for Kosovo helped provide an approximate picture of the labor market in 2023. Serbia also revised the 2022 LFS data.

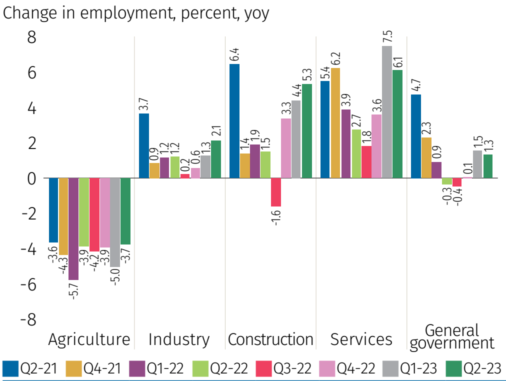
4 The employment rate is the region's simple average for the population aged 15–64 years for Kosovo and 15+ for all other WB countries.

On a regional level, all sectors except agriculture contributed to the job market recovery (Figure 3.3). During the summer, a record strong tourism sector boosted employment, followed by a rise in trade, ICT, as well as transport. The construction sector also observed an increase in employment across countries, including in North Macedonia where construction of the Corridor VIII and Xd highways started. Employment in agriculture continued to shrink, with the exception of Kosovo, BiH, and Montenegro.

In fact, in 2023, labor shortages continued to be among top concerns raised by businesses in the Western Balkans (Figure 3.4). A continued services sector recovery resulted in a sharp increase in unfilled vacancies, and a surge in imported labor from Asian countries. Some of the countries of the Western Balkans—Albania, North Macedonia, and Serbia—have already liberalized their work permit regimes to enable cross-border labor mobility, but this does not seem to be enough to fill vacancies. Businesses are requesting authorities to deploy policies to retain workers (70 percent of respondents and the highest in Albania and North Macedonia), encourage diaspora workers to return back home (45 percent of responding firms, with 62 percent in Kosovo) or transfer knowledge back home (34 percent of responding firms), incentivize private businesses to offer more attractive conditions for diaspora to return (33 percent of responding firms), improve institutional effectiveness (28 percent of responding firms), and facilitate immigration of skilled labor force from third countries (17 percent of responding firms).

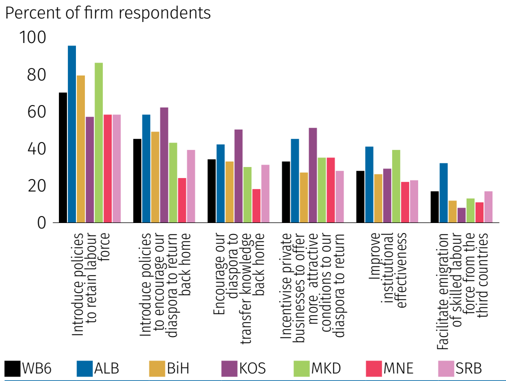
Unemployment declined in all Western Balkan countries, except in Serbia. The unemployment rate (ages 15+) in the Western Balkans declined by 0.9 of a percentage point to 11.7 percent in mid-2023, the lowest on the record (Figure 3.5). This is still double the EU27 unemployment rate for ages 15+ which stood at 5.8 percent in mid-2023. Serbia has seen a rise to 9.6 percent compared with 8.9 percent a year ago as more people entered the labor force. The unemployment rate in BiH dropped significantly, by 2.6 percentage points yoy, largely on account of a decline in the activity rate. In North Macedonia, the unemployment rate also dropped, on account of more jobs for

Figure 3.3. Services and construction had the highest job creation rates



Source: National statistics offices; World Bank staff estimates.

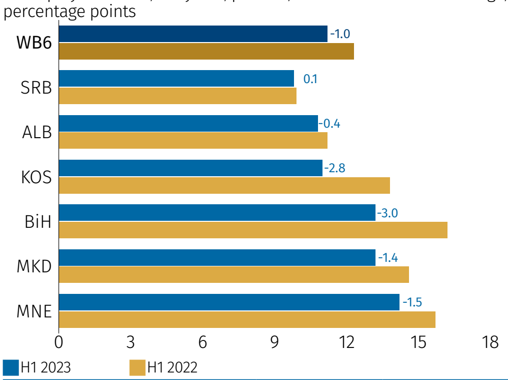
Figure 3.4. Businesses require policies to retain the labor force and attract diaspora to the Western Balkans labor market



Source: Balkan Business Barometer 2023 survey.

Figure 3.5. Unemployment rate declined to a new low

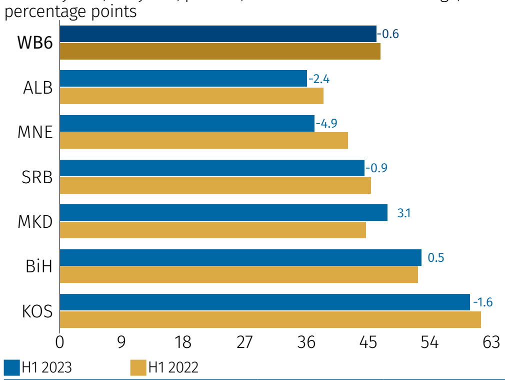
Unemployment rate, 15+ years, percent, and H1 2023–H1 2022 change, percentage points



Source: National statistics offices; World Bank staff estimates.
Note: 15–64 years for Kosovo.

Figure 3.6. Inactivity declined in most countries as labor market strengthened

Inactivity rate, 15+ years, percent, and H1 2023–H1 2022 change, percentage points



Source: National statistics offices; World Bank staff estimates.
Note: 15–64 years for Kosovo.

the younger cohort and the exit to inactivity of the older cohorts. Yet, in both BiH and North Macedonia, the unemployment rate remains high at 13.1 percent, the highest rate recorded in the WB6 region in Q2 2023. In Montenegro, strong economic activity, and in particular in the tourism sector, helped push down the unemployment rate to 12.9 percent by mid-2023 and more people moved to the labor market. A similar development is observed in Albania, ahead of the summer tourism season—its unemployment rate fell to 10.7 percent in mid-2023 and the inactive population declined.

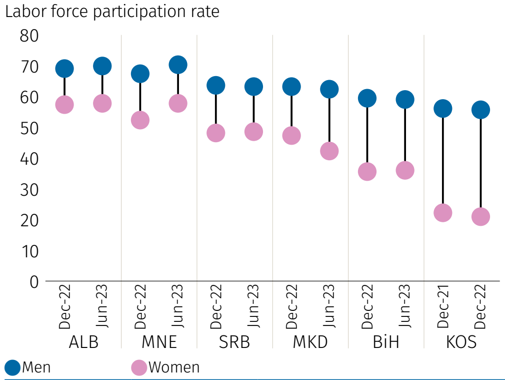
The labor force participation rate increased to a new high. The annual decline in unemployment reached 25,900 people by June 2023 and was lower than the rise in employment, which meant that more people entered the labor market and that inactivity declined (Figure 3.6). The participation rate reached 54.1 percent, up by 1.2 percentage points compared with mid-2022. Montenegro and Albania are leading the group with 64.2 and 63.9 percent, respectively, whereby Montenegro saw the largest gain over the year. In North Macedonia, the participation rate declined compared with 2022, but annual comparability is hampered by methodological changes.

The recovery in the labor market also benefited vulnerable groups—youth and women. Youth unemployment declined to 22.7 percent in mid-2023—the lowest on record—and was down by 2.5 percentage points yoy (Figure 3.7). This still compares poorly with 14.3 percent in the EU27 in June 2023, but the gap is narrowing compared with a year ago. Around 1,800 young people were moved out of unemployment over the year, with the largest improvements recorded in BiH, while Albania and Serbia saw youth unemployment rising. In Serbia, the percentage of young people who are not in employment, education or training (NEET) also declined by 0.8 of a percentage point to 11.7 percent. Kosovo and Montenegro have the lowest youth unemployment rates in the region—below 20 percent—while, despite improvements, the youth unemployment rate in BiH is the highest in the region, at over 29 percent. However, most of the decline in youth unemployment was due to exits from the labor force rather than increased employment.

Figure 3.7. Youth unemployment rate declined to a new low

Source: National statistics offices; World Bank staff estimates.
Note: 15–29 years for Albania.

Figure 3.8. More women returned to the labor market than men in 2023, except in Kosovo and North Macedonia



Source: National statistics offices; World Bank staff estimates.

The female labor force participation rate increased in four countries. Except for Kosovo and North Macedonia, the female labor force participation rate increased but, at 45.7 percent for the region, it was still lagging that of men (at 63.6 percent) in mid-2023 (Figure 3.8). The largest improvement was in Montenegro (5.5 percentage points) where the rate reached 58.1 percent, the same as in Albania.

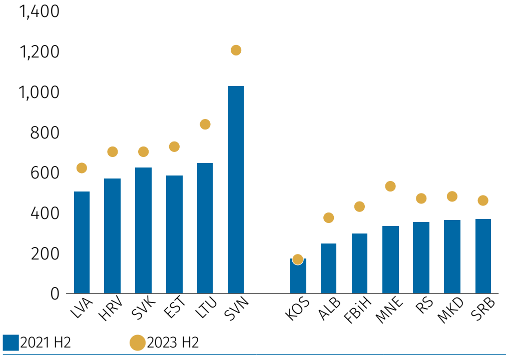
Strong labor demand, earlier shortages, and high inflation in the Western Balkans have created wage pressures. The trend of rising minimum wages in the region continued throughout 2023. Minimum wages increased by 9.9 percent in FBiH and 12.5 percent in North Macedonia in accordance with a recently introduced indexation mechanism with average wage and consumer price growth. In Albania and Republic of Srpska minimum wages increased, through government decision, by 17.6 and 18.7 percent, respectively. In Kosovo, the minimum wage was raised to EUR 264 over the summer, but the decision by Parliament is currently under review by the Constitutional Court. Serbia's minimum wage was increased by 14.3 percent, along with an increase in the threshold for non-taxable income. The minimum wage in Montenegro remained unchanged in 2023 relative to the previous year, after the substantial increase in 2022.

Minimum wages increased twice as fast in the Western Balkans compared with EU peers. The rise in minimum wages in the region of around 43 percent on average since mid-2021 was almost double that of EU peers, at 22 percent (Figure 3.9). The highest increase in minimum wages was observed in Montenegro, where the minimum wage in September 2023 stood at 60 percent above the level from H2 2021. Montenegro's minimum wage is more than three times higher than the lowest minimum wage observed in the region (in Kosovo). The ratio of minimum to average wage is above 50 percent in Albania, North Macedonia, and Montenegro.

Such wage pressures, combined with growth headwinds, are likely to slow the pace of hiring by firms in the future. Around three-quarters of the Western Balkan firms surveyed in the 2023 Balkan Barometer have seen labor and other costs, including energy costs, increase (Figure 3.10). As firms try to offset the impact

Figure 3.9. Gross minimum wages increased twice as fast compared with EU peers over the past two years

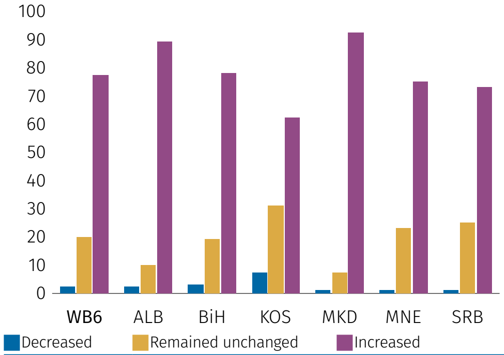
in EUR terms, 2021–23



Sources: Eurostat, National statistics offices; World Bank staff estimates.
Note: LVA=Latvia; HRV=Croatia; SVK=Slovakia; EST=Estonia; LTU=Lithuania; SVN=Slovenia; FBiH=Federation of Bosnia and Herzegovina; RS=Republic of Srpska.

Figure 3.10. Labor and other costs increased over the last year

Percent of firm respondents



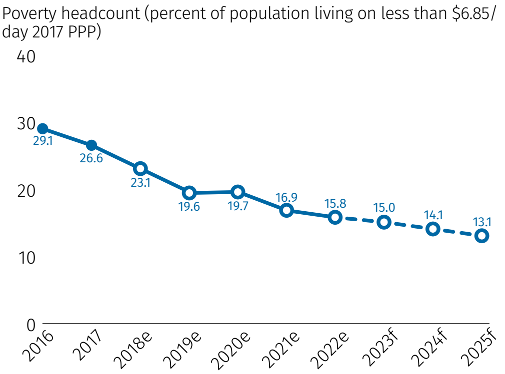
Source: Balkan Business Barometer 2023 survey.

of higher labor costs that add to pressures from other input prices, including energy, defensive restructuring can take place, as is already happening in the car supply industry where global demand is on the decline.

4. Low labor force participation, coupled with significant gender gaps, constrains further poverty reduction

For 2023, poverty rates in the region are estimated to continue their downward trend, which had slowed down due to the COVID-19 pandemic and the subsequent inflation shocks of 2022. The pre-pandemic poverty reduction trend in the Western Balkans was halted in 2020 by the impact of the crisis, which resulted in significant job losses and an average contraction of GDP by 3 percent in 2020. While the economic recovery in 2021 was strong, with 7.8 percent GDP growth overall for the Western Balkans, and reflected in a reduction of 2.8 percentage points in regional poverty by 2021, the poverty reduction pace decelerated in 2022 as households' welfare was affected by soaring food and energy prices (Figure 4.1).

Figure 4.1. Poverty is projected to continue to fall in the region, but at a slower pace



Source: World Bank staff estimates and projections based on 2018 income data from the Survey of Income and Living Conditions (SILC) for Montenegro; 2019 for Albania, and North Macedonia, 2020 Serbia; and 2017 Household Budget Survey (HBS) for Kosovo.
Note: Income measures in the SILC and consumption measures in the HBS are not strictly comparable. Welfare is estimated in US dollars using 2017 PPPs. The regional estimate excludes BiH due to a lack of comparable data. Forecasts are based on GDP per capita in constant LCU, e = estimate, f = forecast.

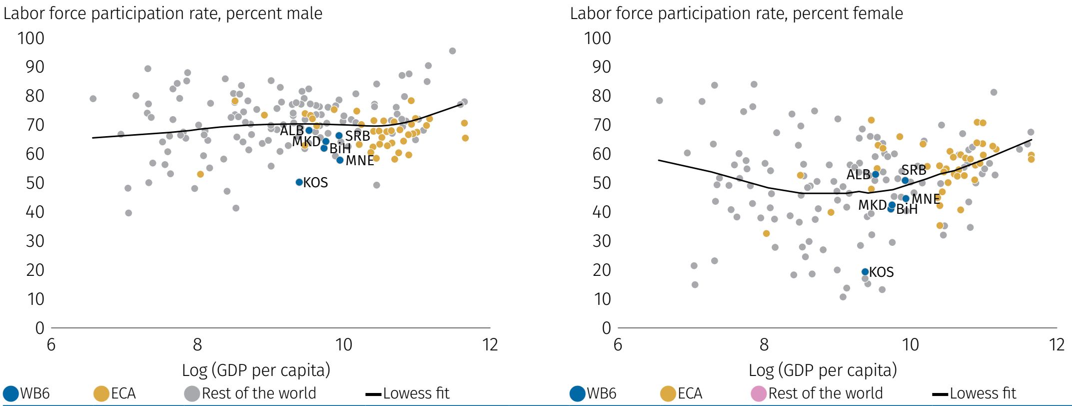
Inflation remains high in the region. By July of 2023, food inflation remained high in the region at 14.6 percent. These levels, while lower than the ones registered in the same month of 2022, are 12.3 percentage points higher than the inflation levels registered in July of 2021, for the regional average. Energy inflation increased marginally in July 2023 compared with July 2022, but remained at levels below food inflation. Serbia stands out as the country with the highest energy inflation rate at 22.1 percent, while Albania has the lowest, at less than 1 percent as of July of 2023. Food inflation also remains the highest in Serbia at 21.1 percent, compared with 6 percent in Kosovo, the country with lowest food inflation in the region by July of 2023.

The less well-off consistently face higher inflation rates compared with the better-off due to differences in the composition of consumption baskets. Furthermore, as discussed in the Spring 2023 Regular Economic Report (World Bank, 2023), if household-specific inflation were used instead, the estimates for poverty and inequality rates, as well as the profile of the poor, would differ systematically, with the largest differences in case of higher inflation.

Historically, employment and labor income have explained a significant share of poverty reduction in the region. While the unavailability of up-to-date household survey data for all countries in the region does not allow to ascertain the actual magnitude of the increase in poverty in 2020 and subsequent reduction, past analysis has highlighted the critical role of employment and labor income in explaining poverty dynamics. In Albania, between 2016 and 2019, 71 percent of the reduction in the poverty rate can be attributed to labor income growth. In Kosovo, while labor income growth can explain half of the poverty reduction that the country experienced between 2017 and 2019, changes in employment can explain two-thirds of the reduction in the poverty headcount. Employment and labor income have been important drivers of poverty dynamics not only in recent years, but over a longer horizon. In North Macedonia for the period 2010–2020 and in Serbia between 2013 and 2020, labor income explained 51 and 59 percent of their respective declines in the poverty rate. Increases in minimum wages across the region since 2021, mostly in response to higher inflation (see Section 3) could be beneficial for low-income households, and for in-work poverty, but could also pose challenges to generate more employment in the future, despite consensus estimates of employment effects of increasing wages of minimum-wage earners (Grunberger et al., 2021).[5]

Despite some improvements over time, labor force participation rates in the Western Balkans continue to lag other countries with similar levels of economic development. Data for H1 2023 suggest that employment growth has resumed in the region, with an average annual growth rate of 1.5 percent, but challenges remain on the horizon (see Section 3). Labor force participation rates in Western Balkan countries remain lower than those predicted by their level of GDP per capita, with the sole exception of Albania. Notably, this is not only on account of low labor force participation among women; labor force participation rates among men, while higher than women's, are actually even further below those predicted by the countries' level of development than the rates for women (Figure 4.2). Furthermore, labor market attachment in the region lags significantly behind the EU27 average labor force participation rate of 74.5 percent in 2022, particularly in Kosovo (38.6 percent) and BiH (47.6 percent).

Figure 4.2. Male and female labor force participation (15+) and GDP per capita, latest data

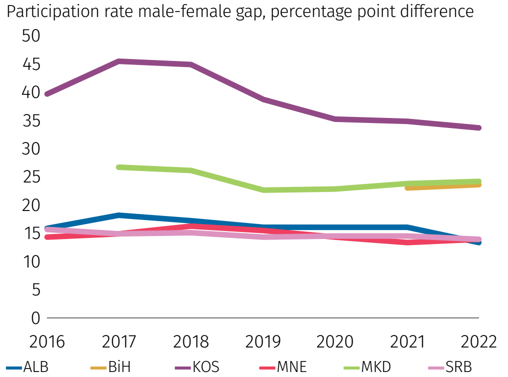


Source: World Development Indicators.
Note: Latest year available for each country.

5 Grunberger, Klaus, Edira Narazani, Stefano Filauro, and Aron Kiss. 2021. "Social and fiscal impacts of statutory minimum wages in EU countries: A microsimulation analysis with EUROMOD." Joint Research Centre Working Papers on Taxation and Structural Reforms No. 06/2021, European Commission, Brussels.

Gender disparities in the labor market persist in all countries, despite a gradual increase in female labor force participation. Among the countries in the region, Kosovo stands out as the one that has made progress in narrowing the gap between male and female labor participation. In 2017, the gap was as wide as 45 percentage points but, by 2022, it had reduced to 33 percentage points. Nevertheless, Kosovo continues to present the largest gap in the region, followed by North Macedonia and BiH, at 24 percentage points, and by other countries in the region at around 14 percentage points (Figure 4.3).

Figure 4.3. Significant differences between male and female labor force participation pose a major challenge



Source: Labor Force Survey for each country.
Note: All estimations for the 15–64 population except for BiH which uses the 15–89 population.

Women are particularly affected by the lack of both child and elderly care services that impact their (formal) labor market participation. The time required to care for school-age children is high (see Box 4.1). According to a 2014 World Bank study, formal childcare use outside the home in the region is low, reaching 24 percent of households with at least one child under age 7, which is below the EU15 average of 35 percent. Similarly, the use of formal elderly care ranged from 0 to 4.8 percent for countries in the region. More recently, the ILO estimated that less than 2 percent of the elderly in need of care in Albania receive formal care services and that 22 percent of the population aged 65 or above need long-term care, causing them to rely heavily on informal care provision by family members.[6] Given the lack of access to child- and elderly-care services, combined with social norms across many communities in the Western Balkans, both child and elderly care responsibilities fall disproportionately on the female members of households, affecting their ability—and aspirations—to participate actively in the labor market.

Box 4.1. The burden of care and labor market participation

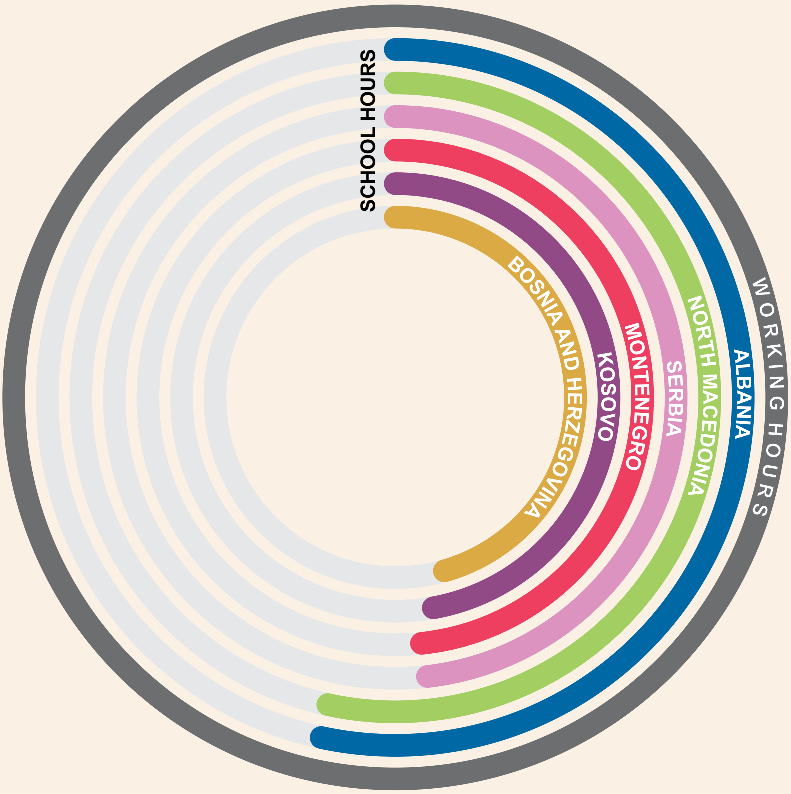
Parents of young children face a tough balancing act between the responsibility of caring for their kids and earning an income. The limited supply of childcare centers in all countries in the Western Balkans makes it challenging for parents to find suitable care for their children. Parents may have to resort to less-than-ideal options such as leaving their children with untrained caregivers, quitting their jobs, or working part-time to care for their children. The problem is not just early childhood care. Indeed, even once children enter primary school, the challenge of balancing work and childcare persists. With vacations and

6 "Long-term care for the elderly in Albania: Challenges and key policy issues". ILO (2022).

(Box 4.1 continued)

days off, as well as the fact that children are only in school for about 5 hours a day, parents still need to find care for their children during these gaps. This can be particularly challenging for single parents or households where both parents must work full-time. Figure 4.4 shows that children in primary school are in school for half the working hours of a full-time worker.

Figure 4.4. Share of regular full-time working hours children spend in public school



Source: World Bank staff.

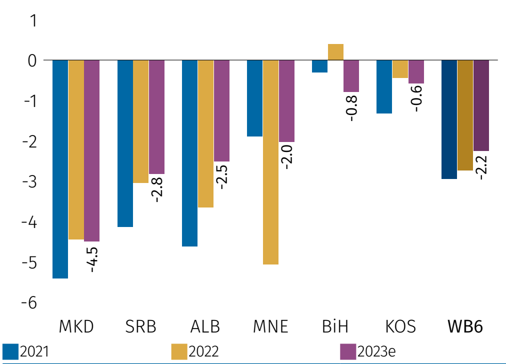
Thus, the shortage of accessible and affordable pre-school and afterschool care can profoundly impact parents and families. It can limit parents' ability to return to work or force them to make difficult choices about the quality of care their children receive. Besides childcare, caring for an elderly parent is not an easy task and can be just as challenging, if not more so. In many cases, it requires significant time, effort, and resources, making it difficult for household members to maintain a full-time job. The physical and emotional demands of elderly care, such as medication management, transportation, and assistance with daily activities, can be overwhelming and exhausting, leading to burnout and stress. In addition, the financial burden of elderly care can be significant, especially if the parent requires specialized medical attention or long-term care.

5. High financing costs and fleeting revenue growth call for structural fiscal consolidation

Fiscal policy in the Western Balkans remains on a revenue-driven consolidation path, but notable country variation in expenditure trends shows signs of renewed pressures. Despite persistent external volatility, all Western Balkan countries in 2023 are expected to continue running fiscal deficits below, or close to, their 2021 levels. The WB6 regional average[7] fiscal deficit is expected to drop by 0.5 of a percentage point of GDP in 2023, down from 2.7 percent of GDP in 2022 (Figure 5.1). The annual improvement in 2023 is primarily driven by expectations of significant consolidation in Montenegro (3.1 percentage points of GDP), Albania (1.2 percentage points of GDP), and Serbia (0.2 of a percentage point of GDP). In Kosovo, the level of fiscal deficit is expected to remain low—below 1 percent of GDP—and broadly the same as in 2022. BiH is also expected to run a fiscal deficit level that does not exceed 1 percent of GDP, but its balance will nevertheless deteriorate given that the country ran a fiscal surplus in 2022. North Macedonia, meanwhile, is expected to maintain the highest level of fiscal deficit in the region, at the same level as in 2022, at around 4.5 percent of GDP.

Inflation boosted revenue growth, which remains strong. All WB6 countries continue to experience strong yoy nominal revenue growth. Except for Serbia, revenues in percent of GDP are also expected to grow across WB6 countries, gaining 1.1 percentage points of GDP, on average. Montenegro, Albania, and North Macedonia are expected to see even higher-level increases of over 1 percentage point of GDP. Moreover, in Montenegro, the increase in revenue coincides with a contraction of expenditure as a percentage of GDP, leading to a more significant improvement in fiscal balance. In Serbia, contained expenditures reflecting the retraction of crisis support measures are expected to lead to an improvement in the

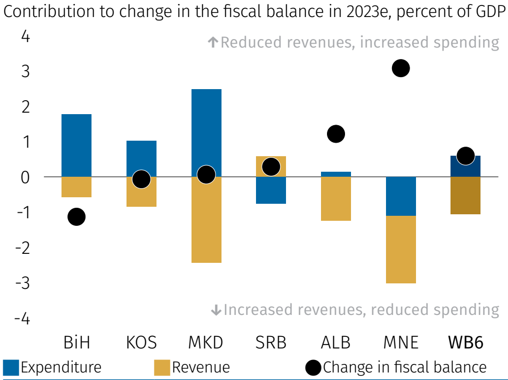
Figure 5.1. Montenegro, Albania, and Serbia set to experience an improvement in fiscal balances...



Sources: National statistical offices; Ministries of Finance; World Bank staff estimates.

Figure 5.2. ...but consolidation is driven by contained expenditures only in Serbia and Montenegro

Contribution to change in the fiscal balance in 2023e, percent of GDP



Sources: National statistical offices; Ministries of Finance; World Bank staff estimates.

7 From here on, the regional average refers to the regional unweighted arithmetic average.

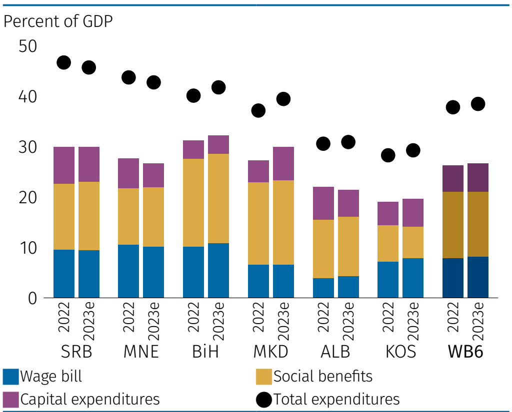
fiscal balance, despite a drop in revenue relative to GDP. On the other hand, BiH and North Macedonia, despite experiencing significant revenue growth, are expected to experience a deterioration of fiscal balances against a surge in expenditure (Figure 5.2).

After two years of post-pandemic normalization, WB6 average expenditure levels are growing again in 2023. In 2022, expenditures in the region contracted by an average of 1.3 percentage points of GDP. In 2023, expenditures, as a percentage of GDP, will only continue to drop in Serbia and Montenegro (by close to 1 percent of GDP). In Albania, expenditures are expected to only marginally increase, while in North Macedonia, BiH and, to a lesser degree, Kosovo, expenditures are set to grow (Figure 5.3). Pressures for recurrent expenditure remain high and continue to drive expenditure growth. Capital expenditures are expected to provide a positive, yet relatively smaller contribution to growth. In North Macedonia, capital expenditure is expected to increase by 2.5 percentage points of GDP over 2023.

While maintaining elevated social protection spending, all WB6 countries will also spend more on public wages during 2023. Social protection spending during the year is expected to remain elevated, at an average of 12.9 percent of GDP, and to exceed 15 percent of GDP in BiH and North Macedonia (Figure 5.4). In Serbia and Montenegro, despite contractions in total spending as a percentage of GDP, social protection spending is expected to increase. Kosovo is the only country in the region where social spending is expected to contract compared with a year before. On the other hand, and after a year of lower real public wages in 2022, the whole region is expected to see continued increases in public wage compensation. Nonetheless, in North Macedonia and Kosovo, increased capital expenditure is expected to be the main driver of expenditure growth.

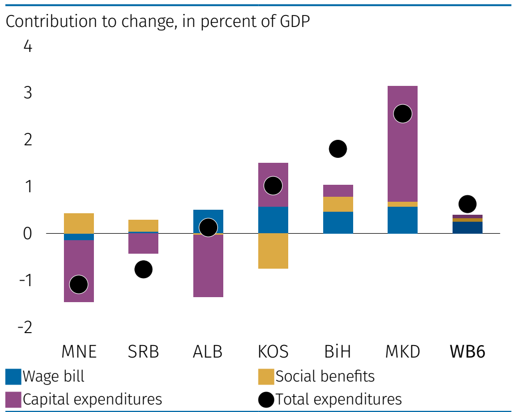
Inflation-supported revenue gains may lead to structurally higher expenditure pressures and budget rigidity. Most WB6 countries have been on a post-pandemic consolidation trend, which was largely driven by positive revenue

Figure 5.3. The share of social benefit remains high...



Sources: National statistical offices; Ministries of Finance; World Bank staff estimates.

Figure 5.4. ...while all WB6 countries have turned to higher spending on public wages



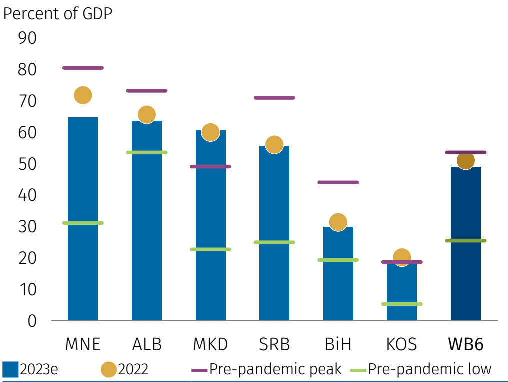
Sources: National statistical offices; Ministries of Finance; World Bank staff estimates.

performance, but also by a gradual retraction of crisis-related measures. The continued impetus of inflation on revenue will, however, not be permanent. At the same time, the retraction of crisis measures is being replaced with increases in rigid expenditure categories, such as wages and pensions. To the extent that revenue gains came mostly from inflation, and less from the expansion of the revenue base, WB6 countries may face higher budget rigidity and less room for maneuver to reprioritize their budgets, as fiscal space is being eroded by a parallel increase in rigid (inflation-driven) spending, such as pensions and wages.

Owing to solid fiscal performance and the denominator effect, public and publicly guaranteed debt for the region declined as a share of GDP. While growth performance is mixed across the region, GDP deflators remain high in all countries, resulting in higher-than-expected nominal GDP. This has led to a reduction of public and publicly guaranteed (PPG) debt as a share of GDP in most countries (Figure 5.5). The average PPG debt-to-GDP ratio for the region is estimated to decline to 48.5 percent of GDP from 50.6 percent in 2022. North Macedonia is the only country where PPG as a share of GDP is expected to increase in 2023, by 0.6 of a percentage point, as the country undertakes large capital projects. The most pronounced decline in PPG debt to GDP is expected for Montenegro—from 71.7 percent of GDP in 2022 to 64.2 percent of GDP in 2023—due to the highest nominal growth of GDP, but also due to a much stronger-than-expected revenue performance. Albania and BiH's PPG debt-to-GDP ratios are estimated to decline by 2.3 and 2 percent of GDP, respectively, while Serbia's public debt remained at similar levels as in 2022. In Kosovo, large amortizations in 2023 and limited new borrowing are estimated to result in a decline in PPG debt to GDP from 19.9 percent in 2022 to 18.6 percent in 2023. Contingent liabilities coming from SOEs and public private partnerships remain significant fiscal risks, especially in Albania and Serbia.

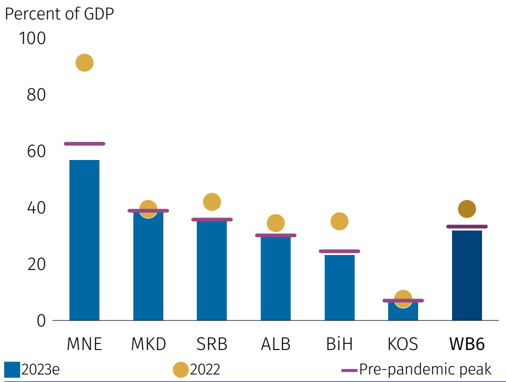
External PPG debt is estimated to have declined marginally (Figure 5.6). The estimated decline of external PPG to GDP from 33.3 to 32.0 percent for the region is a result of higher nominal GDP and limited new borrowings. Montenegro recorded the strongest decline of 5.6 percentage points of

Figure 5.5. PPG debt is declining in all countries except North Macedonia...



Sources: National statistics offices; World Bank staff estimates.

Figure 5.6. ...and the trend is similar for external debt



Sources: National statistics offices; World Bank staff estimates.

GDP, followed by BiH (-1.6 percentage points of GDP). The decline is estimated to be only marginal for North Macedonia and Albania, while Serbia and Kosovo's external PPG to GDP is expected to remain at the same levels as in 2022. In April 2023, the IMF approved for Kosovo a 24-month precautionary Stand-By Arrangement (SBA) of EUR 100 million and an arrangement under the Resilience and Sustainability Facility of EUR 78 million, the first of such operation in Europe. Kosovo therefore joins Serbia and North Macedonia in having an active engagement with the IMF, with Serbia's SBA signed in December 2022 and North Macedonia's Precautionary and Liquidity Line signed in November 2022. In 2023, the World Bank provided additional support through the development policy loans approved for Kosovo (EUR 50.6 million), Albania (EUR 110 million), and Serbia (EUR 149.9 million), which aims to assist in strengthening the resilience of these countries' economies and their environmental sustainability. At the EU-Western Balkans Summit in Tirana in December 2022, the European Commission put forward an Energy Support Package of EUR1 billion budget support for the Western Balkans.

Tightening financial conditions are being reflected in increased cost of financing for the WB6. Most WB6 countries have become increasingly reliant on external financing over the past few years and are vulnerable to the rising costs of financing resulting from monetary policy tightening. After a pause in 2022, most Western Balkan countries returned to the markets in 2023, but the environment is vastly different. In January, Serbia issued two Eurobonds—a five-year Eurobond of US$750 million at a coupon rate of 6.25 percent, and a 10-year Eurobond of US$1 billion at a coupon rate of 6.5 percent. In March, North Macedonia issued a four-year Eurobond of EUR 500 million at a coupon rate of 6.96 percent. In June, Albania issued a EUR 600 million at a coupon rate of 5.9 percent. All these Eurobond placements come at a much greater cost for the countries than in the previous two years, when Serbia placed a Eurobond at a coupon rate of 1 percent and North Macedonia at a coupon rate of 1.625 percent. Consequently, yields on the outstanding Eurobonds of the Western Balkans countries are elevated, although on average lower than half a year before (Table 5.1). At the same time, spreads with yields on German bonds have narrowed since the beginning of the year.

Table 5.1. Yields on Western Balkans countries outstanding Eurobonds

	Coupon	Maturity	Yield in % (28 Mar 2023)	Yield in % (26 Sep 2023)	Spreads (basis points)
Albania	3.5	16/06/2027	6.5	5.5	273.2
	3.5	09/10/2025	6.1	5.5	213.0
Montenegro	2.785	16/12/2027	8.4	6.8	405.8
	3.375	21/04/2025	7.3	5.9	249.8
North Macedonia	6.96	13/03/2027	–	6.0	319.4
	2.75	18/01/2025	6.4	6.0	258.0
Serbia	3.125	15/05/2027	5.8	6.2	341.8
	6.25	26/05/2028	–	6.8	413.2
Bosnia and Herzegovina, Republic of Srpska	4.75	01/01/2026	7.0	7.1	408.2

Source: https://www.boerse-frankfurt.de/en, accessed on 26 September 2023.
Note: Spreads refer to spreads with yields on German bonds with the same or similar residual maturity.

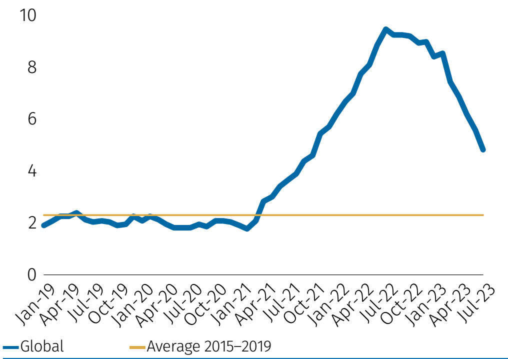
6. Inflation is easing, but price pressures persist

Global inflation is gradually declining supported by easing commodity price pressures. However, both headline and core inflation remain elevated and above target in many inflation-targeting economies. Following a peak of 9.4 percent in July 2022, global median headline inflation declined to 4.8 in July 2023 (Figure 6.1). The deceleration largely reflects favorable base effects from 2022 peaks along with a contraction in fuel and energy prices. Core inflation has, on average, declined more gradually reaching 5 percent in July 2023 but remains heightened in both AEs and emerging market and developing economies (EMDEs). In the euro area, inflation decelerated to 5.3 percent in July 2023, with energy prices declining (-6.1 percent) and food inflation remaining above 10 percent (Figure 6.2). Global commodity prices fell by 14 percent during Q1 2023 and, by the end of March, they were roughly 30 percent below their historic peak in June 2022.[8] The surge in prices that followed Russia's invasion of Ukraine has largely been unwound on a combination of slowing economic activity, favorable winter weather, and a global reallocation of commodity trade flows. On the energy front, prices were 20 percent lower in Q1 2023 than in Q4 2022. Despite recent energy price volatility, by August 2023, the Brent oil and the Europe natural gas prices were below their 2022 peaks by 28 and 70 percent, respectively.

The drivers of inflation are changing. Recent trends suggest that, on average, external sources of inflation are easing, while domestic factors are taking a more prominent role in driving inflation. With supply chain pressures easing and international commodity prices declining, domestic pressure stemming from excess demand, lagged effects of crisis support measures, corporate profits remaining high and indexation of wages, appear to be a key driver of continuing high inflation in many countries (see Box 6.1). At the same time, the sharp tightening of monetary policy and financing conditions has also played an important factor in bringing down inflation. Despite the easing

Figure 6.1. Inflation is decelerating, but price pressures remain elevated

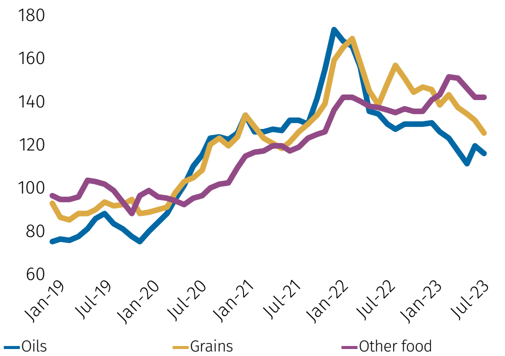
Median headline global inflation



Source: World Bank Global Economic Prospects, 2023.

Figure 6.2. Domestic food price inflation remains high around the world

Monthly food price indexes based on US$



Source: World Bank Commodity Price Data.

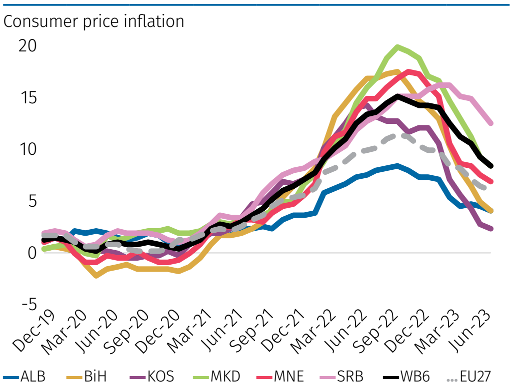
8 World Bank Commodity Market Outlook, 2023.

of several commodity prices, domestic food price inflation remains high around the world. Information from May 2023 shows high food inflation in many low and middle-income countries, with inflation higher than 5 percent in 63.2 percent of low-income countries, 79.5 percent of lower middle-income countries, and 67.0 percent of upper middle-income countries, and many experiencing double-digit inflation.[9] Elevated food prices contribute to higher food insecurity, with severe implications for poorer populations in many developing economies.

Inflation pressures in the WB6 region are easing, although price pressures persist. After peaking in October 2022 at 15 percent, average consumer price inflation for the WB6 region has been on a downward trend reaching 8.4 percent in July 2023 (Figure 6.3). Significant contributors to consumer price inflation have been the deceleration in international commodity prices, including food prices which represent a larger share of the CPI basket in WB6 economies than the EU average[10] and are a key determinant of inflation in the WB6 (Figure 6.4). While consumer price inflation is easing at the regional level, there is significant country-level heterogeneity. By July 2023, consumer price inflation stood below 5 percent in Albania (4.1 percent), BiH (4.0 percent) and Kosovo (2.4 percent), while it remains above 5 percent in Serbia (12.5), Montenegro (6.9 percent) and North Macedonia (8.4 percent).

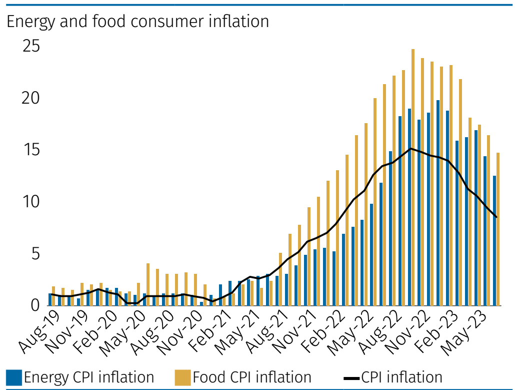
Core inflation momentum remains high pointing to persistent and broad-based price pressures. Core inflation in WB6 peaked at 9.6 percent in February 2023 and has been decelerating since then. However, as of July 2023, it remains above 5 percent partly owing to the persistent impact of past commodity price increases on economy-wide prices.[11] By July 2023, core inflation stood at 9.4 percent in Serbia and Montenegro, 7.9 percent in North Macedonia and 3.4 percent in Kosovo. Its persistence reflects, depending on the economy considered, strong domestic demand, the strength of the labor markets and wage growth,

Figure 6.3. After peaking in 2022, inflation in the WB6 has been on a downward trend...



Source: Statistical offices; World Bank staff.

Figure 6.4. ...supported by easing commodity prices



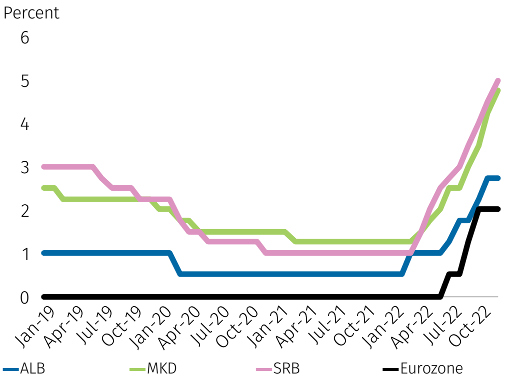
Source: Statistical offices; World Bank staff.

9 World Bank Food Security Update, July 2023.
10 The simple average of the weight of food in the CPI basket for the region is around 42 percent (IMF, 2023).
11 A recent IMF paper documents empirically that besides being a key driver of headline inflation, international food prices in the WB6 directly affect core inflation measures.

a high pass-through of past shocks to headline inflation into core inflation, and the lagged effects of crisis response programs.

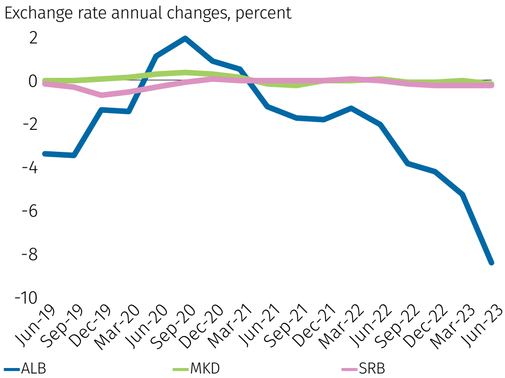
In countries with independent monetary policy, authorities increased monetary policy key rates throughout H1 2023 (Figures 6.5 and 6.6). On one hand, inflation targeting countries experienced inflation well above their targets. On the other hand, exchange rate considerations, including the strength of pass-through, the trends and competitiveness concerns, impacted differently the magnitude of tightening by central banks in the region. In Serbia, after 16 months of continuous gradual increases, the policy rate was eventually kept unchanged in August 2023 at the level of 6.5 percent. While the nominal exchange rate remained stable, the real exchange rate appreciated by 4.4 percent. In Albania, the currency appreciation aided a faster convergence of inflation to the target and, on account of further domestic currency appreciation, the central bank's policy rate stood at 3 percent since March 2023. In North Macedonia, the key policy rate stood at 6.15 percent in August, up from 1.25 percent from spring 2022. The pegged exchange rate has remained stable and foreign exchange reserves have recovered from losses incurred largely at the outbreak of the war in Ukraine, standing at more than four months of imports in June 2023. Monetary conditions are still accommodative, as real policy rates remain negative, reflecting rising inflation and inflation expectations.

Figure 6.5. Policy rates increased reflecting persistent inflation, but real policy rates remain negative



Source: Central banks; World Bank staff.

Figure 6.6. Exchange rates were stable in North Macedonia and Serbia but appreciated in Albania



Source: Central banks; World Bank staff.

Box 6.1. Inflation drivers in the Western Balkans since 2021: profits, then wages

The inflation drivers over the past two years have been in the focus of debates across the EU countries and the Western Balkans. The analysis of the inflation drivers for the Western Balkans follows the recent approach of the ECB[12] and IMF[13] to decompose GDP deflator growth, used as a proxy for inflation, into a weighted sum of unit labor cost (additionally split into wages and productivity), unit profits, and unit taxes, all measured as per unit of real GDP.[14] Since no Western Balkan country publishes timely, high-frequency GDP income approach data (only yearly data exist for BiH and Montenegro), this analysis relies on proxies.[15] The total compensation of employees is estimated by multiplying the number of employees by the average gross wage, plus a markup for employers' social contributions, while profits, precisely gross-operating surplus and mixed income, are calculated as the difference between gross value added and labor cost. Net taxes on production are taken from the GDP production approach data. Despite relying on proxies due to data availability limitations, the results of the methodology appear to be robust. Comparisons of yearly aggregated proxy outcomes with those of published GDP income approach data confirmed the findings for BiH and Montenegro.

The analysis shows that, while profit growth was an important driver of inflation in 2021 and in H1 2022 in several Western Balkan countries, labor costs have been the inflation driver since H2 2022. Similar to EU countries, profits' contribution to inflation in the WB6 began to rise already one year before the war in Ukraine, in the middle of the COVID-19 pandemic. Limits to short-term supply elasticities meant that the recovery in demand enabled firms to increase profit margins in those sectors exhibiting supply-demand mismatches. As the supply capacity improved over time and demand patterns normalized, a decline in profit margins translated into lower inflationary pressures.[16] However, with the beginning of the cost-of-living crisis in 2022, wage pressures strengthened.

Profits became the largest driver of domestic inflation in 2021 in Albania, BiH, and Montenegro, and in 2022 in North Macedonia, while wage growth primarily drove inflation in Serbia and Montenegro from early 2022, and in North Macedonia and BiH from late 2022, as minimum wages and labor demand increased. In *Albania*, profits grew from mid-2021, contributing on average 2.6 percentage points to inflation in that year, and showed exceptional growth in 2022, pushing inflation up by 7.7 percent. As the share of

12 https://www.ecb.europa.eu/press/blog/date/2023/html/ecb.blog.230330~00e522ecb5.en.html
13 Hansen, Toscani, Zhou (2023): *Euro Area Inflation after the Pandemic and Energy Shock: Import Prices, Profits and Wages*. IMF Working Paper. WP/23/131.
14 The weights are determined by each unit cost's share in real GDP. To analyze the effect of wages on inflation, unit labor cost growth is split up into wage growth and labor productivity growth, assuming equal weights.
15 There are no published data on quarterly gross wages in Kosovo, hence Kosovo is excluded from the analysis. Changes in labor force survey methodologies in North Macedonia, BiH and Montenegro proved to be an obstacle to getting consistent employment statistics: (i) the 2022's employment in North Macedonia was estimated by applying employment rate growth to historical employment data before the revision; (ii) in BiH, since the adjustment was stepwise, only data from Q2 2020, after the completed adjustment, are used; and (iii) Montenegro LFS employment showed large volatile fluctuations, hence administrative employment data are used.
16 https://www.ecb.europa.eu/press/key/date/2023/html/ecb.sp230306~57f17143da.en.html

(Box 6.1 continued)

the self-employed who earn mixed income that counts toward profits is high in Albania, profits have a larger weight in inflation. On the other hand, lower contribution of wages (also due to informality) also limits the pass through from a minimum wage increase. In *Bosnia and Herzegovina*, profits were the main driver of inflation in 2021 and remained strong throughout 2022, contributing around 5.3 percentage points to inflation. A gradual increase in gross nominal wages raised their contribution to inflation from 2022 and took over as the main inflation driver in H2 2022. In *North Macedonia*, the role of profits in driving inflation remained relatively low in 2021, with an average contribution of around 0.7 of a percentage point. However, in 2022, they contributed 5.7 percentage points to inflation, although the wage contribution became slightly larger than that of profits in H2 2022. In *Montenegro*, profits pushed inflation up on average by 3.7 percentage points in 2021, but in 2022 this trend was interrupted by the increase in employment and minimum wage, which pushed up labor costs. Since then, wages have become a main contributor to inflation, yet profit growth has started increasing again in H2 2022.

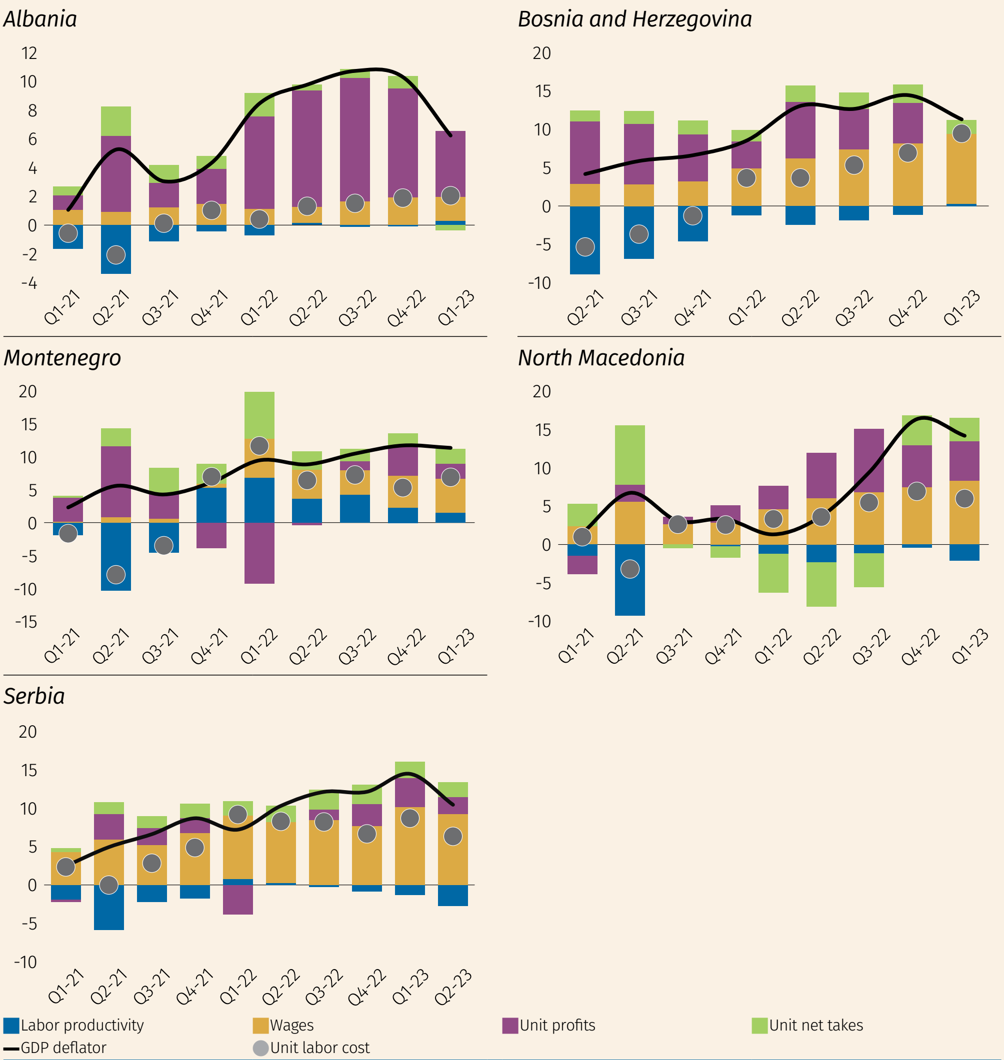
Finally, net taxes also contributed to a rise in inflation in 2022, except in North Macedonia. In 2022, net taxes in North Macedonia lowered inflation by 5 percentage points. This was due to a sharp rise in subsidies on products that was larger than the rise in indirect taxes, thus turning the unit tax contribution to inflation growth negative. This has changed in 2023 as the Government of North Macedonia reduced subsidies to the economy. In other countries, net taxes have had small, albeit noticeable upward pressure on GDP deflator growth since 2021.

Inflationary pressures are subsiding across the Western Balkans but vigilance is needed to lower the alleviated price levels. On one side, supply side pressures lowered, due to decline in energy inflation and some signs of deceleration of food inflation. Also, demand started weakening in several countries in 2023 as high inflation started eroding real incomes. However, core inflation has not declined, and inflation expectations are high. In order to maintain a declining trend, it will be important to ensure synchronization of monetary policy tightening with tighter fiscal policy and avoid fueling inflation through wage increases. On the structural front, strengthening the competition policy to avoid oligopolies, and reducing market entry and conduct barriers in retail and non-tradables, as well as network industries, will help to alleviate the price pressures over the medium to longer term.

(Box 6.1 continued)

Figure 6.7. Drivers of inflation (GDP deflator income approach)

Annual percentage changes, weighted percentage point contributions



Sources: Statistical offices; World Bank staff.
Note: Labor productivity affects inflation negatively because it reduces labor costs.

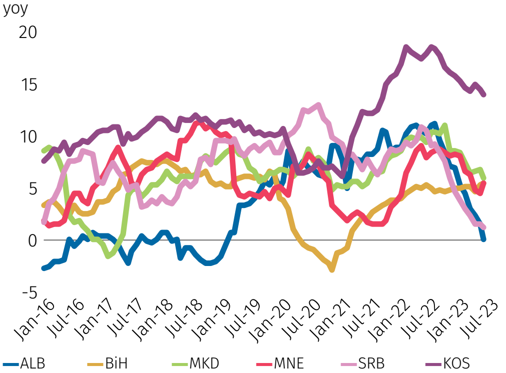
7. The financial sector remains stable while the outlook is fragile

The financial sector in the Western Balkans has remained stable and resilient despite the continuation of multiple challenges testing financial stability posed by the ongoing war in Ukraine and weak economic growth prospects, as well as the surge in interest rates and inflation. Non-performing loans (NPLs) continued to follow a downward trend, declining to a historical low (3.9 percent), while profitability exceeded pre-pandemic levels and capital buffers were preserved. Current financial sector performance demonstrates the strong resilience of the sector thanks to the robust financial position of banks achieved by decisive reforms and restructuring over the past decade (following the global financial crisis) and strong support from governments during the COVID-19 pandemic.

In H1 2023, credit growth continued to decline with the expectations of deteriorating credit supply conditions, testing corporate and household resilience as a result, which may have spillover effects on the banking sector. Tighter financial conditions are affected by various factors, including the war in Ukraine, higher inflation, higher interest rates, and the slowdown of economies. Average credit growth in the Western Balkans had already flattened by June 2022 before starting to slow down since October 2022. Although still positive, credit growth decelerated to 5.7 percent as of June 2023, almost half of its peak in June 2022 (10.4 percent) in the post-pandemic period. The largest declines in credit growth as of June 2023 compared with June 2022 were in Serbia and Albania (credit growth fell to 1.5 and 1.6 percent, respectively), while growth remained strong in Kosovo and flat in BiH (Figure 7.1). Corporate loan growth decelerated sharply in H1 2023, faster than household loan growth, indicating that banks tightened standards more for small and medium enterprises (SMEs) and corporate clients (Figure 7.2). SMEs may be particularly vulnerable to tightening credit supply conditions, higher

Figure 7.1. Credit growth was slashed by half compared with a year ago

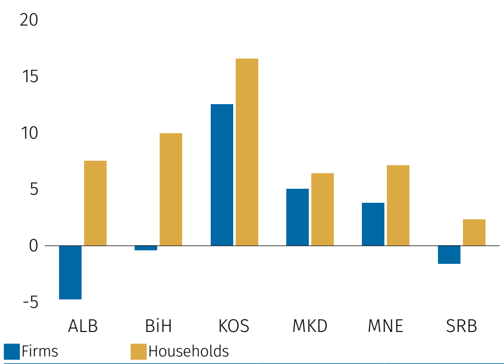
Change in nonfinancial private sector credit outstanding, percent, yoy



Sources: IMF International Financial Statistics; central banks.

Figure 7.2. Corporate loans experienced a sharp slowdown and even shrunk in Albania, BiH and Serbia

Change in credit outstanding, July 2023, percent, yoy



Source: Central banks.

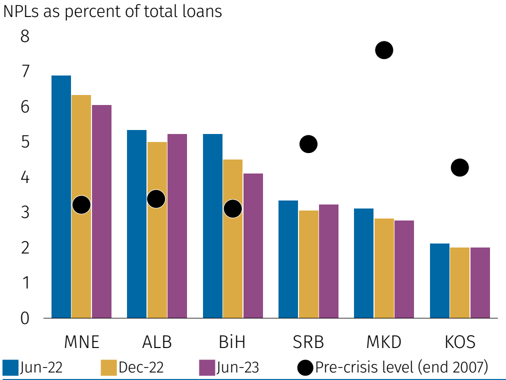
financing costs and a slowdown in economic activity, while households' real incomes and consumption remain under pressure from persistently high inflation.

Gradually weakening credit demand is expected to narrow the mismatch between credit demand and supply in H2 2023. According to the results of the latest Central, Eastern and Southeastern Europe (CESEE) Bank Lending Survey,[17] after gradually weakening since 2021, credit demand stabilized and remained healthy during the first months of 2023. Corporate liquidity needs for inventories and, in particular, working capital are expected to be the main drivers of demand, while fixed investments and retail segments are expected to contribute negatively. On the supply side, credit supply conditions are expected to deteriorate further over H2 2023 as a result of increased uncertainty, a worsening economic outlook, and increased costs of financing. All business segments have been similarly affected, especially regarding longer tenor lending. While banks continue their selective approach in search of creditworthy customers, cross-border banking groups do not foresee a significant deleveraging or strategic change in the region. Positive funding conditions driven by corporate and retail deposits are expected to continue in H2 2023.

The regional average NPL ratio continued to decline, recording a historical low value, while asset quality concerns remain given the weakening economic outlook (Figure 7.3). The regional average NPL ratio decreased by 0.4 of a percentage point from June 2022 to 3.9 percent in June 2023. NPL ratios are higher than the region's average in Montenegro (6.1 percent), Albania (5.2 percent) and BiH (4.1 percent). All countries recorded declining or stable NPLs compared with their June 2022 levels, while Kosovo's NPLs remained the lowest in the region (2 percent).

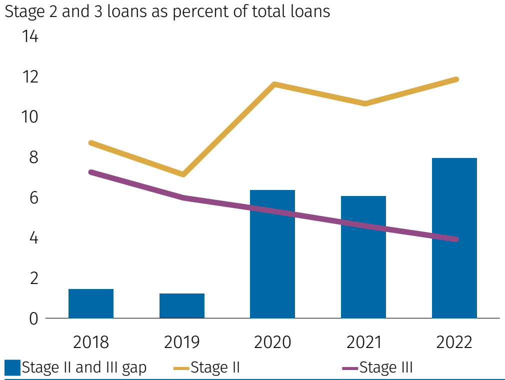
Asset quality resilience remains under stress, due to persistent macroeconomic pressures, including high inflation and interest rates, combined with low economic growth prospects in many jurisdictions, as well as remaining vulnerabilities in the

Figure 7.3. NPLs continued a downward trend



Sources: IMF Financial Soundness Indicators; central banks.

Figure 7.4. Gap between Stage 3 and 2 loans is increasing, an indication of forward-looking recognition of potential loan impairment



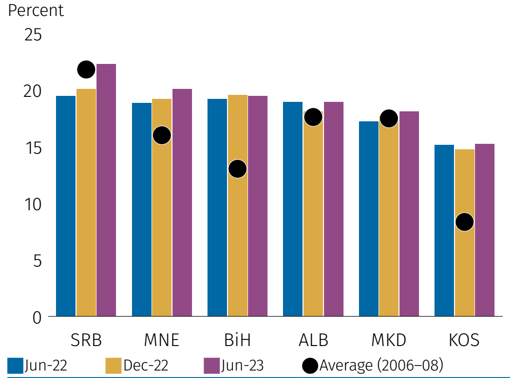
Sources: Fitch; World Bank staff.

17 EIB Central, Eastern and Southeastern Europe Bank Lending Survey, Spring 2023.

post-pandemic period. The widening gap between stage 2 and stage 3 loans[18] (Figure 7.4) is clear evidence of existing and potentially growing pressures on credit risk. Elevated stage 2 loans—forward-looking recognition of potential loan impairment—point to a higher share of loans with a significant increase in credit risk. As of December 2022, the Western Balkans' regional average for stage 2 loans was at 11.82 percent, much higher than NPLs, at 3.9 percent. Stage 2 loans have been increasing consistently in the post-pandemic environment and, as of December 2022, are 4.73 percent above their end-2019 level (pre-pandemic period). The CESEE Bank Lending Survey also indicates that, given the unfavorable economic outlook, banks still expect an increase in NPLs during 2023[19] consistent with their stage 2 loan portfolios.

Capital buffers in the Western Balkan countries remained broadly stable, while bank liquidity is slightly lower compared with December 2022. As of June 2023, the bank capital adequacy ratio averaged 19.1 percent, far above the regulatory minimum, and higher compared with December 2022, at 18.3 percent (Figure 7.5). The ratio of liquid to total assets averaged 28.7 percent in June 2023, recovering from its lowest level in June 2022, potentially reflecting slowing loan growth in recent months. Loan-to-deposit ratios were well below 100 across the board (76.4 percent on average in June 2023), indicating slower loan growth than deposit growth.

Figure 7.5. Banks' capital buffers were preserved



Sources: IMF Financial Soundness Indicators; central banks.

Higher interest rates helped boost banks' lending margin and profitability. Profitability as measured by return on assets has increased to 2.3 percent in June 2023 from 1.6 percent a year ago, supported mainly by the rising interest rates. As of June 2023, Kosovo and Serbia had the highest profitability (2.6 percent), while Albania had the lowest (1.8 percent). Going forward, it will be important to monitor profitability, considering the risks for the outlook. A weaker economy and increased credit risk may weigh on bank profitability prospects in the medium term by increasing provisioning and impairment cost.

However, despite the demonstrated resilience, the financial stability outlook continues to remain fragile amid weak macro-financial conditions. The outlook in the WB6 region remains uncertain, given the presence of downside risks to growth accompanied by persistent inflationary pressures. The high-interest environment, which is now expected to last longer than previously anticipated, is triggering asset repricing, changing investor

18 Stage 2 Assets, in the context of International Financial Reporting Standard (IFRS) 9, are financial instruments that have deteriorated significantly in credit quality since initial recognition but that offer no objective evidence of a credit loss event. Assets are classified Stage 3 if the loan's credit risk increases to the point where it is considered credit impaired. The IFRS is published by the International Accounting Standards Board. IFRS 9 specifies how an entity should classify and measure financial assets, financial liabilities, and some contracts to buy and sell nonfinancial items.

19 Central, Eastern and Southeastern Europe (CESEE) Bank Lending Survey, Spring 2023.

sentiment, and asset allocations. In such an environment, remaining vulnerabilities can easily create stress, as was seen in the banking sectors of some mature economies.

Banks and regulators should have a comprehensive understanding of potential pressure points in the lending books, which includes having clear and implementable plans for different credit or liquidity risk deterioration scenarios. Credit risks from residential and commercial real estate, uncollateralized consumer finance, interest rate sensitive portfolios, and sovereign exposures must all be monitored closely. As banks are expected to continue tightening financial conditions and credit standards, highly indebted households and corporates may come under stress.

Financial stability is paramount for the financial sector to play its fundamental roles in growth and development. While authorities need to keep their focus on monitoring any remaining pockets of vulnerability in the financial sector, they should also continue reforms to enhance the financial sector's role in growth and development. The financial sector plays a key role in allocating resources efficiently, operating payment systems—a key element of a country's economic and financial activity—and helping to manage risks and provide long-term funding for critical investments. Countries in the WB6 region have been embarking on reforms to harmonize their frameworks with international and EU standards in recent years. One of the areas that has achieved significant progress is in digital payments. All the countries in the region are in the process of adopting EU payment laws and regulations. However, there is more to be done to complete this harmonization, as well as to build capacity and infrastructure. As the central nervous system of the economy, modernized payment systems could help WB6 economies boost businesses efficiency, facilitate trade and investment, address informality, enhance financial inclusion and facilitate remittances, which represent a significant share in WB6 countries' GDPs (see Box 7.1).

Box 7.1. Digitalization through modernization of Western Balkans' payment systems

Digital payments have become more prevalent in the Western Balkans, though there still remains more to be done. As economies become more digital, payments—particularly digital payments—enable this transition. They allow economic and financial activities to occur at a faster, more convenient, and safer rate. The usage rate of digital payments—transferring payments through a digital payment instrument, device or channel such as electronic bank transfers, credit and debits cards, electronic money (e-money), QR codes—has been increasing across the Western Balkans over the past few years, driven by regulatory reforms and market initiatives (Figure 7.6).

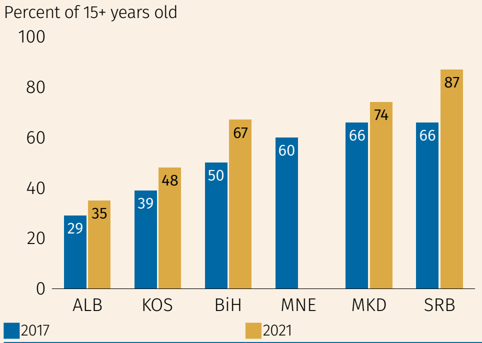
The digitalization of payments is particularly pertinent to the Western Balkan countries, both for domestic and cross-border payments/transfers in their efforts to align with EU standards. Domestically, digital payments support businesses to operate

(Box 7.1 continued)

more efficiently and safely with less cash. Furthermore, they help reduce the informal economy and increase transparency, support financial inclusion efforts by closing the urban and rural divide and, finally, support broader fintech development. For example, increasing digital payments by 10 percent (by means of converting payments from cash to digital) would reduce acceptance cost and is projected to decrease the informal economy by 2 percent.[20] Cross-border digital payments support remittance flows by lowering transaction costs and enabling deeper intra-regional and EU integration for the Western Balkan economies. There is a large diaspora of Western Balkan citizens abroad with nearly 20 percent of the WB6 population residing abroad, generating a substantial flow of remittances, equivalent to 10 percent of GDP in the WB6[21] (see also Section 8). The average cost of sending remittances to WB6 was 6.71 percent at the end of 2022 and sending remittances to WB6 countries from the EU region is 32 percent more expensive than from other regions.[22] The higher remittance costs in the WB6 are driven by several factors, including: (i) not being part of regional/continental initiatives yet such as the Single European Payments Area (SEPA); (ii) the lack of innovative payment service providers in the domestic markets (though it is changing with the transposition of the EU Payment Systems Directive 2); (iii) the lack of interoperable instant payments infrastructures that could also facilitate cross-border payment linkages; and (iv) limited financial literacy and overall cash culture. If there were a 3-percentage-point reduction in the cost of sending remittances, this could bring estimated savings of EUR 0.5 billion for end users.[23]

Figure 7.6. Western Balkans: Digital Payments

Made or received a digital payment



Source: World Bank Global Findex 2017, 2021.
Note: Data were not included for Montenegro in the 2021 Global Findex Survey.

Given the importance of digital payments, the Western Balkans authorities have prioritized efforts to improve the enabling environment for the underlying payments systems. The Western Balkan authorities continue their broad efforts to improve the enabling environment. This requires improving their legal and regulatory frameworks to align with the relevant EU directives and regulations, strengthening their oversight roles of their payment systems, further enhancing cybersecurity, know-your-customer (KYC) aspects, and introducing open banking, as well as implementing new generation payment infrastructures, such as fast payment systems (FPS).

20 The hidden economy in the Western Balkans in a time of crisis: Friend or foe; Southeast European Leadership for Development and Integrity (SELDI), 2022.
21 https://www.oecd.org/south-east-europe/programme/Labour-Migration-report.pdf
22 World Bank analysis and https://remittanceprices.worldbank.org/
23 World Bank staff calculations.

(Box 7.1 continued)

In particular, FPS implementation has been viewed as a critical missing milestone for the region. FPS allow for instant transfer of funds, 24/7/365 availability of service, as well as interoperability among different types of payment service providers (banks and non-banks), thus leading to faster, more efficient, more affordable and safer domestic and cross-border digital payments. Furthermore, the region has set as a prominent objective, and is working toward, membership of the SEPA. Customers in SEPA member countries can make cashless euro payments—via credit transfer and direct debit—to anywhere within the SEPA jurisdiction just like national payments. In general, payment integration triggered by the SEPA has contributed to the efficiency and competitiveness of the European economy as a whole by eliminating differences between national and cross-border payment costs, and by harmonizing standards in all the participating countries. SEPA membership would also enable subsequently indirect access to the European TARGET Instant Payment Settlement (TIPS) system for the Western Balkans, which would allow their respective payment service providers to offer instant, seamless fund transfers on a 24/7/7365 basis. This would thereby facilitate intra-regional and EU integration of the Western Balkan economies.

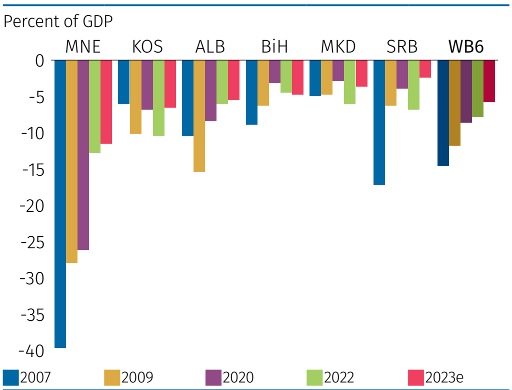
Policy makers in the Western Balkans should continue their efforts to modernize their payment systems by implementing the required legal reforms, as well as modernizing their payments infrastructure. Concerted efforts in both areas are a crucial step toward digitalization of their economies, as well as advancing their economic integration with the EU. This includes the achievement of SEPA membership and eventual access to TIPS.

8. Despite elevated merchandise trade deficits, external current accounts are set to improve

After a temporary spike in 2022, the average CAD is expected to improve in the Western Balkans over the course of 2023, even though merchandise trade deficits remain elevated (Figure 8.1). The WB6 external account is projected to decline to 5.8 percent of GDP in 2023, following a temporary spike to 7.8 percent of GDP in 2022, which was 2 percentage points higher than the previous year. This is the lowest CAD in the WB6 since 2006. The largest WB6 CAD in 2023 is set to occur in Montenegro at 11.5 percent of GDP, the only country with a double-digit external deficit in the region, while the smallest is expected in Serbia at a mere 2.5 percent of GDP. The most pronounced improvements in the CAD are likely to materialize in Serbia and Kosovo. In Serbia, the CAD is expected to improve from 6.9 percent of GDP in 2022 to 2.5 percent in 2023. In Kosovo, the external deficit is expected to almost halve, from 10.5 percent of GDP in 2022 to 6.5 percent in 2023. BiH is the only country in the WB6 where the CAD is projected to marginally deteriorate, from 4.5 percent in 2022 to 4.7 percent in 2023.

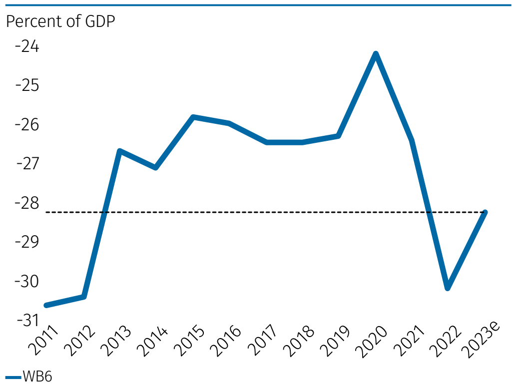
Food, oil, and electricity prices slowly trended downward toward the end of 2022 and in H1 2023, but nonetheless the merchandise trade deficit remains stubbornly high. Some pressure on the merchandise deficit has been released with the sharp deceleration in aggregate demand and import prices that started trending downward. Nevertheless, the merchandise trade deficit in the WB6[24] is expected to reach close to 28.3 percent of GDP in 2023 (Figure 8.2). This sizable shortfall, while 2 percentage points smaller than the year before, remains more pronounced than the merchandise trade deficits seen since 2013, including during the pandemic year. The somewhat smaller merchandise trade deficit in 2023 is the result of a contraction in imports (2.6 percentage points) that exceeds

Figure 8.1. Current account deficits (CAD) improved in most countries in the region...



Sources: Central banks; World Bank staff estimates.
Note: WB6 is simple average of WB6 CADs.

Figure 8.2. ...despite continued elevated merchandise trade deficits from a historical perspective



Sources: Central banks; World Bank staff estimates.
Note: WB6 is simple average of WB6 CADs.

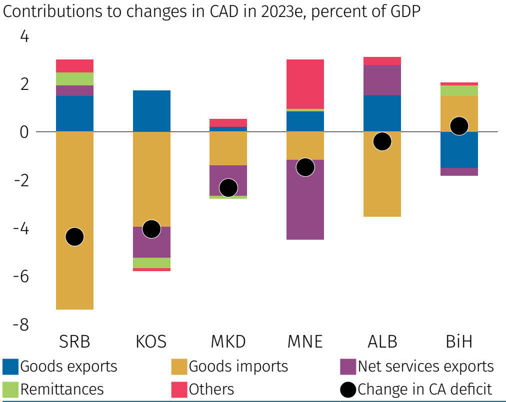
24 Exports and imports of goods, simple average of the six countries.

the contraction in exports (0.7 of a percentage point). This contraction in imports of goods is largely driven by Serbia (7.3 percentage points), Kosovo (3.9 percentage points), and Albania (3.5 percentage points) as the value of imported fuels dropped. In Albania, for example, the fall in the value of imported fuels, mainly from Algeria, was accompanied by a decline in the value of imported construction materials and metals, which together more than offset higher imports of machinery and other equipment. Meanwhile, the marginal decline in exports of goods was a combination of a reduction observed in the range between 0.2 and 1.7 percentage points in North Macedonia, Montenegro, Albania, Serbia, and Kosovo, together with an improvement of 1.5 percentage points in BiH. In Montenegro, for example, the surge in electricity exports was more than offset by the drop in exports of metals and metal ores to the EU and China. The export of goods is set to barely change in North Macedonia, with a decline of 0.2 of a percentage point in 2023 compared with 2022.

Net services and remittances play an increasing role in mitigating structural merchandise trade deficits (Figures 8.3 and 8.4). In 2023, net services exports and remittances are projected to average 19.0 percent of GDP, demonstrating a consistent upward trend in GDP terms since 2014 when these net inflows accounted for 13.5 percent of GDP.[25] Visits by workers residing abroad contribute most to travel inflows in BiH, Kosovo, and North Macedonia, whereas Albania and Montenegro have a more prominent tourism sector. It is worth noting that BiH has been steadily increasing its tourism revenues, with overnight stays from Croatia, Serbia, Türkiye, Saudi Arabia, and the United Arab Emirates accounting for 45 percent of the 1.4 million overnight stays recorded during January to July 2023. This represents a 30 percent increase compared with the previous year. Meanwhile, remittances in the WB6 have been recovering since hitting a low in 2016 and have surged since 2021 (Figure 8.4). While this is not immediately obvious from levels expressed in GDP terms, it is worth bearing in mind that growth in the denominator (nominal GDP)

Figure 8.3. Services and remittances across the WB6 help contain external deficit...

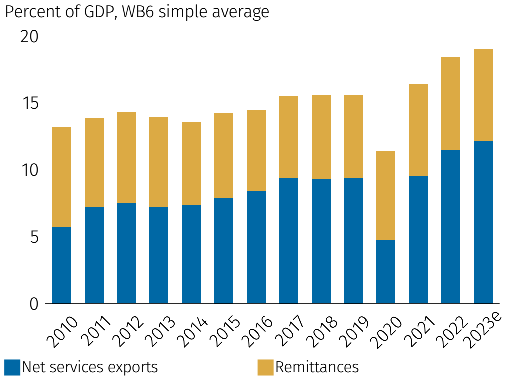
Contributions to changes in CAD in 2023e, percent of GDP



Sources: Central banks; World Bank staff estimates.

Figure 8.4. ...and exhibit a continuous increase compared with pre-pandemic years

Percent of GDP, WB6 simple average



Sources: Central banks; World Bank staff estimates.

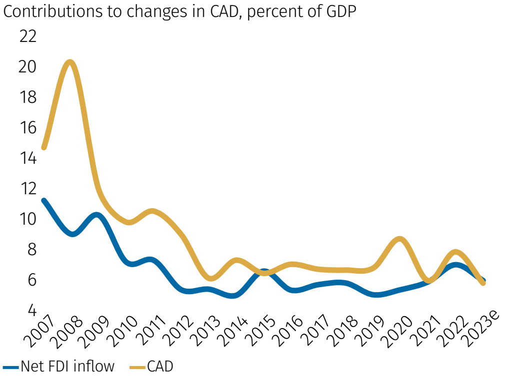
25 With the exception of 2020, the pandemic year.

has been in the double digits in most countries in the region from 2021 to 2023 due to extraordinarily high inflation rates. Specifically, in 2023, remittances are expected to remain robust at 6.9 percent of GDP, only 0.1 of a percentage point less than the level recorded in 2022, when remittances reached a historical peak over the past two decades. During these two years (2022 and 2023), nominal GDP grew on average 11.9 and 11.2 percent, respectively, across the WB6 compared with an average growth rate of only 4.4 percent in 2019.

Net FDI inflows, on average, continue to finance the external imbalance in the WB6. Since 2021, net FDI inflows have continued to play a crucial role in funding CADs in the Western Balkans (Figure 8.5). In 2023, Albania, Kosovo, and Serbia are expected to experience significant net FDI inflows estimated at over 6 percent of GDP, fully financing their respective CADs (Figure 8.6). In Serbia and North Macedonia, intercompany loans—a debt-creating FDI flow—dominate, as these countries continue integrating into EU-centric manufacturing value chains, in particular in the automotive industry. In BiH and Montenegro, net FDI inflows primarily consist of non-debt creating flows in the form of equity and reinvested earnings. It is expected that BiH and Montenegro will finance about 71 and 52 percent of their CADs, respectively (Figure 8.6). This is a large shift for Montenegro, which is estimated to experience a significant decline in net FDI inflows of about 5 percentage points.

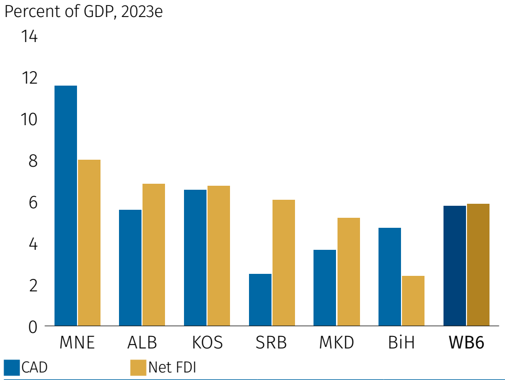
Total external debt in the Western Balkans region is showing a downward trend, with a projected average of 73 percent of GDP, from its peak at close to 90 percent of GDP in 2020. This decline in external debt can be attributed to reductions in both public and private debt, with both sectors witnessing a reduction of about 8 percentage points since 2020. Continued foreign net inflows exceeding the borrowing requirement have supported the buildup of foreign exchange reserves. By end-September 2023, foreign exchange reserves remained strong for the region and prudent adequacy levels were maintained for all WB6 countries.

Figure 8.5. Net FDI inflows have almost entirely financed the external deficit over the past three years...



Sources: Central banks; World Bank staff estimates.

Figure 8.6. ...although on a country basis the extent to which CADs are financed by FDI inflows varies significantly



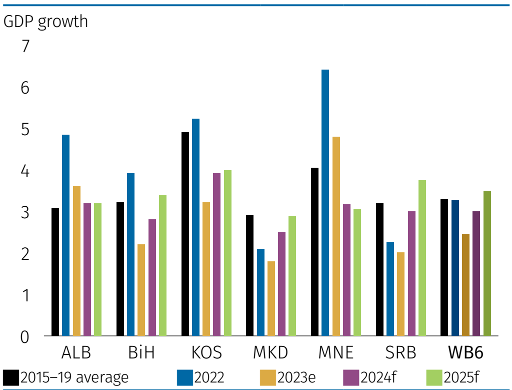
Sources: Central banks; World Bank staff estimates.

9. Reforms are needed to consolidate the recovery and move toward sustainable growth

Global and regional economies are set to recover in 2024. As the WB6 countries are open economies, their economic performance is dependent on the performance of the rest of the world. The WB6 are integrated into the global economy mainly through the trade route, and with the EU and ECA through exports, remittances and FDI inflows. Growth in the global economy, the EU and ECA is expected to bottom out in 2023 and to recover in 2024. Since June, output for both the global economy and ECA has been revised slightly upward for 2023, with better performance in ECA driven by the Russian Federation, Türkiye, and Ukraine, despite the continuation of Russia's invasion of Ukraine. Output for the EU has instead been revised downward, attesting to the fragility of the recovery (see Box 9.1). For all three groupings, growth is expected to be below the pre-pandemic five-year average,[26] suggesting that the recovery is still weak, while the persistence of inflation suggests that monetary tightening is expected to continue.

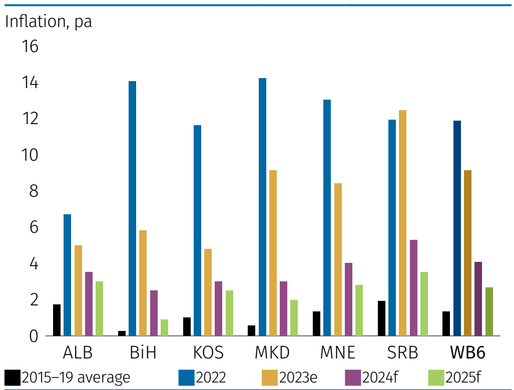
Growth is expected to decelerate across the WB6 countries in 2023 and then to gradually recover over the medium term (Figure 9.1). After the strong post-COVID-19 recovery in 2021, growth decreased in 2022 in part due to base effects and due to the impact of Russia's invasion of Ukraine. In 2023, slower growth in the WB6 is primarily due to weaker consumption and exports, reflecting weaker EU performance, including weaker EU imports for industrial goods. While GDP growth is expected to recover in 2024 and 2025 and return to trend, as inflation subsides and real incomes increase, there are differences across countries. Serbia, North Macedonia and to some extent BiH and Kosovo are expected to accelerate growth in 2024 and beyond. On the other hand, Albania and Montenegro are

Figure 9.1. GDP growth is expected to decelerate in 2023 and gradually recover over the medium-term



Source: World Bank staff.

Figure 9.2. All WB6 countries are expecting to bring inflation closer to their medium-term targets



Source: World Bank staff.

26 Average annual GDP growth rates for the world, the EU and ECA during 2015–19 were 3.0, 2.4, and 2.1 percent, respectively.

expected to observe decreasing rates of growth over the next couple of years.

All WB6 countries are expecting to bring inflation closer to their medium-term targets, which should help strengthen disposable income and support the consumption side of growth (Figure 9.2). The WB6 countries, except Albania, faced double-digit inflation in 2022, including food and energy price surges, which resulted from the measures taken during the pandemic and the supply shortages that followed and by Russia's invasion of Ukraine. Inflation is on a downward trend in the region, though for three of the countries (Montenegro, North Macedonia and Serbia) in 2023, it is still expected to be more than half the 2022 rates. Core inflation also remains high, suggesting sticky and broad-based price pressures. At the same time, strong labor markets and wage growth may weigh further on inflation, in the absence of supply responses. In this context, while efforts to combat inflation have yielded good results through 2022, monetary authorities are expected to remain vigilant to meet their medium-term targets.

Fiscal balances are expected to improve in 2023 for Albania, Montenegro and Serbia, to remain unchanged for North Macedonia, while to deteriorate for the other Western Balkans. BiH's fiscal balance is expected to deteriorate in 2023 owing to the municipal elections to be held later in the year. These elections are expected to erode some of the 2022 deficit gains. In 2024, Kosovo and Montenegro are expected to push ahead with large-scale infrastructure projects, which will adversely affect their fiscal positions that year. However, most of the WB6 countries are expected to adopt revenue measures to strengthen their fiscal balances and to offset some of the expenditures increases.

Public debt is on sustainable paths, based on low fiscal deficits, although downside risks can easily reverse the trend. All WB6 countries are projecting a decrease in fiscal deficits over the medium term. Kosovo and Montenegro expect a one-off increase in its deficit in 2024 and then to return to a declining path. As a result, public debt is expected to be on a declining path and to be sustainable. The average share of public debt in GDP is projected to fall from 50.6 percent at the end of 2022 to 47.9 percent in 2025. Risks similar to those of the growth outlook (i.e., natural disasters and SOE performance) could pose risks to the baseline fiscal projections.

Numerous uncertainties are expected to have a differing impact on the external account of the WB6. On average, the trend is toward deterioration. Pressure from domestic consumption (and capital expenditures for some countries) on the one hand and weakened EU growth prospects on the other, are expected to have a negative effect on the external account. This may be compounded by stubbornly high food prices and the impact of energy insecurity should downside risks materialize. Importantly, the region has historically relied on Russian energy supplies, making it susceptible to disruptions in energy transit routes and price fluctuations caused by disruptions in supply chains. At the same time, the presence of political tensions in the region contributes to a heightened risk premium in the countries, acting as a deterrent to attracting even greater levels of foreign investment. Financing for the current accounts is expected from FDI and external borrowing. Overall external debt for the WB6 countries is high, yet declining, with the external debt-to-GDP ratio expected to reach 73.1 percent of GDP in 2023.

Risks to the growth outlook remain tilted to the downside. A prolonged slowdown in the EU, as well as internal structural bottlenecks, could lead to even further downward revisions to growth projections. In addition, if inflation rates are not brought back to long-term averages as planned, this may further hurt the domestic demand, which is usually one of the key drivers of growth in the WB6 region. Finally, in some countries (Albania and Serbia, in particular) natural disasters could pose a significant risk to the growth outlook by impacting the agriculture and energy sectors.

Reforms are needed to consolidate the recovery toward sustainable growth. The ongoing energy crisis has highlighted the need to accelerate the green transition across Europe, including in the Western Balkans, and with a focus on key sectors, such as agriculture (see Spotlight). The crisis has also highlighted the importance of promoting diversification of energy sources, moving toward renewables, and energy efficiency. Other reforms aimed at increasing market competition, attracting higher-quality investments, and addressing barriers that limit labor force participation (especially among women) or attracting workers, also hold the potential to boost economic growth in the region. Accelerating regional integration would also help accelerate convergence.

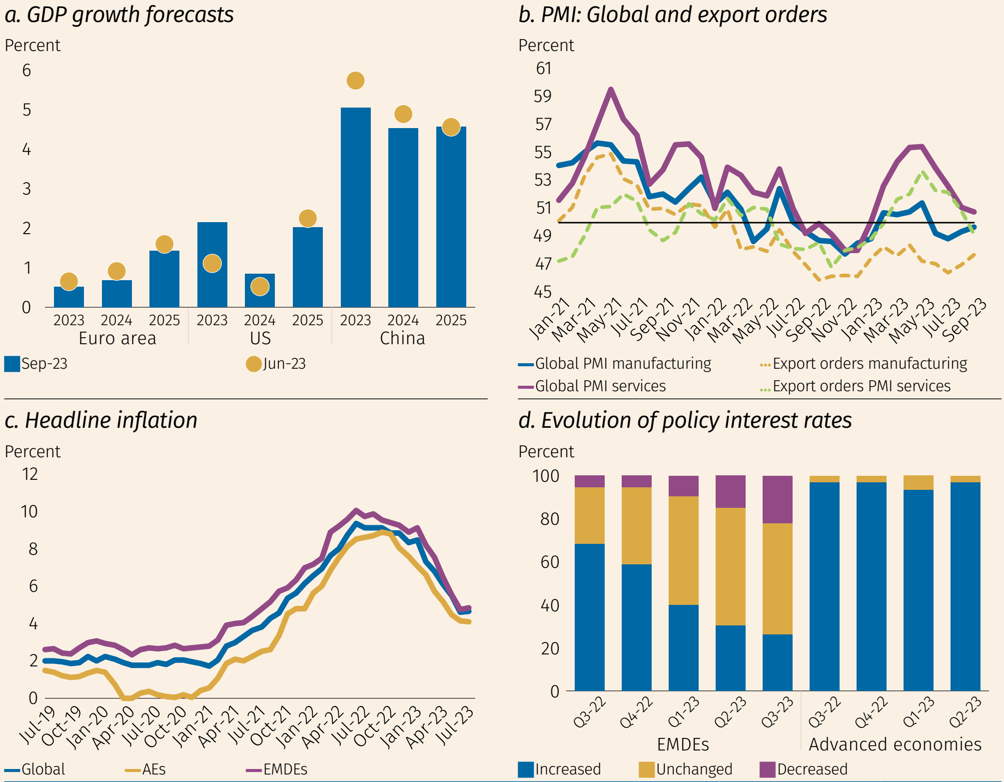
Negotiations with the EU hold the potential to bolster prospects in the Western Balkans. While the pace of these negotiations has been slow, there is an opportunity to mitigate the geopolitical spillover effect from the war in Ukraine through a renewed push for EU integration in the region. The recent summit in Bled, Slovenia, has discussed prospects for an acceleration in the EU accession process with an aspirational timeline to join the EU by 2030. This presents a significant opportunity for the region's external accounts and economic prosperity in general, although in the case of some countries with more pronounced political risks, a shortened timeline may be advantageous.

Box 9.1. Global activity is improving but remains on thin ice

Growth is expected to bottom out in 2023 and should rebound modestly. According to the last edition of Global Economic Prospects (June 2023), global growth is expected to reach only 2.1 percent this year before picking up to 2.4 percent in 2024 and 3.0 percent in 2025, below its pre-pandemic level with average between 2010 and 2019 at 3.33 percent. Growth in AEs has been more resilient than expected in H1 2023, especially in the United States. In contrast, economic prospects deteriorated for China, reflecting a slump in the real estate sector (Figure 9.3a). Global PMIs indicate a deceleration in global activity, with manufacturing remaining soft and services growth cooling. PMI readings for manufacturing new export orders, which remain in negative territory, signal continued weakness in trade (Figure 9.3b).

(Box 9.1 continued)

Figure 9.3. Global economic developments



Sources: Consensus Economies; Haver Analytics; World Bank.
Notes: EMDEs = emerging market and developing economies. PMI = Purchasing Managers' Index.
a) Bars show the consensus forecast estimates for GDP growth based on surveys from September 2023. Diamonds show the estimates based on surveys from June 2023.
b) Blue lines show monthly data on the Purchasing Managers' Index (PMI) for manufacturing. Red lines show monthly data on the PMI for services. Last observation is September 2023.
c) Lines show the median headline CPI inflation (yoy). Last observation is August 2023.
d) Bars show the share of countries where the policy rates have increased, decreased, or remained unchanged in the specific quarter. Euro Area is disaggregated into constituent countries. Last observation is Q3 2023.

Monetary tightening will continue to weigh on the global recovery but appears close to its peak. Headline and core inflation are decelerating, with global headline inflation almost cut in half since the beginning of the year, reaching 4.7 percent in September 2023 (Figure 9.3c). In most AEs, inflation remains above target, which led to further tightening monetary policy in Q2 2023. In contrast, significant progress has been made in many EMDEs, as many central banks have recently paused or lowered policy rates (Figure 9.3d). Though the lagged effect of the monetary tightening will continue to weigh on economic activity, it appears close to its peak. At the same time, the phasing-out of fiscal support due to energy price shocks will also prevent a more dynamic recovery.

(Box 9.1 continued)

Growth in the euro area is expected to be anemic in 2023 before gradually improving in the coming years. Economic activity has been sluggish in the euro area during H1 2023, with only 0.1 percent growth (qoq) each quarter. Most of the high-frequency indicators, including PMI and retail sales, point toward a deterioration of activity in the short term. This momentum will also weigh on growth in 2024. Moreover, declining but still high inflation will likely result in a 'higher-for-longer' interest rates environment, and continue to impact domestic demand adversely. Consumption will, however, remain the main growth driver as real wages catch up gradually. This overall lack of dynamism will negatively impact the WB6 region, as close to 45 percent of its total exports of goods go to the euro area. As growth will stay below its pre-pandemic trend, the convergence process toward the EU will take time.

Risks to the global and regional outlooks remain tilted to the downside in the context of Russia's invasion of Ukraine but have partially receded. In March 2023, the collapse of multiple banks triggered a surge in market volatility and a decline in bank equity prices, and thus fear of contagion of financial stress. The financial tensions have abated over the past six months. In addition, both headline and core inflation have decreased. However, they remain elevated in the ECA region, and the risk of more persistent inflation that would trigger further tightening of monetary and financial conditions cannot be excluded. In this scenario, the WB6 countries, which are characterized by high levels of foreign currency exposure or debt rollover needs, would face challenges. In addition, the high political uncertainty in ECA is mainly associated with the possibility of an escalation of the war in Ukraine and could lead to further geopolitical tensions.

10. *Spotlight*: Greening Agriculture in the Western Balkans[27]

The WB6 agriculture sector is becoming smaller as a share of GDP, while remaining important in terms of value added and employment, and contributing toward environmental sustainability and climate resilience. As the sector is undergoing an important structural transformation, efforts to green agriculture are also important to ensure access to the EU market and should be viewed as complementary to that transformation.

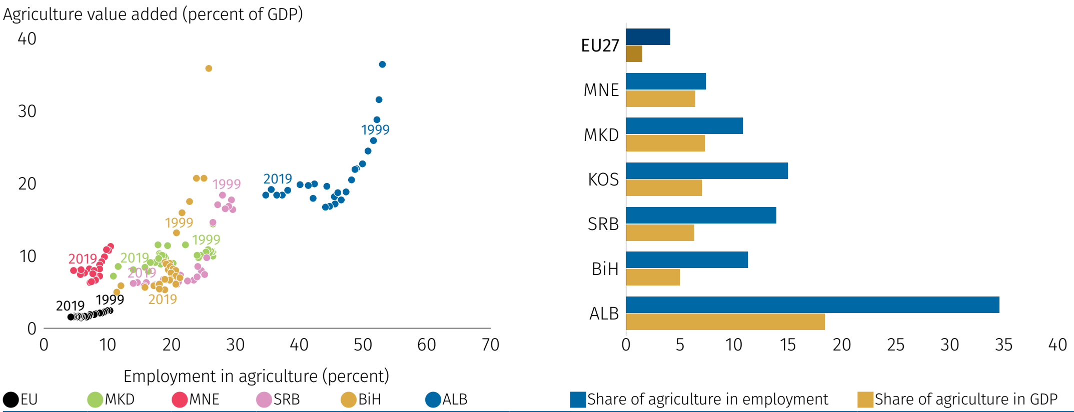
While the size of the agriculture sector is shrinking, it remains significant in most WB6 economies, both in terms of GDP and employment (Figure 10.1a). The agriculture sector no longer accounts for 20 percent of GDP in North Macedonia and 57 percent in Albania, as it did in the early 1990s, but it is nonetheless much larger than in the EU (Figure 10.1b). In 2021, the GDP share of agriculture varied from 18.4 percent in Albania to 5–8 percent in other WB6 countries, while the contribution to employment ranged from 34.6 percent in Albania to 7.4 percent in Montenegro. This compares with an EU27 GDP share of agriculture at only 1.6 percent, and an employment share of just 4.1 percent.

The WB6 agriculture sector, with few exceptions, is still characterized by low productivity and weak export competitiveness, complicated by deeply rooted structural problems. Compared with the EU27 average farm size (16 ha per farm), the average farm size in the WB6 is almost one-third (Serbia) to one-tenth (Albania) the size of the EU27 average, discouraging investment. Farm labor and land productivity are also very low due to underinvestment in capital formation, and research and advisory services, as well as the continued engagement of many

Figure 10.1. Structural transformation of the WB6 agriculture sector

a. Convergence of the WB6 agriculture sector with the EU, 1991–2021

b. Agriculture as a share of GDP and employment in the WB6 and the EU27 in 2021



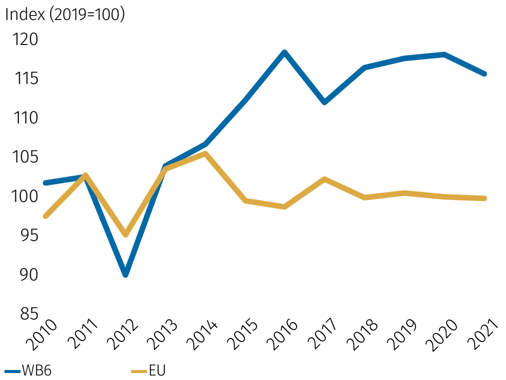
Source: World Bank Development Indicators, 2023.

27 This Spotlight was prepared by the team that included Sergiy Zorya (Lead Agricultural Economist, SCAAG), Fang Zhang (Agriculture Economist, SCAAG), Demetris Psaltopoulos (Professor of Department of Economics, Aristotle University of Thessaloniki), and Goran Zhivkov (Seedev Consulting).

households in subsistence farming.[28] The skills of the primary agriculture sector's labor force are limited due to low educational levels and a lack of opportunities for training, which also limits the sector's contribution to generating added value and off-farm jobs, diversifying livelihoods in rural areas, and raising rural incomes.[29] Younger and more educated people are more likely to migrate away from rural areas. Other challenges, including underfunded and weak institutional capacity, weak linkages among agrifood value chain actors, (still) little buy-in in climate smart technologies, and food supply vulnerabilities caused by climate change, are all adversely affecting agrifood productivity and its contribution to the economy.

The WB6 is among the global hotspots of climate change, with above-average warming and highly vulnerable populations employed in agriculture. The accelerated climate change is triggering more frequent and intense hazardous weather events, which endangers the sector's contribution to the broader economy. In May 2014, catastrophic floods hit the WB6 countries, causing damage to BiH estimated to be equivalent to 15 percent of GDP, while making 12,000 ha of land unusable in Serbia. Most recently, in January 2023, floods caused huge damage and drownings, and affected thousands of hectares of land in northern Albania.[30] Droughts have also become more frequent. These not only reduce crop yields but also contribute to soil degradation and long-term water scarcity. Increasingly frequent and intense droughts during the last two decades have already caused great damage to agriculture in Serbia. Production is expected to fall by 10 percent in the second half of this century (Knez et al., 2022). More frequent frost had a negative effect on wheat yields in all WB6 countries, with the strongest impact in Serbia (Muller and Hofmann, 2022). Climate change associated with disasters and the low preparedness for climate change, has already resulted in WB6 agricultural production becoming more volatile than in the EU (Figure 10.2). Thus, assisting producers and governments with adaptation plans and practices to avoid the worst consequences of climate change could have substantial impacts on the WB6 agriculture sector. As such, accelerating support for the broad adoption of climate-smart agriculture (CSA) is an urgent call. The World Bank defines climate-smart agriculture (CSA) as an integrated approach to tackle three main objectives: sustainably increasing agricultural productivity and incomes; adapting and building resilience to climate change; and reducing and/or removing greenhouse gas emissions, where possible.

Figure 10.2. Changes in agricultural value added in the WB6 and the EU, 2010–2022



Source: World Bank Development Indicators, 2023.
Note: Agricultural value added is in constant 2015 US$.

28 World Bank. 2018. *Exploring the Potential of Agriculture in the Western Balkans*. Washington, DC.
29 World Bank. 2017. *Agriculture for Jobs and Growth in the Western Balkans: A Regional Report*. Washington, DC.
30 https://balkaninsight.com/2023/01/20/floods-in-western-balkans-cause-huge-damage-drownings/

Box 10.1. The New EU CAP

The Common Agricultural Policy (CAP) is one of the oldest and most comprehensive policies of the EU, and accounts for nearly 40 percent of the EU's total common budget. With many objectives in place, such as supporting farm incomes, becoming competitive on global markets, producing healthy foods at affordable prices, and improving living conditions in the rural areas, more recently managing natural resources in a sustainable manner and agriculture's greening have become new priorities. The CAP greening started in 2014 with discussions on measures such as farmland set aside for biodiversity, minimum areas for organic farming, and the reduced use of plant protection products and fertilizers. Finally, in December 2021, the agreement on the New CAP reform was formally adopted for the period of 2023–2027. The New CAP supports agriculture in making a much stronger contribution to the EU Green Deal (EGD) goals to become climate neutral in 2050.[a] Under the New CAP, there is a direct link to the EGD targets.[b] Payments to beneficiaries are linked to a stronger set of conditionalities instead of previous weaker cross-compliance measures. There is a higher share of eco-schemes targeting organic farming, animal welfare and others (at least 25 percent of direct payments). Rural development measures need to include climate, biodiversity, animal welfare and environmental targets (at least 35 percent of rural development funds). Forty percent of the budget will have to be climate-relevant and support biodiversity. EU member states should reduce the use of fertilizers by 20 percent and pesticides by 50 percent by 2030. At least 25 percent of the EU's agricultural land should be under organic farming. The sale of antimicrobials for farmed animals and in aquaculture should be reduced by 50 percent by 2030. Nutrient losses should be reduced by at least 50 percent, while ensuring no deterioration in soil fertility, and bringing back at least 10 percent of agricultural area under high diversity spaces are called for by 2030.

a. https://ec.europa.eu/info/strategy/priorities-2019-2024/european-green-deal_en
b. https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM%3A2019%3A640%3AFIN

The WB6 agriculture sector has a relatively low carbon footprint but the emission structure and per capita are similar to the EU. In 2020, it accounted for a relatively low 0.2 percent of global agricultural methane and nitrous oxide emissions. The carbon footprint of the WB6 agriculture sector is almost 40 times smaller than the EU while emission per capita are close to the EU with Serbia exceeding.[31] Despite the low carbon footprint, the WB6 authorities seem to be committed to promoting both adaptation to, and mitigation of, climate change. The Sophia Declaration, which was signed in 2020,[32] launched the WB6 Greening Agenda, facilitating an inclusion of greening agriculture in the WB6 new strategic

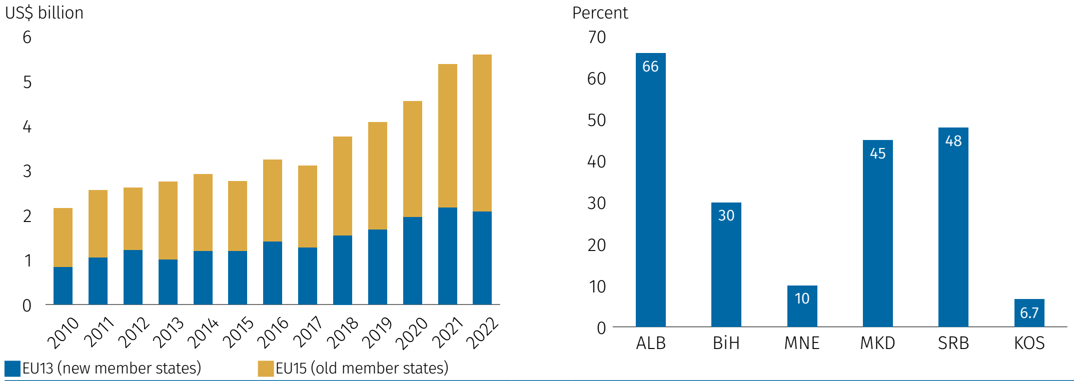
31 The figures are 0.4 percent for Serbia, 0.1 percent for North Macedonia, and 0.03 percent for Montenegro.

32 The leaders from the WB6 countries gathered in Sofia on November 10, 2020, at the WB Summit under the framework of the Berlin Process initiative and adopted the *Document on the Green Agenda for the Western Balkans*, laying down the key initiatives aimed at a green transition for the region.

Figure 10.3. Agricultural exports from the WB6 to the EU

a. Export of agricultural products from the WB6 to the EU (2012–2022)

b. Share of agricultural export to the EU in total export (av. 2018–2020)



Source: World Bank staff calculations based on national trade statistics.

plans for agriculture and rural development. Most of these strategic plans include specific quantitative targets as commitments and budgets, similar to the New EU Common Agricultural Policy (CAP) strategic plans (Box 10.1).

Supporting climate mitigation measures is critical for the WB6 not only to align with the EU Green Deal (EGD) as part of the EU accession, but also to maintain access to the EU market. The EU increasingly requires exporters to meet similar environmental requirements as introduced in the EU under the EGD. In 2022, the WB6 agricultural exports to the EU reached US$5.7 billion, increasing more than twofold since 2010 (Figure 10.3a). The EU market accounts for almost 50 percent of North Macedonia and Serbia's agricultural exports, while reaching 66 percent for Albania (Figure 10.3b). Going forward, maintaining and increasing WB6 access to the EU market will require doing more on climate mitigation.

Thus, going forward, strengthening the WB6 countries' commitment and actions on greening agriculture is critical for transforming the sector, and generating multiplier effects for jobs, growth, and climate resilience. The WB6 countries have the potential to provide high-quality, ecologically friendly, and competitive agrifood products and should capitalize on this advantage. Most of the WB6 countries have access to the Instrument for Pre-Accession Assistance for Rural Development (IPARD) funds and other funds for greening agriculture, and will receive more funding for this purpose after joining the EU. The European Commission's (EC) Economic and Investment Plan for the Western Balkans[33] refers to the EGD as a blueprint for joint action aimed at a green transition, while the accompanying Staff Working Document[34] sets out a Green Agenda for the WB6 countries and proposes relevant actions, including actions for agriculture. This Spotlight sheds light on the current state of greening of the WB6 agriculture sector and the way forward using the lessons learned from the EU experience.

33 EC. 2020. *North Macedonia 2020 Report*. Commission Staff Working Document Accompanying the 2020 Communication on EU Enlargement Policy. SWD (2020) 351 final. Brussels.

34 EC. 2020. *An Economic and Investment Plan for the Western Balkans*. COM (2020) 641 final, Brussels.

The low current environmental footprint of the WB6 agriculture sector is more an unintended outcome of still high rurality and low farming intensity than a result of strategic policy choices.

In some respects, the WB6 agriculture sector is relatively more environmentally friendly than that of the EU. On average, most WB6 countries use less fertilizers and chemicals (pesticides, insecticides, herbicides, etc.) per hectare (Figures 10.4a and 10.4b), and emit less greenhouse gas (GHG) emissions per capita (Table 10.1a). In some countries, the share of high-diversity landscapes, especially in BiH, exceeds that of the EU. Thus, the WB6 countries are in a good position to meet many EGD targets by 2030, in the case that they are required to do so as part of EU accession (Table 10.1b).

Average use of fertilizers and pesticides in the WB6 countries, with the exception of Montenegro, has been relatively low and trails behind the averages in the most EU member states (Figures 10.4a and 10.4b). The WB6 region has a high proportion of small-

Table 10.1a. Agriculture GHG emissions per capita in the WB6 vs the EU27 (CO2eq t/pc)

	ALB	BiH	MNE	MKD	SRB	EU27
Agrifood systems	1.6	1.8	1.7	1.5	2.9	2.4
Emissions on agricultural land	1.1	0.9	0.7	0.6	1.9	1.3
AFOLU	0.9	0.3	0.7	0.6	0.9	0.5

Source: World Bank staff estimates using various sources and latest available data.

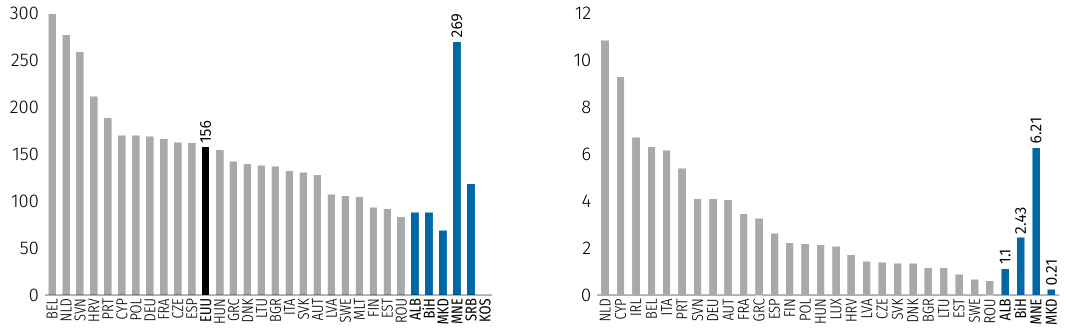
Table 10.1b. WB6 vis-à-vis the EU27 in meeting the EGD targets for agriculture

EGD Ambitions	ALB	BiH	KOS	MNE	MKD	SRB	EU27	EU targets
Organic farming (% of land under organic farming)	0.1	0.1	0.4	1.8	0.4	0.7	8.0	25% by 2030
High-diversity landscape (% share of fallow land in UAA)[a]	n/a	30.0	n/a	n/a	2.4	6.5	4.6	10% by 2030
Use of fertilizers (% change between 2018–19 average and 2012–14 average)	-10.4	-24.5	n/a	+21.9	-8.1	-44.0	+3.8	-20% by 2030
Use of pesticides (% change between 2012–2014 average and 2018–2020 average)	-52.0	+8.0	n/a	+12.0	0.0	n/a	+6.6	-50% by 2030
Individuals using the internet (% of population) (WDI 2022)	82.6	78.8	n/a	88.2	83[b]	83.5	88.8	100% by 2030
Protected areas as % of land (data 2022)	14.0	4.0	11.0	9.0	15.0	8.0	24.0	30% by 2030
GHG emissions from agriculture (% change between 2017 and 2019 average and 1990)	25.2	79.5	n/a	-12.5	-31.6	-12.5	-20.1	-55% by 2030
A minimum % of public spending (Pillar 1 of EU, Measure 4 of IPARD III) on agri-environmental measures	2	n/a	n/a	5	1	14	25	25%
Cross-compliance	No	No	No	No	No	No	Yes	Yes

Source: World Bank staff estimates using various sources and latest available data.
Note: "-" means a decline and "+" means an increase. a) Fallow land refers to agricultural land that is intentionally left uncultivated or unplanted for a certain time, often as part of crop rotation or land management. b) Internet access data for North Macedonia is available as of 2021.

Figure 10.4. Use of fertilizers and chemicals in the WB6 and the EU, 2018–2020

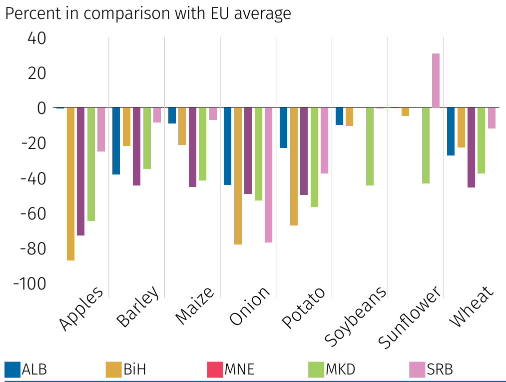
a. Fertilizer consumption in kg per ha of arable land, av. 2018–2020 | *b. Use of pesticides in kg per ha of arable land, 2020*



Source: World Bank staff estimates using FAO and national sources.
Note: Serbia does not officially publish the data on pesticides.

scale or subsistence farms, where the use of modern inputs is rather limited. The use of modern inputs among commercial farmers is also limited due to inadequate access to finance and low levels of productivity. Furthermore, the WB6 region is still predominantly rural with 32 percent of the population in Montenegro to 50 percent in BiH living in rural areas (WDI 2022). The rurality defines people's approach to food, agriculture, and the environment. People living in rural areas may have a closer connection to nature and rely more directly on natural resources for their livelihoods.

Figure 10.5. Crop yields in the WB6 vis-à-vis the EU27 (av. 2018–2020)



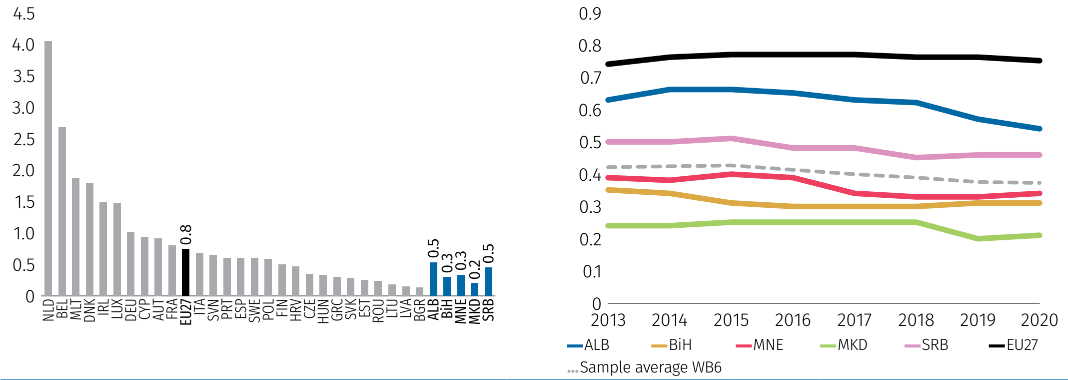
Source: World Bank staff estimates using FAOSTAT data.

The average crop yields in the WB6 countries are far lower than in the EU, with the exception of Serbia. In part, low input use contributes to the WB6 region's low yields, but by no means is this the only, or most critical, reason for this. Serbia stands out with higher average yields compared with other WB6 countries (Figure 10.5). Serbia accounts for about two-thirds of the WB6 region's production, and exports of cereals and industrial crops (maize, sour cherry, plum, peach, strawberry, carrot, and processed food and beverages).[35] However, yields in Serbia are still below the best-performing EU countries. Other countries rely on cereal and meat imports. Albania and BiH generally have lower yields, except for stone fruits in BiH and indoor perishable vegetable production in Albania. Montenegro has relatively small primary production and this is mainly focused on fodder and self-sufficient vegetable farming that adopts highly intensive methods where manual labor handles weed removal, harvesting, and planting. Such intensive, yet environmentally friendly, agricultural practices are observable in other WB6 countries as well.

35 World Bank. 2018. *Exploring the Potential of Agriculture in the Western Balkans.* Washington, DC.

Figure 10.6. Livestock herd density in the WB6 and the EU, 2013–2020

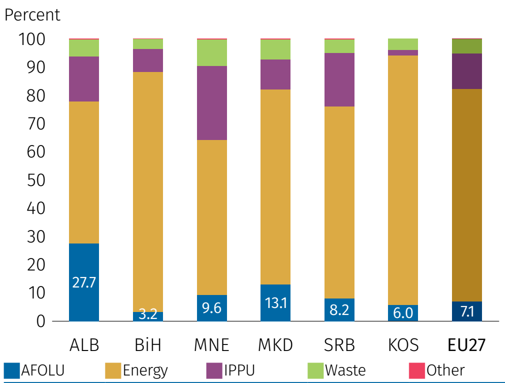
a. Livestock unit per ha, 2020 *b. Trends in livestock units by country, 2013–2020*



Source: World Bank staff estimates using FAOSTAT data.

The extent and intensity of livestock production in the WB6 countries have been low and declining, resulting in a relatively low carbon footprint from livestock. The density of animals in the WB6 region, at 0.4 per ha, is lower than the average livestock density in the EU. Indeed, it is much lower than in the EU countries with large livestock herds, such as the Netherlands, Denmark, and Austria, where land is limited, requiring highly intensive production methods and practices to overcome land constraints (Figure 10.6a) The WB6 region is characterized by a long-term stagnation in livestock production and productivity, indicating the difficulty for WB6 farmers to manage more capital and labor-intensive technologies, exacerbated by strict requirements on food safety, traceability, and animal welfare in the EU that affects the WB6's export of livestock products there. They choose instead to engage in crop production. As a result, the WB6 countries are experiencing a decreasing trend in livestock production, except for poultry (Figure 10.6b).

Figure 10.7. GHG emissions by sector and country in the WB6, 2020



Source: FAOSTAT, 2023.

The low intensity of crop and livestock production has contributed to the relatively low level of GHG emissions in the WB6 agriculture sector, as well as their decoupling from agricultural growth. In most WB6 countries in 2020, the agriculture sector generated about 10 percent of total emissions (Table 10.2). The share was large only in Albania, at 28 percent. In comparison, the agriculture sector globally generates more than 25 percent of total emissions. During 2010–2020, annual average agricultural growth of the WB6 region was 0.9 percent, while agricultural methane and nitrous oxide emissions annually declined by 1.3 and 1.4 percent, respectively (Figure 10.7). In comparison, the EU agriculture sector grew by 0.4 percent annually during 2010–2020, while agricultural methane emissions declined annually by 0.4 percent.

Table 10.2. Agricultural growth and GHG emissions in the WB6 and the EU, 2010–2020

Regions	Annual average agricultural growth, %	Annual average growth of agricultural methane emissions, %	Annual average growth of agricultural nitrous oxide emissions, %
EU	0.4	-0.4	0.0
WB6	0.9	-1.3	-1.4

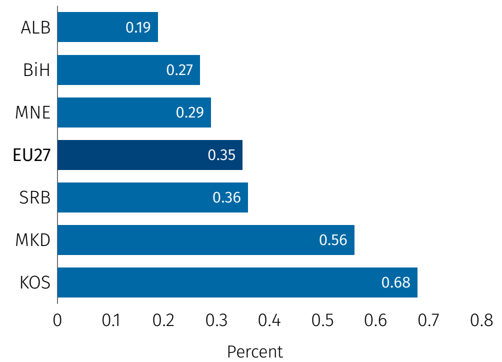
Source: World Bank staff estimates using the World Development Indicators.

Agricultural nitrous oxide emissions have not declined at all in the EU over the past decade. This implies that agricultural growth in the WB6 region was much more decoupled from GHG emissions than in the EU.

WB6 agricultural public expenditures, while substantial in terms of amounts/levels to influence on agricultural production, have not yet prioritized financing of greening and climate-smart agriculture.

WB6 agricultural public expenditures have been substantial and are growing, providing a good foundation for making funds available for the green transition. During 2020–2022, North Macedonia[36], Kosovo, and Serbia allocated more funds for agriculture as a share of GDP than the EU27 (Figure 10.8).[37] However, as a share of agricultural value added, WB6 support was only half of that in the EU27, implying that WB6 farmers are less dependent on state support, thereby offering the authorities an opportunity to reform agricultural public expenditure for enhanced support of greening the sector without large losses to farmers. Only Albania stands out as a country in the WB6 region with a comparably low level of agricultural support, requiring both spending more and spending better going forward.

Figure 10.8. Agricultural budget support in the WB6 and the EU27 in percent of GDP



Source: World Bank staff calculations using the data from Standing Working Group (SWG) for the WB6 countries and EUROSTAT.
Note: Public expenditures and GDP are the average of 2020 and 2021.

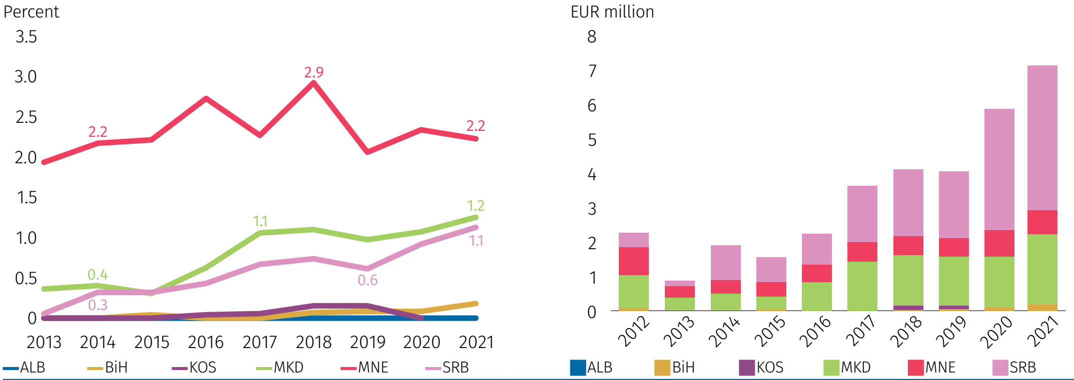
National, IPARD, and development partner funding has been readily available to finance CSA measures in the WB6 region. As a result, the agri-environmental/CSA budget increased annually by 24 percent on average for all WB6 countries from 2012 to 2021 (Figures 10.9a and 10.9b). Growth is particularly noticeable after 2020, driven by increases in Serbia and North Macedonia. Moreover, the third phase of the IPARD funds, available for all WB6 countries except BiH and Kosovo, is projected to reach EUR 115 million in 2027, which is three times more than the EUR 38 million budget provided in 2021 (Figure 10.10). All WB6 countries offer a menu of options to select from and invest in agri-environmental measures under the sub-measure "Agri-

36 World Bank. 2023. *Green Growth in North Macedonian Agriculture*. Washington, DC.
37 Overall agricultural budget support in the WB6 region is probably even higher. WB6 farmers receive tax exemptions and fuel subsidies such as for blue fuel. However, the data on these expenditures are not readily available and, thus, not added here.

Figure 10.9. Public expenditures for agri-environmental measures in the WB6 region, 2012–2021

a. Support for agri-environmental measures in the WB6 countries

b. Agri-environmental measures in percent to total agricultural budget

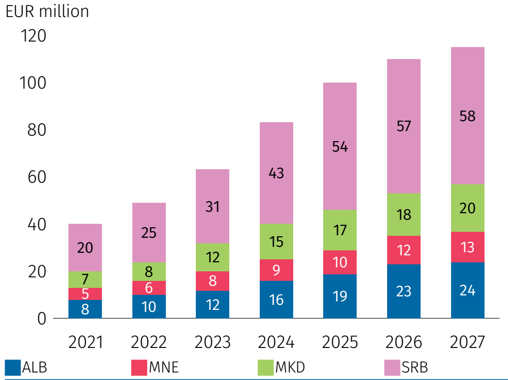


Source: World Bank calculations using the SWG data and national budgets.

environment-climate and organic farming". The most popular measure has been organic farming. Other proposed investments include conservation of local breeds of small ruminants and the preservation of genetic resources (Albania and Montenegro), advanced crop rotations (North Macedonia and Serbia), green cover of permanent crops (North Macedonia), establishment of pollinator strips (Serbia), sustainable management of pastures (Montenegro and Serbia), and livestock waste management (Montenegro).

Despite increasing, actual spending on CSA/ agri-environmental measures has remained modest. In the country with the largest recent increase in spending, i.e., North Macedonia, the share in total IPARD expenditures grew from 0.4 percent in 2013 to 1.2 percent in 2021 (Figure 10.9b). The largest share of this spending is seen in Montenegro, at a meager 2.2 percent. In addition, when funds are offered for agri-environmental measures, these are less popular among farmers than other options in the IPARD or national budgets for investments in measures that do not require such strict environmental standards. In this regard, the adoption of CSA practices in the WB6 countries remains very small. In addition, commercial banks in the region do not offer any financial products to promote CSA practices or reward farmers for adopting CSA. Private financing has also been limited in this area.[38]

Figure 10.10. IPARD III allocations by the eligible WB6 countries



Source: World Bank staff estimates using the EU DG AGRI data.

38 IFC. 2022. *Potential Climate Smart Investments in Agriculture and Agribusinesses in Albania, North Macedonia, and Serbia*. Western Balkans Agricultural Risk Management Facility.

The budget spent on the Agricultural Knowledge and Innovation System (AKIS) which combines agricultural education, research and farm advisory services has been consistently low. This is one major unfavorable factor that constraints the sector from leveraging private finance, and a missed opportunity to boost agricultural growth, since innovation and digitalization play a crucial role in addressing environmental concerns and climate change in agriculture. A recent estimate by the World Bank indicates that closing the 25 percent gap for investments in research and development, as a part of AKIS, with the EU could increase agricultural productivity by 15 percent in Albania, 25 percent in BiH, 16 percent in North Macedonia, and 6 percent in Serbia.[39] Along with the weak capacity of AKIS institutions and ineffective service delivery models, the small budgets have undermined the support for CSA adoption, proven to be critical in the EU member states, for example. AKIS in the WB6 countries struggles to effectively raise productivity and competitiveness that it was designed for, making it challenging to expect its effective leadership on greening the agriculture sector. In addition, the current AKIS structure lacks a necessary expertise and knowledge in digital agriculture and new technologies on climate adaptation and mitigation, which are crucial for tackling new challenges in the region's changing landscape. Strengthening the institutional capacity within AKIS by fostering collaboration between research institutions, agricultural organizations, the private sector, and policy makers would help bridge the existing knowledge gaps and facilitate the dissemination of up-to-date information and innovative approaches. It is also important to equip AKIS institutions with staffing, knowledge, and infrastructure to design and support implementation of even simple agri-environmental measures, while measuring and verifying environmental outcomes of the support. Over time, they should be able to administer the implementation of more complex agri-environmental measures, such as eco-schemes, which are now required in the EU.

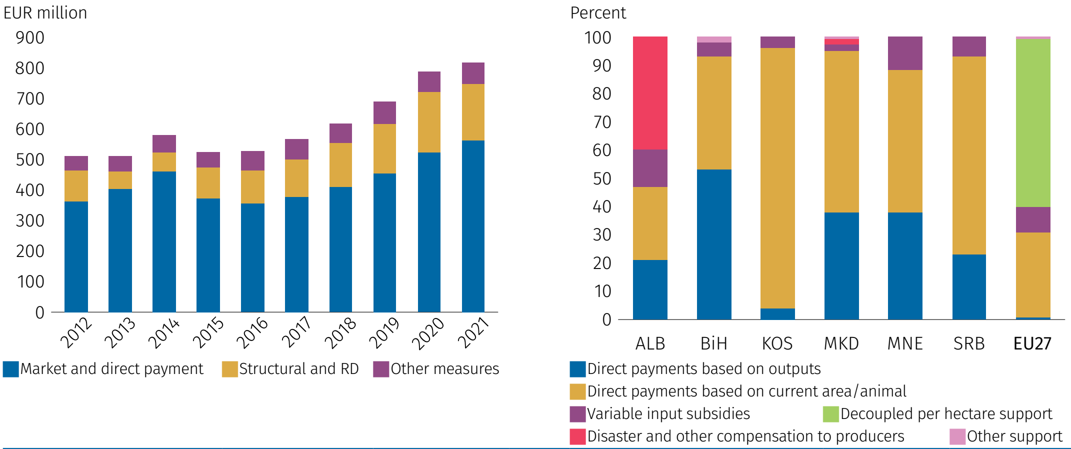
Instead of supporting the CSA measures, most agricultural public expenditures in the WB6 region are used for direct farm payments (Figure 10.11a)**, a large share of which is coupled to production of specific crop and livestock products.** In countries such as BiH, Kosovo, North Macedonia, and Serbia, the share of direct farm payments in total agricultural budgets reaches 70–80 percent (Figure 10.11b), most of which is coupled to livestock production or the use of fertilizers and chemicals.[40] These measures are not subject to minimum cross-compliance requirements (i.e., good agricultural and environmental practices), while they generate significant GHG emissions and bring other environmental damage, in addition to reducing overall agricultural productivity and creating other market distortions.[41] Less distortive decoupled support, which dominates the EU CAP, is still limited in the WB6 countries. North Macedonia has recently committed to shift from coupled to decoupled support and introduce cross-compliance, in line with the EU requirements, but the actual implementation of these actions remains to be seen. Other countries have yet to

39 World Bank. 2018. *Exploring the Potential of Agriculture in the Western Balkans*. Washington, DC.
40 EU. 2021. *Recent Agricultural Policy Developments in the Context of the EU Approximation Process in the Pre-Accession Countries*. Joint Research Center Technical Report.
41 World Bank. 2018. *Exploring the Potential of Agriculture in the Western Balkans*. Washington, DC.

Figure 10.11. Functional composition of agricultural public expenditures in the WB6 and the EU

a. Total agricultural expenditures in the WB6

b. Composition of direct farm payments, 2019–2021



Source: World Bank staff calculations using the data from SWG for WB6 countries.

introduce cross-compliance as a condition for farmers to receive support.

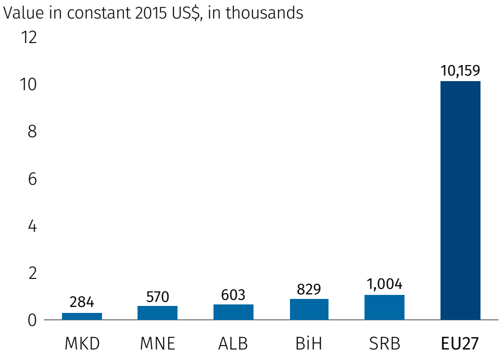
Coupled direct payments are most distortive as they usually reduce agricultural productivity and contribute to GHG emissions. In 2018, the World Bank concluded that improvements in agricultural productivity and employment in the EU went hand in hand when supported by decoupled CAP payments of both Pillar 1 and Pillar 2, but not the coupled payments under Pillar 1.[42] This is because farmers, when they no longer receive subsidies coupled to the production of low value-added crops, switch to higher value-added crops. The same conclusion was derived from the analysis of agricultural support in the WB6 countries during 2011–2015, namely that support coupled to the production of specific crops was found to reduce agricultural productivity, while decoupled support had a positive and significant effect on agricultural productivity.[43]

Furthermore, funds spent on coupled support crowd out capital investments, undermining long-term competitiveness and climate resiliency. This can be already seen in the WB6 countries where the level of investments in farm capital formation remains small, and the gap with the level in the EU is huge (Figures 10.12a and 10.12b).[44] Little public spending on stimulating private capital investments is a missed opportunity in the WB6 region, where agriculture is dominated by small farms that require public co-financing of investments to be able to afford them in principle. Efforts to re-orient public support to agriculture from coupled payments to decoupled support could contribute to increasing productivity across the WB6 region.

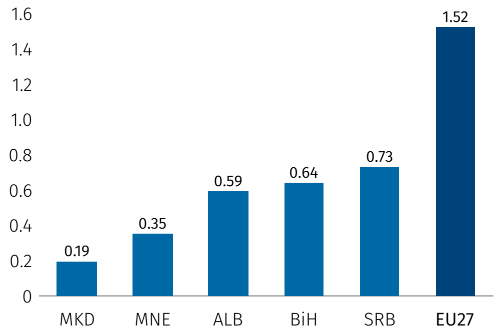
42 World Bank. 2018. *Thinking CAP: Supporting Agricultural Jobs and Incomes in the EU*. EU Regular Economic Report No. 4, Washington, DC.
43 World Bank. 2018. *Exploring the Potential of Agriculture in the Western Balkans*. Washington, DC.
44 The recent estimate of the World Bank indicates that closing one-quarter of the gap in the stock of agricultural capital per worker relative to EU27 levels would increase agricultural labor productivity by 76 percent in Albania, 82 percent in BiH, 30 percent in Serbia, and 6 percent in Montenegro.

Figure 10.12. Investments in capital formation in agriculture in the WB6 and the EU

a. Gross capital formation per worker in agriculture in 2020



b. Investment ratio agricultural orientation index, 2020



Source: World Bank staff calculations using the data from WDI and FAOSTAT.
Note: Investment ratio orientation index is calculated as a share of gross fixed (private) capital formation in agriculture per unit of value added in agriculture over the share of gross fixed capital formation in other sectors per unit of value added in those sectors.

While more attention is increasingly being given to greening the WB6 agriculture sector to deepen and accelerate the green transition, historical roadblocks need to be removed.

Many structural barriers, including those discussed above, also slow down climate adaptation. A relatively high rurality in the WB6 countries underpins the slow change of attitude toward agriculture commercialization and greening. The small farm size prevents a wider adoption of CSA technologies that have proven successful elsewhere but that require scale for cost-effective adoption. Moreover, underinvestment in AKIS and other public institutions and lagging digitalization, which are critical to design and support implementation of more complex agri-environmental measures, hamper CSA adaptation.

Given the low carbon footprint nature of the WB6 agriculture sector, climate mitigation historically was not given a high priority by WB6 authorities. WB6 authorities are also awaiting further results from EGD implementation. Uncertainties remain around EGD implementation, for example related to the adequacy of funding mechanisms, the availability of technological solutions necessary to achieve the EGD targets, the suitability of CSA technologies to specific agroecology in the WB6 region, institutional requirements, and socio-economic implications of the change, including potential job losses in agriculture. The extent to which the EU can effectively find internal strengths to carry out all these processes is also uncertain. Moreover, the EGD requires a comprehensive framework of laws and regulations to guide its implementation. The exact details of these legislative measures, including timelines, targets, and enforcement mechanisms, are still being developed. As policy makers in the WB6 countries support the EGD actions, focusing primarily on aligning their efforts with direct EU initiatives and not having own, the ongoing discussions and implementation will shape the position and actions of the WB6 countries.

First, climate change makes climate adaptation of the agriculture sector more urgent, requiring public support (AKIS, public institutions, budget) to help farmers enhance their climate resiliency investments.

There is also a need to increase or shift public spending for AKIS toward climate-resilient agricultural practices and technologies. An IFC study has estimated the financial costs and investments of several types of CSA technologies that could be implemented by WB6 farmers on a commercial basis (Table 10.3). The potential of increasing commercial adoption of CSA technologies for irrigation, land cultivation, greenhouses, and livestock is estimated to cover 92,000 ha in Serbia, 25,000 ha in North Macedonia, and 19,000 ha in Albania.[45] It would be highly valuable to conduct a similar exercise for assessing a potential application of various CSA practices, such as conservation agriculture, improved nutrient management, enhanced feeding practices, cultivation of cover crops or integration of green manure, efficient water management, and integrated pest management.

Second, the need to maintain access to the EU market and the EU accession commitments should encourage more investment in climate mitigation and CSAs/sustainable practices. Competitive export-oriented producers in WB6 countries are proactively adjusting their practices and operations to comply with new EU rules and standards. The defined minimum residue level influences pesticide use, which significantly affects the adoption of sustainable practices by

Table 10.3. Potential for adoption of CSA technologies in selected WB6 countries

Technology	Estimated Cost	Units	Potential for commercial adoption		
			Serbia	North Macedonia	Albania
Pivot Irrigation	US$1,050/ha	ha	16,000	23,616	17,530
Drip Irrigation	US$2,100/ha	ha	1,270	1,181	1,210
Greenhouse Irrigation	US$4,594/0.25 ha	ha	324	20	
Pump Replacement	US$555/ha	ha	2,175		
Pump Upgrade	US$210/ha	ha	2,175		
Tillage Equipment	US$20,000/ machine	ha	70,056		
Cattle Genetics	US$1,785/animal	cattle heads	2,372	3,214	2,780
Electric Fencing	US$1,100/ enclosure	livestock heads	1,582	1,422	506
Hydroponic Upgrade	US$15,251/0.1 ha	ha	1.3		14
Boiler Heater	US$9,844/0.25 ha	ha	0.25		
Greenhouse Expansion	US$50,000/0.1 ha	ha	142	20	
On-farm Solar	US$22,042/yard	# of farmers	28,223	8,906	9,643
Total potential for adoption		ha	92,143	24,837	18,754
		% of total arable land	4%	6%	3%
		livestock heads	3,954	4,636	3,286

Source: IFC, 2022.

45 IFC. 2022. *Potential Climate Smart Investments in Agriculture and Agribusinesses in Albania, North Macedonia, and Serbia.* Western Balkans Agricultural Risk Management Facility.

farmers in the WB6. The widespread adoption of Global Gap standards by the WB6 export-oriented producers, as required by the EU and most other sophisticated markets, has become unquestioned to ensure product quality, safety, and meet international market requirements. Thus, increasing requirements for accessing the EU market will be a great driver for changes in the environmental standards of the WB6 countries.

Lastly, rapidly developing digitalization can help overcome some structural and institutional constraints for the adoption of CSA measures, as demonstrated in the EU. The private sector may increase its interest in providing agricultural green/carbon financing if digitalization helps reduce the cost of monitoring, results measurement, and verification, as well as the adoption of CSA technologies themselves.

The EU can offer important lessons for the green transition of the WB6 agriculture sector, particularly its experience on policies and public spending on climate mitigation and CSA adoption.

As part of the reforms of the New EU CAP, the transition to decoupled farm support has helped reduce the carbon footprint of the agriculture sector. In addition, green direct payments[46] of the 2014–2020 CAP Pillar 1, supporting farmers for activities going beyond minimum requirements, have aimed at enhancing the environmental performance of farm activities and contributed most to the reduction of GHG emissions. Pillar 2 measures[47] offered a wide range of tools potentially beneficial to the environment and climate. This includes agri-environment-climate measures, which provide public goods in climate change mitigation and adaptation, and protection and improvement of ecosystem services.

Cross-compliance is an important cross-cutting tool to generate environmental benefits that also increase productivity. Cross-compliance provides foundations of minimum requirements for farmers on environment and climate, and links CAP measures to farmers' compliance with basic standards and the application of good agricultural practices. It should be meaningfully strict and enforced if it is to make an impact.

Another cross-cutting measure relevant to environment and climate is Farm Advisory Systems (FAS). FAS are compulsory for the EU member states and facilitate farmers' awareness of farm practices and various standards. FAS provide advice for topics including cross-compliance rules, green direct payments requirements,[48] basic requirements on maintaining agricultural land to be eligible for direct payments, climate change mitigation and adaptation, etc. Serbia and North Macedonia have made significant progress in strengthening their agriculture advisory areas, but still have an underdeveloped agricultural R&D infrastructure and agricultural education. Overall, there is no clear role and strategy for extension services, nor engagement

46 Aiming to maintain crop diversity and permanent grassland and promote biodiversity-friendly practices.

47 Pillar 2 measures included agri-environment-climate measures, which reward farmers for adoption of practices (defined in the national rural development programs) that go beyond cross-compliance and greening requirements under Pillar 1.

48 The greening payment covered the whole eligible area of farm holding (including permanent crops), while obligations applied only on arable land and permanent grassland areas. They introduced three practices, namely crop diversification, maintenance of permanent grasslands, and Ecological Focus Areas (EC, 2017).

and investment by private extension service providers in the WB6 countries.

However, the power of the CAP on climate change mitigation and adaptation seems to not necessarily materialize in all countries. Those EU member states that did not strictly enforce cross-compliance have not reduced GHG emissions. The provision of farm advice on climate performance improvements through adaptation actions has been a low policy priority in many countries. Most mitigation measures supported by the CAP have had a low potential to mitigate climate change. Livestock emissions, mainly driven by cattle, represent around half of emissions from agriculture, while adoption of carbon-reducing livestock practices has been slow.

Not all agri-environmental measures provided over a long time period generate significant positive environmental outcomes. Some ended up as direct farm/area payment without environmental improvements. It takes time to learn from local adoption experience to ensure a scaled-up adoption of impactful agri-environmental measures in the future. For instance, organic farming faces negative market headwinds in the EU and needs to be highly subsidy-dependent to survive. High emphasis on organic farming in the New CAP is more due to reducing the use of pesticides than increasing the supply of organic food.

There were other area-based measures in Pillar 2 aligned with the CAP environment/ climate ambitions. These measures are complemented by support for investments in physical assets to address environmental improvements and facilitate resource efficiency on- and off-farm (e.g., more efficient irrigation). Also, these measures have supported human capital development on aspects related to the environment and climate. Knowledge transfer and information actions have funded vocational training, workshops, etc. The cooperation measure has supported innovation through involving farmers in generation of innovative solutions to practical problems.

The above-mentioned lessons, learned from past CAP implementation, shaped the New CAP. The EU, through the EGD and 2023–2027 CAP, incorporated an increased focus on tackling climate change and promoting a greener production model supported by allocation of public funds. The EU member states had to design CAP 2023–2027 instruments in a manner that fulfils both the objectives of the New CAP and the ambitions of the EGD through development of holistic and integrated strategies. From January 2023, the support for farmers and rural stakeholders across 27 EU member states has been based on the New CAP legal framework and the choices detailed in the CAP Strategic Plans. The plans are expected to make a significant contribution to the ambitions of the EU F2F and Biodiversity Strategies, as well as other elements of the EGD.

EU member states are obliged to spend a minimum of 40 percent of their CAP budget on climate and the environment, and a minimum of 35 percent of EAFRD budget (Pillar 2) on environment/climate in rural development interventions. At least 25 percent of the budget of direct payments (Pillar 1) is allocated to eco-schemes, providing stronger incentives for climate- and environment-friendly farming practices and approaches. This new scheme involves annual commitments and payments, and the possibility to combine with other CAP interventions to jointly address specific environmental and climate issues.

AKIS has a reinforced role *vis-à-vis* environment/climate issues. Together with FAS, AKIS will support farmers in making sustainable management decisions. Also, agricultural European Innovation Partnership (EIP-AGRI) will be funding innovative projects targeting the improvement of environment/ climate performance of farms.

Lastly, but perhaps most importantly, the new green architecture of the CAP requires strengthened capacity of public institutions for supporting more complex but more impactful agri-environmental measures. The new delivery model of the CAP gives a strong emphasis on results and performance. Each EU member state has drawn up its CAP strategic priorities, setting out how it will direct CAP funding toward specific targets, and how these targets will contribute toward the overall and specific objectives of the CAP.

WB6 countries have an opportunity to accelerate greening their agriculture, making further structural transformation more just and resilient to climate change.

Further structural transformation in the WB6 agriculture sector would require more proactive and concerted policy actions on climate adaptation and mitigation, i.e., the green transition. Good initial conditions, such as the low intensity of the current farming practices, greening of the recent national strategic plans, the IPARD funds' availability for financing agri-environmental measures, and the EU laboratory of innovations on CSA development and adoption to learn from all, could support a faster green transition in the WB6 region. Most WB6 countries also spend sufficient amounts of national funds for agriculture; thus, funds are available in principle to support the green transition, but these funds need to be repurposed to make a difference for the Greening Agenda and, at the same time, make structural changes that would improve competitiveness.

Eight policy recommendations are proposed to accelerate greening of the WB6 agriculture sector. These recommendations apply to all WB6 countries, given their relatively low baseline on CSA adoption and lack of concrete CSA-enhancing programs on the ground:

1. **Move from strategies to actions:** Move from strategies to concrete policy actions aimed at promoting and adopting practices that reduce GHGs, conserve natural resources, enhance climate resilience, and promote sustainable livelihoods for farmers. These actions will require leveraging public policies and expenditures to scale up the support for CSA adoption, encouraging research and innovation in CSA technologies, disseminating knowledge, coordinating actors involved in the agrifood systems, educating farmers and consumers about environment and climate impacts, and monitoring and measuring impact.

2. **Improve the regulatory and institutional set-up:** Use the EGD framework and the New CAP developments to guide investments and actions on institutional strengthening, while also being selective on short-term priorities. Prioritize the support to climate adaptation and resiliency now, while building capacity of public institutions, including piloting more

complex agri-environmental programs and cross-compliance mechanisms, to contribute more to climate mitigation in the future. The latter requires strong institutions and mechanisms to be in place for successful scaled-up implementation. Establishing and implementing a fully-functioning Paying Agency with integrated systems, such as a Land Parcel Identification System and an Integrated Accounting and Control System, is crucial in this regard.

3. **Repurpose the budgetary support to increase the climate resiliency of agricultural production and productivity:**

    a. **Phase out market price and coupled farm support** that is known for its potential to increase pressures on natural resources, reduce overall sector productivity, and inefficiency for transferring income to farmers.

    b. **Gradually transition to more decoupled payments** and encourage investments to co-finance capital expenditures for farm modernization and CSA adoption as decoupled payment may provide valuable ecosystem services that serve as better collateral assets.

    c. For all direct farm payments, **launch cross-compliance requirements**, starting with enforcing their minimum level and gradually converging with higher standards adopted by the EU farmers.

    d. **Increase spending on Pillar 2 programs** and Measure 4 & 5 of IPARD III dedicated to increase farm competitiveness and climate resiliency, including support for digital CSA platforms, AKIS and agri-environmental demonstrations/pilots. Directly paying farmers to supply public goods, such as ecosystem services or carbon sequestration in agricultural soils, and to adopt resource-saving production practices, would also help reduce emissions and provide farmers with new sources of income. Montenegro is projected to reduce the use of pesticides from 6 to 3 kg/ha and mineral fertilizers from 151 to 75 kg/ha and increase protected areas from the current 10,000 to 20,000 hectares in 2028.

4. **Step-up efforts for sustainable development of rural areas by implementing Measure 5 (LEADER approach).** The LEADER approach involves simultaneous use of the territorial approach, public-private partnerships, and integrated multi-sector approach. It was designed and developed by the EU as an instrument to build the social capital and development of community in the development of the local development strategies contributing to the economic, social, cultural, and environmental improvements of local areas.

    a. Foster cross-sectoral nature-based solutions by coordinating between conservation and productive activities: supporting/providing incentives for the **implementation of sustainable land uses and management plans and approaches** with attention to enhance and diverse economic opportunities from the sustainable use of natural capitals (forests, land, blue economy) and **stimulate cross-sectoral solutions** to ensure a competitive green agrifood value chain that mitigates increasing climate risks.

b. **Manage overgrazing, mountainous pastures, and meadows of the WB6 countries, and monitor the livestock sector development in the EU,** which is under pressure to become more climate friendly, for market directions to inform and guide livestock subsector development.

5. **Adopt strategic targeting:**

a. **Target matching grants** under IPARD and national programs to farmers who are willing to borrow commercially for CSA investments and improve on-farm efficiency and sustainability to meet the demand for safe, nutritious, and sustainable food and animal welfare.

b. **Target measures and limit types of recipients** based on necessity to upgrade to EU standards, production level, sustainability of production and size of recipients, in one measure subsistent and semi subsistent farms restructure the size of the farms; in one measure agricultural holdings designated to primary production upgrade to higher intensity production systems, while in the other measure recipients are commercial enterprises dealing with marketing and processing.

6. **Support pilots for selected agri-environmental measures informed by local adoption experiences.** Go beyond organic farming, supporting a wider range of CSA technologies and practices. Reliance on organic farming as the main agri-environmental measure is risky due to the low viability of producing organic without continued state support and the weak domestic demand. Support investments in the development of physical infrastructure to enable the creation of alternative and sustainable economic opportunities as rural areas adapt to changing climate and counter deterioration of the rural landscapes and biodiversity loss.

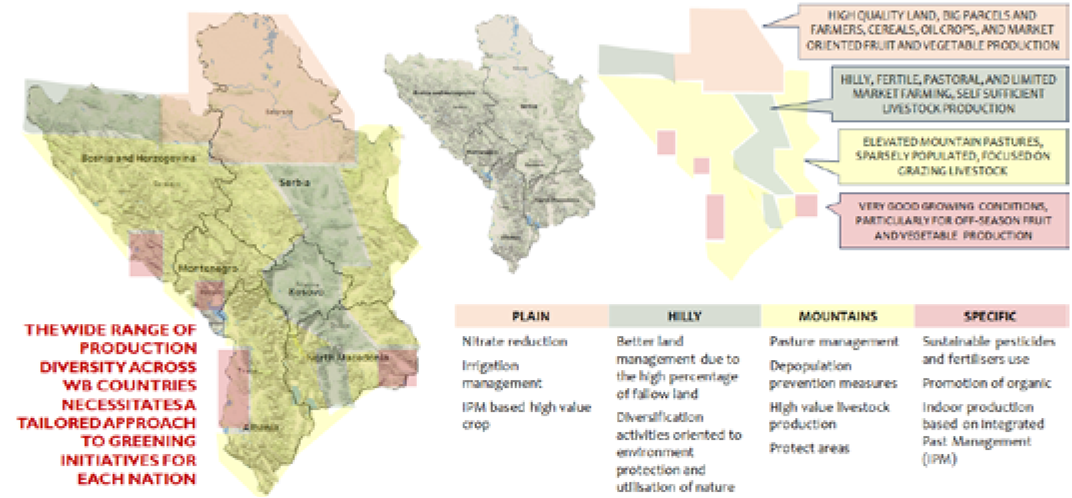
7. **Significantly strengthen knowledge transfer and agricultural knowledge and innovation system (AKIS) with financial resources, human capacity, and new business models to facilitate efficiency gains associated with CSA practices:**

a. **Invest in agri-environmental data collection and decision support tools** (agroclimatic info, soil mapping and information, spatial zoning) with area/site-specific CSA options and **empower smallholder farmers to access** digital FAS.

b. **Knowledge transfer and information actions** through center-state schemes and FAS to support **human capital development** on aspects related to the environment, climate, and finance and fund vocational training/workshops on entrepreneurial and business skills.

c. Systematically develop **digital channels** for CSA promotion and establish CSA dissemination channels (farmers field schools, farmers to farmers, digital platform, etc.) to educate and train farmers on **digital literacy**, and guide and support them in assessing the

Figure 10.13. Diversity of agri-ecology and greening opportunities in the WB6 countries



Source: World Bank staff.

digital channels for CSA knowledge, information on funding schemes and application processes.

8. **Learn globally, implement locally.** As the WB6 countries have a diverse set of agri-ecological zones and natural landscapes, which requires tailored solutions that would not work everywhere (Figure 10.13), it is important for each and every WB6 country to make the above-mentioned investments that enable CSA adoption, strengthen AKIS to help farmers choose suitable CSA technologies and practices, and enhance other public institutions critical for monitoring and verifying agri-environmental outcomes. Learn globally but implement locally is a precondition for successes at the country level in the WB6.

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Country Notes

Albania

- After a strong rebound in 2022, GDP growth is forecast to moderate but remain above the historical average.
- The labor market has improved, with employment and labor force participation increasing, and real wage growth slowing.
- Inflation continued its downward trend, but pressures from domestic demand remain elevated.
- External balances are expected to improve on account of expanding foreign tourism.
- Albania is expected to show a positive primary balance in 2023.

Recent Economic Developments

Following a strong performance in 2022, economic growth started to moderate early in 2023 due to a slowdown in global demand, which adversely affected Albania's industrial output. In Q1 2023, GDP grew by 2.7 percent. Services, including trade and real estate activity, contributed 2.5 percentage points to quarterly GDP growth, followed by construction and manufacturing, while extractive industries and agriculture contracted.

On the demand side, private consumption remained the main driver, following growth of 6.9 percent in 2022 vis-à-vis a negative contribution from public consumption. Private consumption grew by 3 percent in Q1 2023 (yoy), supported by increasing employment and wages, strong consumer confidence, relatively low interest rates and benign credit conditions, despite of monetary policy normalization. Gross Fixed Capital Formation (GFCF) grew by 7 percent in Q1 2023, reflecting higher public investment compared with Q1 2022, but weaker private sector construction activity. Net exports of goods and services adversely affected GDP growth: consumption growth supported an increase in demand for imports in Q1 2023, which outpaced export growth. Leading economic indicators suggest GDP growth accelerated during Q2 and Q3 2023, with construction accelerating and tourist arrivals hitting a record high in July. Increased income from employment, credit growth, business and consumer sentiment indicators, and strong tax revenues, suggest an increasing contribution to growth from consumption, investment and net exports in Q2 and Q3.

Employment grew by 2.7 percent yoy during Q2 2023. Increasing nominal wages and employment incentivized labor force participation (ages 15+), which continued to increase in line with previous years' trends, reaching 63.9 percent in Q2 2023—the highest level since 2019. Average private sector wage growth reached 9.5 percent in Q1 2023, down from 14.2 percent in Q4 2022, mainly driven by wage increases in trade, transport, accommodation, and public administration. In real terms, wages increased by 3 percent in Q1 compared with 6.3 percent in Q4 2022. Unemployment reached 10.7 percent in Q2 2023, slightly higher than the end-2022 rate.

Inflation significantly reduced compared with its peak in 2022. The annual inflation rate dropped to 4.0 percent in August 2023 from a record high of 8.3 percent in October 2022, as a result of downward pressures from lower import prices, domestic currency appreciation, and monetary policy normalization. Upward pressure on inflation included wage increases and high-capacity utilization that kept production costs high. Unprocessed foods contributed most to the increase in inflation, alongside increases in the price of services. Reflecting demand pressures, core inflation averaged 5.5 percent in Q2 2023, down from 8 percent in Q1 2023. In contrast, non-core inflation reached 2.8 percent in Q2, gradually converging to the pre-war average. In 2023 the appreciation trend, which has been accelerating since 2021, has continued, with the exchange rate appreciating by 12.1 percent in July 2023. The trend reflects the gradual reduction in the current account deficit (CAD) and an improvement of external balances as a result of growing services exports. On account of domestic currency appreciation, monetary policy normalization was slower than expected; the central bank's policy rate stood at 3 percent in August 2023, and has remained at this level since the last policy rate increase in March 2023.

In the financial sector, despite increased policy rates, credit to the private sector continued to support demand expansion. Credit growth to the private sector reached 1.6 percent in June 2023 (yoy), slowing since end-2022 due to several factors, such as higher rates, tightening of credit standards by banks, especially for businesses, and exchange rate appreciation. Similarly, bank deposits continued to expand by 9.5 percent, with household savings accounting for most of increase in total deposits in the system.

The Government's fiscal position improved in H1 2023. The Government recorded a high surplus on account of strong revenue collection and lower spending. Grants accounted for most of the revenue increase (14.5 percent yoy, owed to EU disbursements), alongside social insurance contributions and personal income taxes, reflecting the increase in statutory minimum wages. The increase in expenditures was relatively small at 3.4 percent (yoy), but is expected to pick up during H2 2023 owing to increasing capital spending. With a forecast deficit of 2.5 percent of GDP in 2023, public debt is expected to reach 63.1 percent of GDP in 2023, down from 65.4 percent of GDP in 2022. In line with the Government's Debt Management Strategy and the favorable conditions for Albania, a Eurobond amounting EUR 600 million was issued in July 2023, to allow for the rollover of part of a Eurobond maturing in 2025. The rating for the country was confirmed at B1 by Moody's in 2023.

The CAD continued to narrow following strong growth in the export of services (by 38 percent), of which tourism experienced growth of 52 percent and remittances of 16 percent. The CAD narrowed by 45.9 percent in Q1 2023 in nominal terms, reaching 3.1 percent of GDP. The primary income deficit also narrowed by 6.7 percent during the same period, with labor incomes increasing by more than investment income outflows. Foreign direct investment (FDI) financed 195 percent of the CAD and contributed to a build-up in reserves. The reserve coverage at the end of Q1 2023 stood at 6.8 months of imports of goods and services, and covered 3.3 times the short-term external debt.

Outlook and Risks

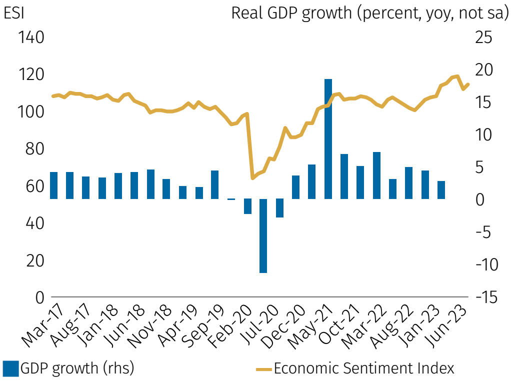
GDP growth is expected to moderate to 3.6 percent in 2023, in the context of tight global financial conditions and limited economic growth in Europe. Nevertheless, increased tourism and construction are expected to drive exports, consumption and investment growth at rates similar to the pre-pandemic period. Overall, the contribution to growth from investment is expected to decelerate, given the very high base effect and the completion of programs for post-earthquake reconstruction. The inflation rate is projected to start converging toward the 3 percent target by 2024.

The primary balance is projected to reach 0.1 percent of GDP in 2023 and stay positive in observance of the fiscal rule. Fiscal consolidation is expected from the spending side. On revenues, the Government plans to introduce further tax policy measures, as envisioned in the Medium-Term Revenue Strategy. Public debt is expected to continue to decline over the medium term, as a result of higher nominal growth and a gradual improvement of the primary balance. Given Albania's growing reliance on external financing, the exchange rate, interest rate, and refinancing related risks remain elevated.

Further increases in food and energy prices are a key risk to growth, as they could affect real disposable income, slow poverty reduction, and potentially constrain the fiscal space. As a small, open economy, Albania is highly exposed to external shocks, such as recession in Europe or further tightening of financing conditions in international capital markets beyond the current year.

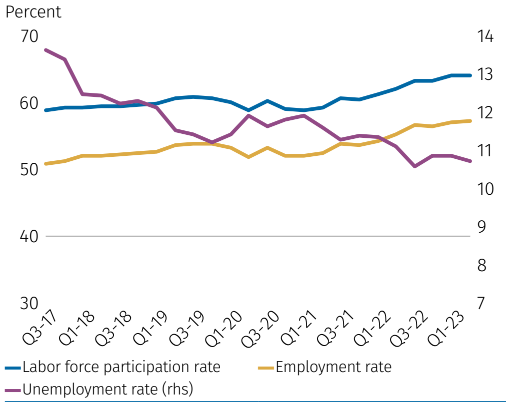
Domestic risks emanate from natural disasters, public-private partnerships, and state-owned enterprises, in addition to fiscal risks stemming from the country's hydropower-based energy sector that are mainly due to variations in hydrology.

GDP grew strongly in 2022 but the speed of recovery moderated.



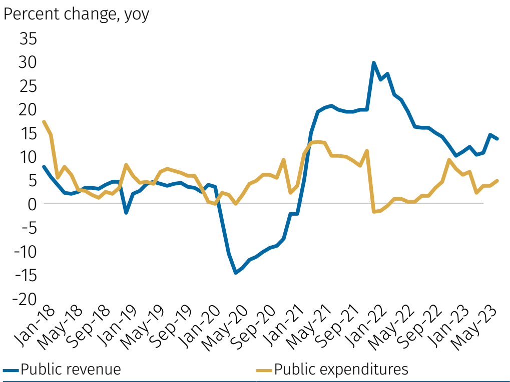
Sources: INSTAT and Bank of Albania.

Labor markets are improving.



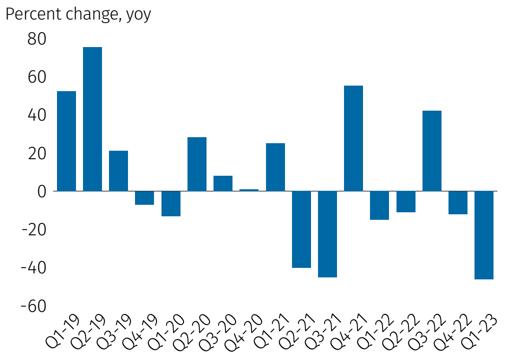
Source: INSTAT.

Public revenue growth outpaced the expenditure growth...



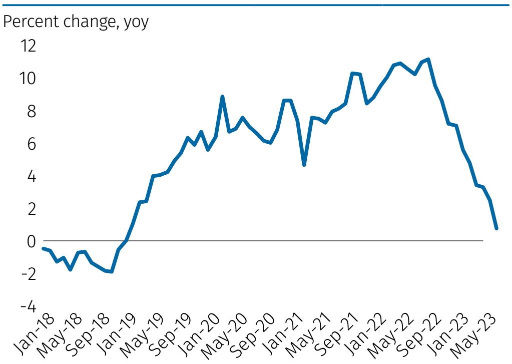
Source: Ministry of Finance.

...and the current account deficit narrowed.



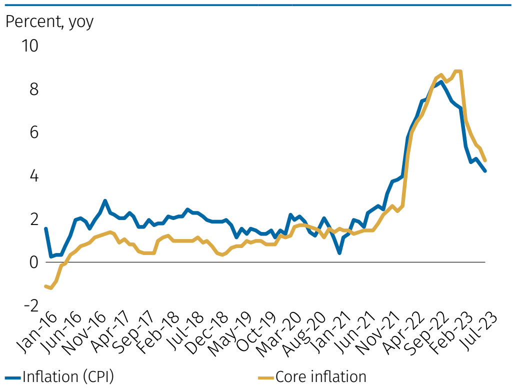
Source: Bank of Albania.

Credit to the private sector continues increasing, but at a slower pace.



Source: Bank of Albania.

Headline and core inflation started to come down.



Source: Bank of Albania.

ALBANIA Selected Economic Indicators	2020	2021	2022	2023e	2024f	2025f
Real GDP growth (percent)	-3.3	8.9	4.8	3.6	3.2	3.2
Composition (percentage points):						
Consumption	-2.5	3.6	6.7	2.1	2.1	2.0
Investment	-0.8	4.6	1.7	-0.3	0.8	0.8
Net exports	0.0	0.7	-3.6	1.8	0.3	0.4
Exports	-9.4	13.0	2.6	2.4	2.0	2.2
Imports (-)	-9.3	12.3	6.2	0.6	1.7	1.8
Consumer price inflation (percent, period average)	2.2	2.6	6.7	5.0	3.5	3.0
Public revenues (percent of GDP)	25.9	27.5	26.8	28.1	27.5	27.7
Public expenditures (percent of GDP)	32.6	32.1	30.5	30.6	29.9	29.6
Of which:						
Wage bill (percent of GDP)	4.7	4.5	4.0	4.5	4.7	4.7
Social benefits (percent of GDP)	13.4	12.3	11.6	11.5	11.1	11.2
Capital expenditures (percent of GDP)	6.2	6.9	6.6	5.3	5.2	5.2
Fiscal balance (percent of GDP)	-6.7	-4.6	-3.7	-2.5	-2.3	-1.9
Primary fiscal balance (percent of GDP)	-4.6	-2.7	-1.8	0.1	0.3	0.5
Public debt (percent of GDP)	73.0	71.5	62.1	60.3	59.4	58.5
Public and publicly guaranteed debt (percent of GDP)	75.8	75.4	65.4	63.1	62.1	60.8
Of which: External (percent of GDP)	35.2	36.8	30.3	29.8	29.3	27.8
Goods exports (percent of GDP)	6.0	8.3	10.8	9.3	9.3	9.3
Goods imports (percent of GDP)	28.4	33.6	34.6	31.1	30.9	30.8
Net services exports (percent of GDP)	8.1	11.7	13.4	12.1	11.8	11.8
Trade balance (percent of GDP)	-14.3	-13.5	-10.4	-9.7	-9.8	-9.7
Net remittance inflows (percent of GDP)	5.1	5.0	5.5	5.4	5.4	5.4
Current account balance (percent of GDP)	-8.5	-7.8	-6.0	-5.6	-5.8	-5.6
Net foreign direct investment inflows (percent of GDP)	6.7	6.5	6.7	6.8	6.8	6.8
External debt (percent of GDP)	60.5	62.7	54.3	51.8	50.0	49.0
Real private credit growth (percent, period average)	4.6	5.5	2.9	–	–	–
Nonperforming loans (percent of gross loans, end of period)	8.1	5.7	5.0	–	–	–
Unemployment rate (percent, period average)	11.7	11.5	11.0	–	–	–
Youth unemployment rate (percent, period average)	20.9	20.9	20.7	–	–	–
Labor force participation rate (percent, period average)	59.5	59.8	62.4	–	–	–
GDP per capita, PPP (current international $)	14,888	16,302	16,782	17,151	17,734	18,515
Poverty rate (percent of population)	34.4	27.5	25.2	23.9	22.0	20.4

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Notes: In annual percent change unless indicated otherwise. Poverty rate calculations based on ECAPOV harmonization using SILC-C data. Nowcasted/projected values start at 2019. Income measures in the SILC and consumption measures in the HBS are not strictly comparable. Poverty is defined as living on less than $6.85/day per person in revised 2017 PPPs.
e = estimate; f = forecast; PPP = purchasing power parity; – = not available.

Bosnia and Herzegovina

- With real GDP growth continuing to slow to 1.1 percent in Q1 2023 (yoy), economic activity in Bosnia and Herzegovina (BiH) is set to further decelerate to 2.2 percent in 2023.
- Softer private consumption and a drop in transport prices should result in an inflation rate of 5.8 percent in 2023, a significant slowdown from 14 percent seen in 2022.
- A sharp deceleration in exports is expected to broaden the external deficit somewhat to 4.7 percent of GDP in 2023.
- The labor market is characterized by declining unemployment, particularly among women, although this is because fewer women were looking for jobs.
- Stronger tax revenues supported by high inflation resulted in a fiscal surplus of 0.4 percent of GDP in 2022 but a return to a deficit is expected in 2023 in part due to municipal elections in 2024.
- Real output growth is expected to improve to 2.8 percent in 2024 and 3.4 percent in 2025 as private consumption recovers, together with EU demand for BiH's goods.
- EU candidacy status received in December 2022 could serve as a catalyst for much-needed structural reforms. Quicker formation of entities' governments following the October 2022 elections than in the previous cycle yields some confidence.

Recent Economic Developments

After surging to 7.4 percent in 2021, real GDP grew by 3.9 percent[1] in 2022, as the rebound from the post-pandemic period subsided. Economic activity in 2022 slowed consistently from 5.9 percent in Q1 2022 (yoy) to 1.7 percent in Q4 2022 (yoy), mainly due to an output deceleration in manufacturing on the supply side and a slowdown in final domestic consumption on the demand side. This trend of rapid deceleration persisted into Q1 2023, with real GDP rising a mere 1.1 percent (yoy). The latter is primarily due to the contraction in private consumption of 0.5 percent (yoy) as remittance inflows dropped by 4.8 percent in real terms in Q1 2023. Meanwhile, gross capital formation grew by 12.6 percent (yoy), which partly offset the decline in private consumption. Nonetheless, private consumption is expected to pick up in Q2 and Q3 of 2023, supported by an average after-tax real wage increase of 17 percent during the period January to June 2023. The impetus on the demand side will be moderated, however, by the poor performance of industrial production on the supply side. Specifically, industrial production dropped 3.9 percent during the period January–July 2023, largely driven by a fall in sales on foreign markets totaling 11 percent, whereas turnover in the domestic market declined 2 percent.

Net exports shrank by 0.3 percent of GDP in Q1 2023, a significant decline from 6.7 percent of GDP posted in Q1 2022. The compression in net exports is the result of an almost total standstill in both exports and imports. More precisely, exports slowed by 1.7 percent (real terms) in Q1 2023 from a jump of 38.6 percent the previous year, while growth in imports dropped to 2 percent (real terms) in Q1 2023 from a jump of 31.9 percent

1 BiH Agency for Statistics, Economic Statistics No.2 from 30.06.2023.

one year ago. This net export performance is driven by weaker demand from the EU, but also represents a base effect considering the high growth rates in early 2022. On the import side, lower growth is due to a decline in private consumption and, similar to the case of exports, represents a base effect due to high import growth in Q1 2022.

During the period January–July 2023, inflation amounted to 8.5 percent, a 3.7-percentage-point drop vis-à-vis the same period in 2022. Inflation slowed to 4.0 percent in July (yoy), a considerable slowdown from 14.1 percent (yoy) seen in January 2023. Inflation dynamics represent a confluence of stubbornly high food prices, together with high prices of housing, water, electricity, and gas on the one hand, and sharply declining transport prices on the other hand. Food prices grew by 15.5 percent during January–July 2023 compared with a rate of 19.3 percent during the same period in 2022. Meanwhile, transport prices declined 12.7 and 13.2 percent in June and July of 2023 (yoy), respectively, which translated into a negative rate of 2.9 percent during January–July. As the impact of lower transport prices exerts downward pressure on input costs, and spreads through the economy, the inflation rate is likely to decelerate to 5.8 percent in 2023.

Key labor market indicators remain static. The overall employment rate (ages 15–89) increased marginally to 40.8 percent in Q1 2023 compared with 40.1 percent in Q1 2022, while the unemployment rate (ages 15–74) shrank to 13.3 percent, a 3.4-percentage-point decline vis-à-vis Q1 2022.[2] However, the decline in the unemployment rate was driven by people moving from employment into inactivity, rather than improvements in employment itself. The overall activity rate declined by 1 percentage point during this period. The decline in the unemployment rate has been particularly pronounced among women, amounting to 4.1 percentage points between Q1 2022 and Q1 2023 compared with 2.8 percentage point decline among men, but this was driven by a larger decline in the activity rate among women. Furthermore, the female unemployment rate remains high compared with other Western Balkans countries.

Stronger tax revenues supported by a high inflation rate were not offset by higher nominal public spending, which resulted in a fiscal surplus of 0.4 percent of GDP in 2022.[3] This compares with a deficit of 0.3 percent of GDP in 2021, and 5.2 percent of GDP in 2020. The fiscal surplus is the result of a fiscal surplus in the Federation BiH and a fiscal deficit in RS. Expenditures in 2022 in both entities were driven by social measures softening the inflationary impact on households and pre-election spending, including wage and pension hikes, as well as higher capital expenditures. However, spending in the RS compared with the Federation was much higher on wage increases, pension outlays, and social assistance, in GDP terms. Gross public debt in BiH remains sustainable at just below 30 percent of GDP.[4]

2 The methodology of the Labor Force Survey was changed in 2021, which makes direct comparisons between 2021 and 2020 data difficult.
3 BiH Global Fiscal Framework for 2022–2024 and World Bank staff estimates; estimates for H1 2023 by CBBiH are expected by end-September 2023.
4 Central Bank of BiH 2023 (data available at Panorama web portal), World Bank staff calculations.

The current account deficit (CAD) widened to 4.5 percent in 2022 from 2.4 percent of GDP in 2021, driven by a rise in the merchandise trade deficit. The merchandise trade deficit rose by 3.8 percentage points to 22.1 percent of GDP in 2022, and was driven by high import prices of fuel, food, and other commodities, amid strong domestic demand. Higher goods imports growth (13.1 percent) more than offset higher growth in goods exports (8.8 percent), which was also driven by higher prices, notably of metals and electricity. Exports of goods were helped by stronger services exports due to a recovery in tourism. BiH's 5.8 percent of GDP in travel inflows in 2022 exceeded pre-pandemic-level inflows, which had come to 3.2 percent in 2019. The contribution of net remittances remained the same as in 2021, totaling 7.8 percent of GDP, while the primary income balance improved. After capital account adjustments, the CAD amounted to 3.8 percent of GDP in 2022, two-thirds of which were financed by net FDI inflows, which were equivalent to 2.5 percent of GDP. Portfolio investment outflows of 0.4 percent of GDP were more than offset by other investment inflows of 0.9 percent of GDP. The latter was dominated by trade credits, whereas net disbursements on government loans dropped significantly.

Preliminary data suggest an improvement in the CAD as the merchandise trade deficit in Q1 2023 narrowed and the services surplus widened. This resulted in an external account deficit of 3.6 percent of GDP in Q1 2023 compared with 4 percent in Q1 2022. Nevertheless, as private consumption strengthens, the CAD is expected to widen marginally to 4.7 percent of GDP. This should be largely financed by net FDI inflows, which improved significantly in Q1 2023 amounting to 3.6 percent of GDP, a 1.6-percentage-point increase compared with the same period in 2022.

The banking sector is well-capitalized and profitable. Banks are liquid, and profitable, with non-performing loans (NPLs) at their lowest level in a decade (4.1 percent in Q2 2023). There have been no direct spillovers from financial stress in advanced economies due to the limited reliance on international and wholesale funding, and fixed-income assets of BiH banks.

Outlook and Risks

Real output growth in BiH is estimated to decelerate further to 2.2 percent in 2023 driven by slower private consumption and exports. In the medium term, real GDP growth is projected at 2.8 percent in 2024, and 3.4 percent in 2025, as private consumption regains momentum driven by a strengthening of real disposable income. Inflation is expected to stabilize in 2024–25 at around 2 percent per year on the back of lower transport prices, and in line with inflation rates prior to the pandemic. Stronger exports on the back of a gradual growth recovery in the EU are likely to be offset by higher imports of consumer goods, resulting in a further widening of the CAD from 4.7 percent of GDP in 2023 to 5.1 percent by 2025.

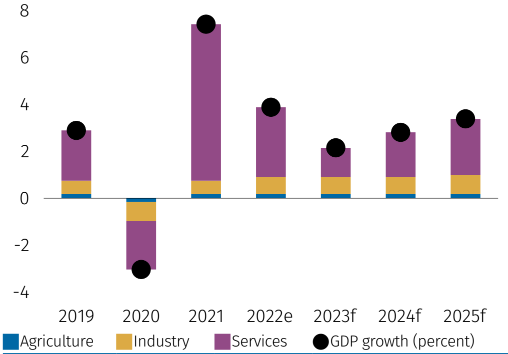
The return to fiscal surplus in 2022 is likely to be short-lived due to the upcoming municipal elections in 2024. An overall higher wage bill, pension outlays, and social benefits are expected in 2023 and 2024, since governments' measures in 2022 were permanent. This spending will further increase as part of the municipal pre-election expenditure cycle. Nevertheless, by 2025 the fiscal stance is expected to be balanced again. Public debt is projected to remain sustainable at below 30 percent of GDP during 2023–2025, although debt levels vary significantly across the two entities.

With general elections completed in October 2022, and entities' governments formed, it would be opportune for policy makers to turn to the structural reform agenda and the fulfillment of legislative priorities for EU accession. In this respect, three of 14 required legislative steps—which are part of the often-referenced European package—have been passed recently by parliaments. These laws define free access to information at the level of BiH, address human rights, and define the role of courts.

Downside risks dominate the outlook. Protracted market disruptions following the pandemic and uncertainties fanned by the war in Ukraine could have a negative impact on aggregate demand through depressed consumer and business confidence. Furthermore, the recovery in the EU remains fragile, potentially adversely impacting demand for BiH exports, except for energy. A weaker labor market across the EU, most specifically in Germany, could limit remittance inflows, which support private consumption. Finally, geopolitical risks could further aggravate domestic political frictions with adverse consequences for the much-needed structural reform push.

GDP growth is expected to slow in 2023

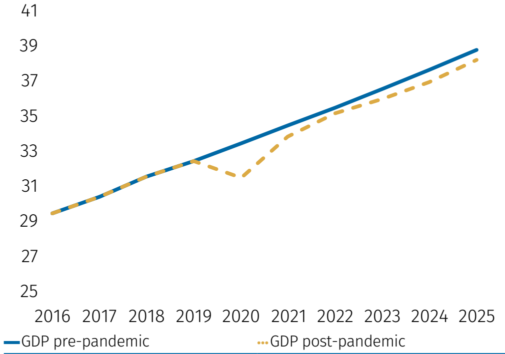
Contributions to growth, percentage points of GDP



Sources: BiH Agency for Statistics; World Bank.
Note: e = estimate; f = forecast.

Post-crisis growth trajectory is unlikely to close the gap with pre-crisis growth path.

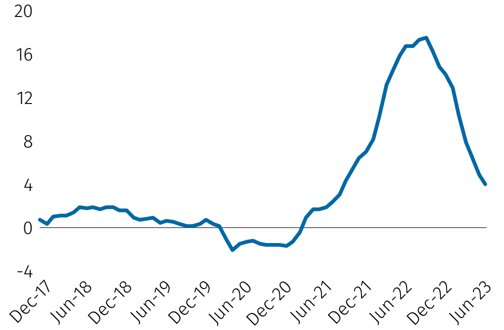
In 2015, thousand KM



Source: World Bank staff estimates.

Consumer price and food inflation continue their downward trend in Q1 2023...

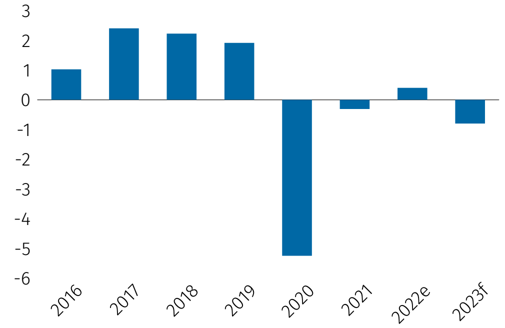
CPI, percent yoy



Sources: BiH Agency for Statistics; World Bank.

...while the fiscal deficit is expected to widen in 2023, despite higher revenues due to inflation.

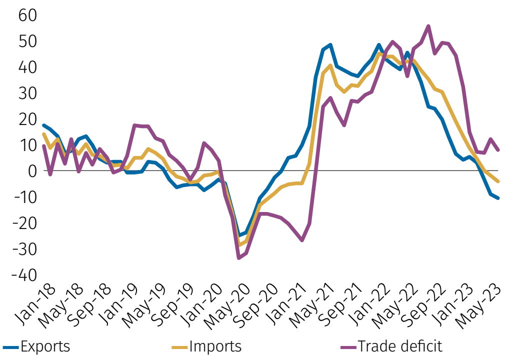
General government fiscal balance, percent of GDP



Sources: BiH fiscal authorities; World Bank staff estimates.

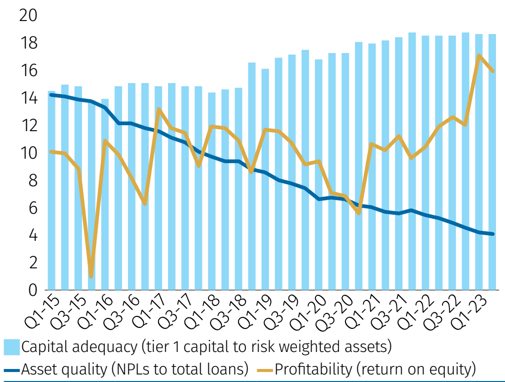
The merchandise trade deficit widened.

Real 3-month moving average (3mma), percent yoy



Sources: BiH Indirect Tax Office; World Bank.

Nonperforming loans in commercial bank portfolios have decline steadily.



Sources: Central Bank of BiH; World Bank calculations.

BOSNIA AND HERZEGOVINA Selected Economic Indicators	2020	2021	2022	2023e	2024f	2025f
Real GDP growth (percent)	-3.0	7.4	3.9	2.2	2.8	3.4
Composition (percentage points):						
Consumption	–	–	2.7	1.9	2.2	2.6
Investment	–	–	3.5	1.9	0.7	0.4
Net exports	–	–	-2.3	-1.6	-0.1	0.5
Exports	–	–	3.5	1.5	2.1	2.3
Imports (-)	–	–	5.8	3.1	2.2	1.9
Consumer price inflation (percent, period average)	-1.1	2.0	14.0	5.8	2.5	0.9
Public revenues (percent of GDP)	41.6	41.1	40.1	40.7	41.0	41.5
Public expenditures (percent of GDP)	46.8	41.3	39.7	41.5	40.9	41.5
Of which:						
Wage bill (percent of GDP)	11.3	10.3	10.3	10.8	10.6	10.3
Social benefits (percent of GDP)	15.9	14.6	17.4	17.7	18.6	19.2
Capital expenditures (percent of GDP)	5.1	3.5	3.5	3.7	3.1	3.4
Fiscal balance (percent of GDP)	-5.2	-0.3	0.4	-0.8	0.0	0.0
Primary fiscal balance (percent of GDP)	-4.5	0.3	1.0	0.1	0.9	0.9
Public debt (percent of GDP)	36.1	34.0	29.3	27.6	27.0	26.3
Public and publicly guaranteed debt (percent of GDP)	38.8	37.6	31.5	29.5	29.2	28.5
Of which: External (percent of GDP)	30.4	29.5	24.9	23.3	22.6	22.0
Goods exports (percent of GDP)	27.1	32.5	35.4	36.9	36.4	35.8
Goods imports (percent of GDP)	45.2	50.8	57.5	59.0	58.0	57.5
Net services exports (percent of GDP)	4.3	6.6	7.9	8.2	7.7	7.3
Trade balance (percent of GDP)	-13.7	-11.8	-14.2	-13.9	-14.0	-14.3
Net remittance inflows (percent of GDP)	7.3	7.8	7.8	7.4	7.2	7.1
Current account balance (percent of GDP)	-3.2	-2.4	-4.5	-4.7	-4.8	-5.1
Net foreign direct investment inflows (percent of GDP)	1.8	2.3	2.5	2.4	2.4	2.3
External debt (percent of GDP)	69.7	62.4	60.5	60.0	59.1	57.4
Real private credit growth (percent, period average)	1.3	-0.3	-8.1	–	–	–
Nonperforming loans (percent of gross loans, end of period)	6.1	5.8	5.4	–	–	–
Unemployment rate (percent, period average)	15.9	17.4	15.4	–	–	–
Youth unemployment rate (percent, period average)	36.6	38.2	35.0	–	–	–
Labor force participation rate (percent, period average)	47.7	48.0	47.6	–	–	–
GDP per capita, PPP (current international $)	15,337	17,377	17,898	18,345	18,896	19,557

Sources: Country authorities, World Bank estimates and projections.
Note: e = estimate; f = forecast; PPP = purchasing power parity; – = not available.

Kosovo

- Amidst challenging external conditions, real GDP growth decelerated but remains positive; economic activity is expected to expand by 3.2 percent during 2023.
- Positive performance of service exports and private consumption were key growth drivers.
- Inflation has been steadily decreasing from its peak of 14.2 percent in July 2022, but price pressures remain heightened; annual consumer inflation averaged close to 6 percent between January and August 2023.
- Although the outlook remains positive, the balance of risks remains tilted to the downside. Continued uncertainties related to the war in Ukraine, a further slowdown of economic activity in Europe, and the complexity of the political environment, represent significant risks.

Recent Economic Developments

Kosovo's macroeconomic conditions remained favorable during H1 2023, despite persistent external volatility and a slowdown in growth in Q2. During Q2 2023, real economic activity reached 2 percent year-on-year (yoy)[5], bringing H1 2023 growth to 2.9 percent. Growth in Q2 was primarily driven by a 5.9 percent real increase in exports thanks to record growth in exports of services (13.6 percent); mostly in diaspora-related travel services, as well as ICT services. Exports of goods, contrary to initial expectations, contracted by 10.7 percent in real terms. Private consumption and gross capital formation witnessed moderate growth of 3.7 and 2 percent, respectively. On the production side, services provided the highest contribution to growth. Monthly indicators, including those on the external sector, firm sales and international travel data, show that the impact from consumption and service exports on growth was strong throughout the first three quarters of the year.

Inflation has been steadily decreasing from its peak of 14.2 percent in July 2022, but price pressures remain elevated. Consumer inflation averaged 6 percent between January and August 2023, and inflation decelerated to 2.4 percent by July 2023, but experienced a slight uptick in August 2023 (3.2 percent). During this period, a significant contribution to inflation resulted from price increases of furnishing, household items and maintenance (7.2 percent), alcoholic beverages and tobacco (6.3 percent), and food and non-alcoholic beverages (5.5 percent). Transport prices—which contributed to inflationary pressures in 2022—subtracted from the inflation rate (-3.8 percent). At 4 percent in August, core inflation also went up, and remains higher than overall inflation. Prices of imports continued to increase, but at a decelerating trend, impacted primarily by a drop in commodity and energy import prices. Meanwhile, both producer and agricultural input prices declined compared with H1 2022.

Employment and employment formalization are on the rise, but the labor market continues to face critical challenges. According to recent

5 All references hereon refer to year on year comparisons, unless otherwise indicated.

administrative data, formal employment increased by 2.8 percent between August 2022 and August 2023.[6] The latest Labor Force Survey (LFS)[7] revealed that the working age population shrank during 2022, possibly due to migration, while the employment-to-population ratio experienced an increase, from 31.1 percent in 2021 to 33.8 percent in 2022. Notably, the unemployment rate has been on a downward trajectory, plummeting to 12.6 percent in 2022; but inactivity rates remain high. The LFS data further highlight prominent gender disparities within the labor market, encompassing significant differences in employment rates (49.4 percent for males and 18.4 percent for females in 2022), inactivity rates (45 percent for males and 78 percent for females), as well as moderate levels of youth unemployment (21.4 percent). Kosovo has no official statistics on open vacancies, but individual surveys from business organizations show increasing challenges for firms in filling vacancies, particularly for qualified employees.

By June 2023, the current account deficit (CAD) showed signs of improvement, driven by lower value imports coupled with a continued positive performance in service exports and secondary income inflows. Nominal merchandise exports and imports dropped by 8.1 and 5.2 percent, respectively. The service trade balance increased further improved by 36 percent as of June 2023. Hence, the trade deficit slightly decreased by 1.8 percent during this period. By August 2023, remittances recorded a cumulative growth rate of 11.7 percent. Foreign direct investment (FDI) continued to experience a positive performance with a cumulative increase of 14.3 percent by June 2023. Nonetheless, FDI remains highly concentrated in the construction and the real estate sector, reflecting the demand of the Kosovar diaspora for real estate assets in Kosovo.

The overall fiscal balance remained within fiscal rule limits. For January–August 2023, and in line with the seasonality of budget expenditures, the Government ran a surplus, slightly above 2022 levels. For the same period, tax revenues grew by 12 percent while overall revenues increased by 15 percent, boosted also by energy-related EU on-budget grants worth EUR 67.5 million. Direct taxes and domestically collected VAT increased by close to 20 percent, while VAT and excises collected at the border (representing more than half of tax revenues) increased by around 6 percent each. Expenditures, on the other hand, increased by 16.2 percent until August 2023. Implementation of the new legislation on public wages has led to a 20 percent increase of the monthly wage bill. Given the discontinuation of energy import subsidies, together with a drop in the number of beneficiaries for several pension schemes and the social assistance program, total spending on subsidies and transfers declined slightly by 1 percent. In July 2023, Parliament amended the state pension legislation which will increase average pension benefits, likely with a significant future fiscal impact. Capital expenditure increased by 77 percent by August 2023, albeit from the relatively low base of 2022. Despite the significant pick up in spending, implementation of externally financed capital projects continues to lag. Implementation of additional energy-related subsidies and seasonally higher payments for

6 Administrative Labor Market Statistics, August 2023, Kosovo Statistics Agency.
7 Kosovo has large delays in publishing Labour Force Survey (LFS) data, and as of today only 2022 data are available.

capital projects are expected to lead to a modest fiscal deficit by year end slightly higher than the previous year's fiscal deficit.

Since January 2023, total public and publicly guaranteed (PPG) debt has been on a downward trend. By end Q2 2023, PPG debt stood at 17.3 percent of GDP, down from 19.9 percent of GDP at end-2022. In 2023, the Government has amortized more than Euro 120 million of domestic debt. On the other hand, external debt continued to increase at a moderate pace, but at less than half the level of the reduction in the stock of domestic debt. During H1 2023, the Government reached a Precautionary Stand-By-Arrangement (around EUR 100 million) and an Arrangement Under the Resilience and Sustainability Facility with the IMF (around EUR 78 million). As of September 2023, no disbursemnts under these programs have taken place. Lastly, the Government decided to commence the repayment of pension savings fund withdrawals authorized in 2020, as part of its pandemic liquidity support measures.

Increases in the cost of borrowing have not reduced credit demand. By August 2023, total bank credit increased by 13.2 percent (8.3 percent for new loans), with total loans to households increasing by 16.9 percent. The microfinance loan portfolio, which represents less than 10 percent of the bank credit portfolio but provides services to a significant number of citizens, increased by close to 24 percent. Concurrently, deposits grew by 12.2 percent. The cost of funding increased by approximately 0.6 of a percentage point on average, in the period January–August 2023 with respect to the same period in 2022. Average interest rates on new loans increasing, for example, increased from 5.9 to 6.5 percent. Capital buffers and asset quality remain positive. The ratio of regulatory capital on risk-weighted assets stood at 15.6 percent in August 2023 and nonperforming loans remained at 2 percent.

Outlook and Risks

Despite continued inflationary pressures, real GDP growth is expected to reach 3.2 percent in 2023, driven by positive export performance and higher private consumption. Higher services exports are expected to offset stalling merchandise exports and increasing imports, leading to a positive real contribution of the external balance to growth. At the same time, strong credit growth and higher net remittances, supported by elevated levels of public transfers, are expected to support private consumption. Higher public wage spending following the implementation of the new Law on Public Wages, coupled with increased public spending on maintenance and services, is expected to support public consumption growth. Likewise, after contracting in 2022, gross fixed investment is expected to add to growth, fueled by construction activity and a more predictable environment for input prices. Public capital expenditure is also expected to boost investment on the heels of recent efforts to lift implementation bottlenecks, including through price adjustments for public contracts. On the production side, services are expected to provide a higher contribution than manufacturing and agriculture combined.

The medium-term outlook remains positive within a context of high uncertainty. The contribution of investment to growth is expected to pick up in 2024–2025, supported by increased investment in public infrastructure, including through the support of external financing, and higher public and private investments in energy supply and efficiency. However, despite expected improvements in capital execution, public investment is expected to remain below budgeted levels. Based on the permitting pipeline, real estate development activity is expected to continue boosting investment and growth in the medium term. Financial deepening and primary and secondary inflows are expected to support consumption, coupled with higher pension transfers in 2024. Reactivation of Kosovo's ferronickel production capacities is expected to boost merchandise exports. With growth expected to accelerate toward 4 percent, the level of economic activity should converge toward Kosovo's potential. Yet, continued uncertainties related to the war in Ukraine and the impact on the energy sector in Kosovo, a further slowdown of economic activity in Europe, and a deterioration of the domestic political context, represent significant risks.

Inflation is expected to decelerate, but price pressures remain high. While decreasing in line with international trends, consumer price inflation is projected to reach 4.8 percent in 2023 and further decelerate over 2024–2025, reflecting expectations on Euro area inflation and international commodity price movements. A tighter labor market could, however, exert an upward pressure on inflation. At the same time, Kosovo's high dependency on imports continues to expose the country to international price fluctuations. Higher fuel and energy prices could lead to an inflation rebound and an energy supply shock, negatively impacting growth.

After a significant deterioration over 2020-2022, the CAD is expected to improve over the medium term. In 2023, the CAD is expected to improve by 4 percentage points of GDP owing to a deceleration in imports and further improvements in the services balance. Over 2024–25, the CAD is expected to further decline on account of improvements in the trade balance, albeit at a much slower pace. Non-debt creating FDI inflows are expected to continue providing the main source of financing for the CAD, but high levels of errors and omissions in the balance of payments remain a source of uncertainty. Over-concentration of FDI on real estate activities is expected to continue over the medium term, but higher energy sector private investment could potentially lead to higher diversification of FDI.

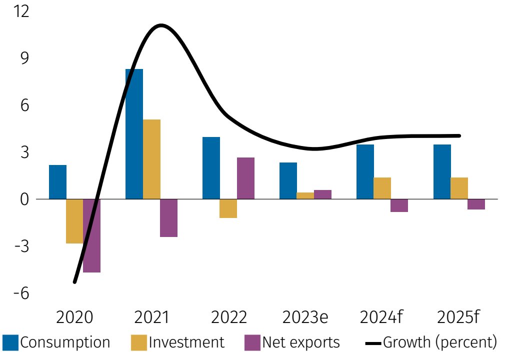
The fiscal deficit is estimated to remain below 1 percent of GDP in 2023, driven by positive tax revenue performance and lower-than-budgeted capital expenditures. Over the medium term, the deficit should on average represent between 1.5 and 2.0 percent of GDP on the back of an increase in capital spending associated to the Energy Strategy, further increases in the public wage coefficients and operationalization of allowances in 2024, and higher spending on pensions. Tax revenues are expected to continue increasing, albeit at a slower rate than 2021–2023 given the fading impact of inflation, particularly on border levied taxes. Implementation of 2023 amendments to personal income tax (PIT) legislation increasing the non-taxable PIT bracket to the level of the minimum wage—currently pending constitutional court review—could further slow down the pace of revenue collection. Until 2025, public debt is projected to remain below 20 percent of GDP, given historic bottlenecks to implementing International Financial Institutions (IFI)-financed capital projects.

Further financial deepening has the potential to support credit growth, private consumption, and investment over the medium term. Envisaged legal changes to payments legislation could further boost digitalization of payments, also enhancing formalization. External private debt, which includes intercompany loans and trade credit, should also be on the rise.

Moving forward, Kosovo needs to enhance resilience to external shocks while advancing structural reforms to unlock higher potential growth and speed up convergence with comparable EU peers. Since the outbreak of the COVID-19 pandemic, prudent macro-fiscal management has allowed Kosovo to respond to the impacts of the crisis. However, closing the gap with EU peers will require maintaining macroeconomic stability while addressing long-standing structural bottlenecks that limit potential output. Timely and effective implementation of the new Energy Strategy while safeguarding fiscal adequacy is imperative in this regard, alongside the need to reduce other infrastructure gaps in water, waste, and connectivity. Improvements of labor market outcomes can no longer be delayed and should focus on supporting greater inclusion of inactive women into the labor market, by reducing barriers to participation, also by scaling up access to childcare services. Furthermore, scaling up human capital investments—as a precondition to unlock higher potential growth—while preserving fiscal adequacy, requires effective and comprehensive reforms, such as: (i) optimizing the school network; (ii) setting up a health financing framework that promotes universal health coverage; and (iii) enhancing targeting of social assistance and the predictability and adequacy of pensions.

Investment bounced back, providing a modest but positive contribution to growth in 2023.

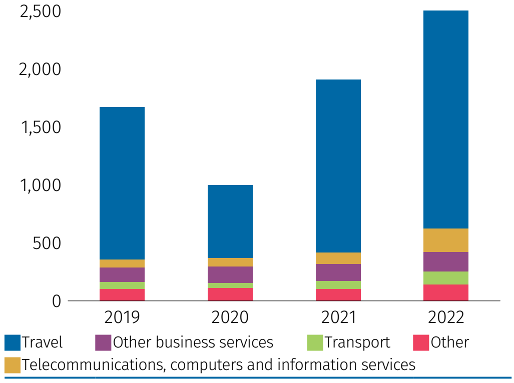
Contributions to growth, percentage points



Sources: Kosovo Statistics Agency; World Bank staff calculations.

Service exports continued to increase, driven by travel, but also ICT and business services.

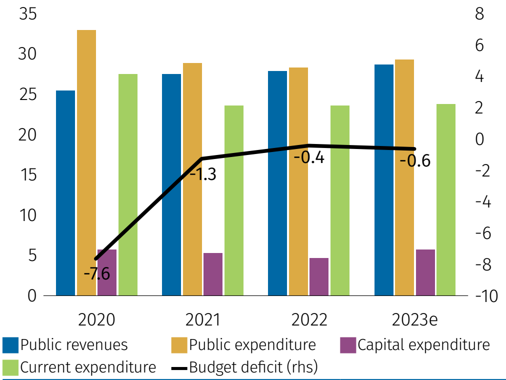
Service exports by category, in EUR million



Source: Central Bank of Kosovo.

The fiscal deficit remains moderate.

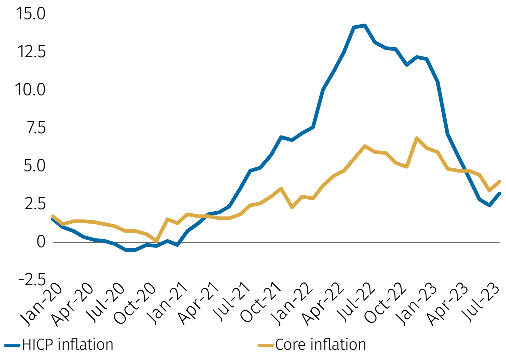
Percent of GDP



Sources: Ministry of Finance; World Bank staff calculations.

Inflationary pressures started to ease in 2023.

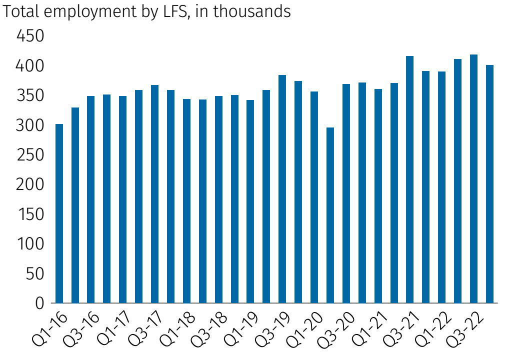
yoy changes, percent



Sources: Kosovo Statistics Agency and Central Bank of Kosovo.

Employment is gradually trending upwards.

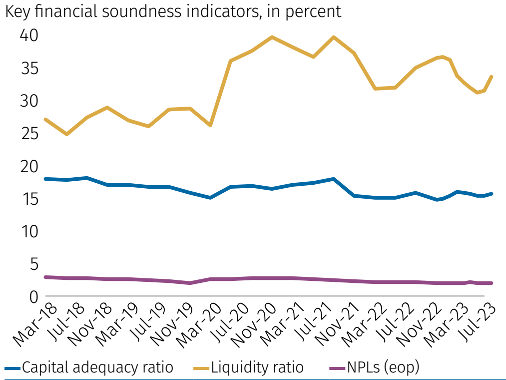
Total employment by LFS, in thousands



Source: Kosovo Statistical Agency.

The financial sector remained stable.

Key financial soundness indicators, in percent



Source: Central Bank of Kosovo.
Note: eop = end-of-period; NPLs = nonperforming loans.

KOSOVO Selected Economic Indicators	2020	2021	2022	2023e	2024f	2025f
Real GDP growth (percent)	-5.3	10.7	5.2	3.2	3.9	4.0
Composition (percentage points):						
Consumption	2.1	8.2	3.9	2.3	3.4	3.4
Investment	-2.8	5.0	-1.2	0.4	1.3	1.3
Net exports	-4.7	-2.4	2.6	0.5	-0.8	-0.7
Exports	-8.3	16.4	6.4	3.8	2.2	2.3
Imports (-)	-3.6	18.8	3.9	3.3	3.1	3.0
Consumer price inflation (percent, period average)	0.2	3.4	11.6	4.8	3.0	2.5
Public revenues (percent of GDP)	25.4	27.4	27.8	28.7	28.2	28.3
Public expenditures (percent of GDP)	33.0	28.8	28.2	29.2	30.1	30.1
Of which:						
Wage bill (percent of GDP)	9.8	8.4	7.3	7.9	7.5	7.5
Social benefits (percent of GDP)	7.7	7.3	7.2	6.4	6.5	6.2
Capital expenditures (percent of GDP)	5.6	5.3	4.7	5.6	6.3	6.8
Fiscal balance (percent of GDP)	-7.6	-1.3	-0.4	-0.6	-1.9	-1.9
Primary fiscal balance (percent of GDP)	-7.2	-0.9	0.0	-0.2	-1.6	-1.3
Public debt (percent of GDP)	22.0	21.2	19.6	18.5	19.3	19.8
Public and publicly guaranteed debt (percent of GDP)	22.4	21.6	19.9	18.6	19.5	20.1
Of which: External (percent of GDP)	7.8	7.3	7.2	7.3	8.2	8.6
Goods exports (percent of GDP)	7.0	9.5	10.4	8.8	9.0	9.2
Goods imports (percent of GDP)	45.0	54.3	58.4	54.5	53.6	53.7
Net services exports (percent of GDP)	5.8	13.0	15.4	16.6	16.3	16.8
Trade balance (percent of GDP)	-32.2	-31.8	-32.6	-29.1	-28.3	-27.7
Net remittance inflows (percent of GDP)	14.0	14.1	13.3	13.7	13.6	13.5
Current account balance (percent of GDP)	-7.0	-8.7	-10.5	-6.5	-6.0	-5.5
Net foreign direct investment inflows (percent of GDP)	4.2	4.0	6.7	6.7	6.7	6.7
External debt (percent of GDP)	36.9	37.6	38.2	38.4	39.0	39.9
Real private credit growth (percent, period average)	7.6	7.5	5.2	–	–	–
Nonperforming loans (percent of gross loans, end of period)	2.5	2.3	2.0	–	–	–
Unemployment rate (percent, period average)	25.9	20.7	12.6	–	–	–
Youth unemployment rate (percent, period average)	49.1	38.0	21.4	–	–	–
Labor force participation rate (percent, period average)	38.3	39.3	38.6	–	–	–
GDP per capita (US$)	4,321	5,270	5,305	5,810	5,804	6,758
Poverty rate (percent of population)	32.4	27.0	25.4	23.6	22.2	20.3

Sources: Country authorities; World Bank staff estimates and projections.
Note: Poverty rate calculations based on ECAPOV harmonization using Household Budget Survey (HBS) data. Nowcasted/projected values start at 2018. Income measures in the SILC and consumption measures in the HBS are not strictly comparable. Poverty is defined as living on less than US$6.85/day per person in revised 2017 PPP. e = estimate; f = forecast; PPP = purchasing power parity; – = not available.

Montenegro

- Montenegro's growth remains strong and is estimated at 4.8 percent for 2023, driven by private consumption and service exports.
- The fiscal performance has been better than planned, largely owing to one-off revenues and capital budget under-execution.
- As Montenegro approaches large debt repayments during 2024–27, it requires very careful fiscal and debt management with well-designed policies affecting the fiscal position.

Recent Economic Developments

The economy made a very strong start in 2023. GDP expanded by 6.6[8] percent in H1, driven by personal consumption, underpinned by an increase in public sector wages, employment gains, and household borrowing. In the first seven months of 2023, total international tourism overnight stays increased by 50 percent, outpacing by nearly a third the levels observed in the same period of 2019. Surging tourism, along with rising employment and an increase in wages, supported retail trade, which expanded by 10.4 percent in real terms over the same period. Despite declining manufacturing due to a halt in aluminium production, industrial production increased by 5.4 percent in the first seven months of 2023, due to favourable hydrometeorological conditions earlier in the year that affected electricity generation. While construction declined by 3.4 percent in H1 2023,[9] an increase in the number of building permits issued points to a likely resumption of construction activity in the near term.

Strong employment gains of 2022 continued into 2023, reflecting the year's strong start. The Labour Force Survey shows that average employment increased by 10.7 percent in H1 2023. The employment rate thus rose to a record high of 55.9 percent in Q2 2023 from 50.7 percent a year ago. The activity rate rose to a record high of 64.2 percent from 59.3 percent a year ago, while the unemployment rate declined to a historical low of 12.9 percent from 14.6 percent. The youth unemployment rate also declined to its lowest ever at 17 percent in Q2 2022 from 26.7 percent.

Administrative data suggest employment also increased in early Q3 2023. In July, total registered employment increased by 9.6 percent to reach a record high of 258,024 employed. In the first seven months, all sectors registered average employment growth, with the ICT sector surging by 43.6 percent, also affected by migrant workers registering businesses in Montenegro. The registered unemployment rate in July 2023 declined by 3 percentage points to a historic low of 13.1 percent.

Inflation has eased but remains elevated. While annual inflation moderated to 10.1 percent over the first eight months of 2023, monthly inflation remains elevated, led by food prices. Montenegro's food prices have not followed the trend of softening of global food prices and most inflation remains explained by increases in the prices of food and non-alcoholic beverages (14.7 percent) and solid fuels (23.5 percent). Over the

8 All comparisons are year-on-year, unless otherwise indicated.
9 Measured as the number of effective hours worked on construction sites.

same period, net average wages increased by 11 percent in nominal terms, leading to an increase of 0.5 percent in real terms. However, this increase was almost entirely driven by public sector wages, while real wages declined in all other sectors, with the exceptions of ICT, construction, and mining.

The financial sector maintains strong capital and liquidity buffers. In August 2023, outstanding loans were up by 8.9 percent, driven by lending to households and non-residents. At the same time, overall deposits were up by 13.6 percent, led by the corporate and household sectors. In the first eight months, amid increasing interest rates, new loans declined by 6.4 percent but outpaced by 17.6 percent new lending in the same period of 2019. The average capital adequacy ratio was a healthy 20.1 percent in June 2023, well above the regulatory minimum, while nonperforming loans declined to 6.1 percent of total loans from 6.9 percent in June 2022. Liquidity is ample, with liquid assets over total assets stood standing at 25.7 percent in June 2023. While the financial sector is stable, at a time of rising global interest rates and rapid credit growth, it is important to closely monitor the risks.

The external imbalances have narrowed slightly in H1 2023. The current account deficit (CAD) narrowed slightly, as export growth of 26.7 percent outpaced import growth of 15.1 percent. Export growth was primarily led by tourism revenues which surged by 90 percent, while merchandise exports slowed down in Q2 2023, as the aluminium plant KAP stopped production. Still strong demand and higher food prices accounted for import growth, but this moderated in Q2 2023. Net primary and secondary income accounts strengthened only marginally, despite a decline in net remittances of 5.7 percent. Net FDI fell by 26.4 percent, financing just half of the CAD, the remainder being financed from reserves. In July 2023, international reserves stood at EUR 1.6 billion, covering five months of merchandise imports.

During 2023, the fiscal performance has been much better than expected. By July, the central government achieved a fiscal surplus of 2.3 percent of GDP, due to strong revenues and capital budget under-execution. The surge in revenues of 24.5 percent was greatly supported by one-off payments (for the economic citizenship program, a hedging fee, and grants) equivalent to 1.8 percent of GDP, but also solid corporate income tax (CIT) and contributions collection. The VAT and excise collection was also strong. Expenditure growth at 12.9 percent was more moderate than that of revenues, as capital spending declined by 54.6 percent, despite an increase in public sector wages and social spending. While there are political pressures to increase spending, Montenegro’s fiscal space is limited, and new spending commitments should be consistent with the need to reduce the deficit and debt.

Despite public debt falling as a share of GDP, it still presents a vulnerability. Montenegro’s public debt declined from 69.3 percent of GDP in 2022 to an estimated 61.3 percent of GDP in June 2023, owing to a larger nominal GDP (that is, a denominator effect), negative net borrowing, and a much better than planned fiscal performance. Subsequently, the stock of central government deposits increased from 1.9 percent of GDP in 2022 to 3.9 percent of GDP in June 2023. However, the tighter global credit conditions imply a far higher cost of financing for Montenegro, as evidenced in March 2023, when Montenegro borrowed EUR 100 million from Deutsche Bank, at a variable interest rate composed of the six-month Euribor reference rate and an interest margin of 5.9 percent per year.

Montenegro's political setting remains fragile. Since a major political change in 2020, Montenegro's political and institutional landscape has been complex and fragile, resulting in a vote of no-confidence in two governments in one year. The new political party, Europe Now, won the most seats in the snap elections that took place in June 2023 and is tasked with forming a government. The political consensus focused on structural reforms, the rule of law, and fiscal prudence will be critical to safeguard and improve development prospects of Montenegro in a very uncertain environment.

Outlook and Risks

Montenegro's growth is expected to remain strong at 4.8 percent in 2023, underpinned by private consumption and service exports, while investments remain subdued. However, the slowing of the global economy is weighing down on Montenegro's outlook. Over 2024–25, declining private consumption growth is expected to result in a slower average growth of 3.2 percent. Tourism is likely to surpass its 2019 level in 2023, and continue growing, although deteriorating growth prospects in the EU and the region may adversely affect tourism. Due to an expected stabilization of exports growth and moderation of imports, due to slowing domestic consumption, the CAD is expected to moderate to 10.9 percent of GDP by 2025.

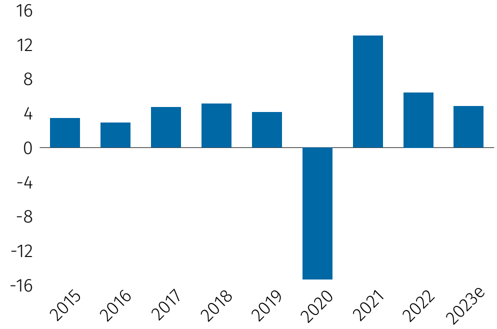
In the medium term, the fiscal deficit is expected to remain elevated. While one-off revenues will result in the lower-than-planned fiscal deficit of 2 percent of GDP in 2023, the fiscal deficit is expected at 3.9 and 3.6 percent of GDP in 2024 and 2025, respectively. This is due to a recovery in capital spending and high levels of the wage bill and social spending. Fiscal consolidation measures would, however, result in a better fiscal performance. Given the tightening of global financial conditions and Montenegro's sizable financing needs over 2024–25, cautious fiscal management is needed, particularly with respect to expenditures, including implementing the pension and public administration reforms.

Significant debt repayments are due in 2024-25. Montenegro's debt amortization in 2024 and 2025 is at an estimated 7.1 and 11.7 percent of GDP, respectively. Owing to stock-flow adjustments, public debt is expected to increase from 62.1 percent of GDP in 2023 to 66.1 percent of GDP in 2024, before declining to 62.3 percent of GDP in 2025, when a large Eurobond is redeemed. Maintaining commitment to important reforms will be crucial as Montenegro will need to tap the market for funding over this period.

The outlook is characterized by downside risks. High geopolitical uncertainties may weaken growth prospects in Montenegro's major trading partners. Monetary tightening is rapidly increasing the cost of external financing. These conditions may lead to greater difficulty in mobilizing large amounts of capital at favorable terms, particularly if fiscal targets are not solidified through fiscal prudence. Political challenges are major domestic risks. The severity of challenges ahead, however, requires strong political and economic stewardship through carefully designed and well-costed policies.

GDP growth is forecasted at strong 4.8 percent...

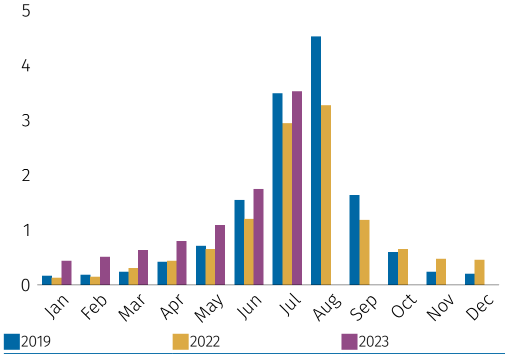
Real GDP growth, percent



Sources: MONSTAT data; World Bank staff calculations.

...supported by continuous tourism recovery.

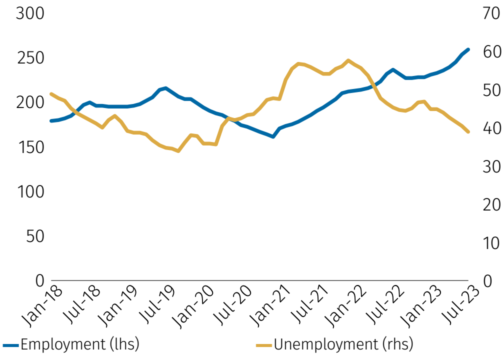
International tourist overnight stays, in million



Sources: MONSTAT; World Bank staff calculations.

Employment gains have been strong...

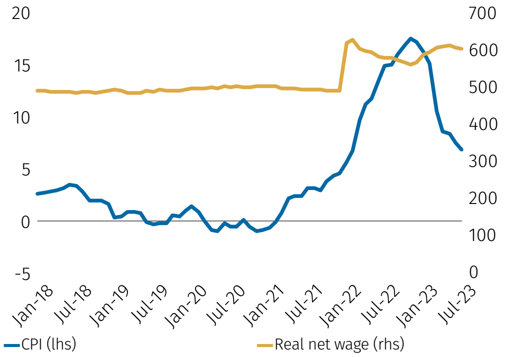
Administrative data, in thousands, Jan 2018–Jul 2023



Source: MONSTAT data.
Note: tc = trend cycle.

...while inflation has eased.

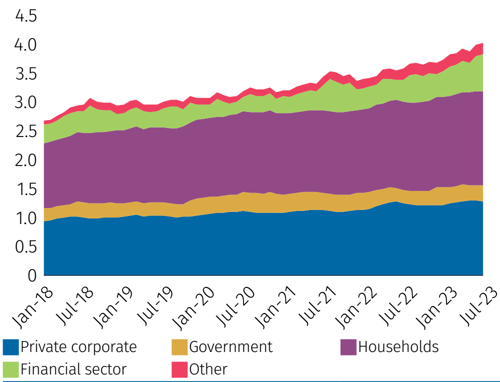
Jan 2018–Jul 2023, percent



Sources: MONSTAT data; World Bank staff calculations.

Outstanding loans increased strongly.

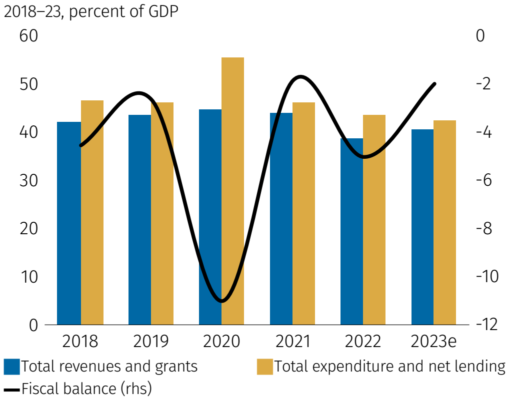
Jan 2018–Jul 2023, in million EUR



Sources: Central Bank; World Bank staff calculations.

The fiscal deficit narrowed.

2018–23, percent of GDP



Sources: Ministry of Finance; World Bank staff calculations.

MONTENEGRO Selected Economic Indicators	2020	2021	2022	2023e	2024f	2025f
Real GDP growth (percent)	-15.3	13.0	6.4	4.8	3.2	3.1
Composition (percentage points):						
Consumption	-3.9	4.1	9.0	6.3	3.2	3.4
Investment	-5.9	-4.7	4.9	-2.2	0.8	0.9
Net exports	-5.5	13.7	-7.4	0.5	-0.9	-1.2
Exports	-24.2	25.7	11.5	6.4	3.0	2.7
Imports (-)	-18.7	12.0	18.9	5.9	3.9	3.9
Consumer price inflation (percent, period average)	-0.3	2.4	13.0	8.4	4.0	2.8
Public revenues (percent of GDP)	44.4	44.0	38.6	40.5	39.0	39.1
Public expenditures (percent of GDP)	55.5	45.9	43.6	42.5	42.9	42.7
Of which:						
Wage bill (percent of GDP)	13.5	12.2	10.5	10.4	10.2	10.0
Social benefits (percent of GDP)	13.4	11.5	11.3	11.8	11.9	11.8
Capital expenditures (percent of GDP)	7.5	5.7	6.0	4.6	5.4	5.4
Fiscal balance (percent of GDP)	-11.0	-1.9	-5.1	-2.0	-3.9	-3.6
Primary fiscal balance (percent of GDP)	-8.3	0.5	-3.4	-0.3	-1.8	-1.0
Public debt (percent of GDP)	105.3	84.0	69.3	62.1	66.1	62.3
Public and publicly guaranteed debt (percent of GDP)	106.8	86.8	71.7	64.2	68.1	64.2
Of which: External (percent of GDP)	91.6	78.3	62.6	57.0	62.0	57.2
Goods exports (percent of GDP)	9.8	10.6	12.9	12.0	12.2	12.4
Goods imports (percent of GDP)	49.0	49.3	58.0	56.8	55.9	55.0
Net services exports (percent of GDP)	4.2	19.3	22.2	25.6	25.5	24.8
Trade and services balance (percent of GDP)	-35.0	-19.4	-22.8	-19.2	-18.2	-17.8
Net remittance inflows (percent of GDP)	5.3	6.1	6.5	6.4	6.2	6.1
Current account balance (percent of GDP)	-26.1	-9.2	-12.9	-11.5	-11.3	-10.9
Net foreign direct investment inflows (percent of GDP)	11.2	11.7	13.2	8.0	8.1	7.9
External debt (percent of GDP)	221.6	190.0	158.6	144.0	137.5	132.6
Real private credit growth (percent, period average)	6.4	-0.2	-4.9	–	–	–
Nonperforming loans (percent of gross loans, end of period)	5.9	6.8	6.3	–	–	–
Unemployment rate (percent, period average)	17.9	16.6	14.7	–	–	–
Youth unemployment rate (percent, period average)	36.0	37.1	29.4	–	–	–
Labor force participation rate (percent, period average)	53.3	50.9	58.9	–	–	–
GDP per capita, PPP (current international $)	20,511	23,440	26,984	30,918	33,076	35,050
Poverty rate (percent of population)	21.1	18.3	17.2	16.4	15.7	15.2

Sources: Country authorities; World Bank estimates and projections.
Note: e = estimate; f = forecast; PPP = purchasing power parity; – = not available. Poverty rate calculations based on ECAPOV harmonization using SILC-C data. Nowcasted/projected values start at 2019. Income measures in the SILC and consumption measures in the HBS are not strictly comparable. Poverty is defined as living on less than $6.85/day per person in revised 2017 PPPs.

North Macedonia

- While the economy showed some resilience to crises, consumption is decelerating driven by the increased cost of living, while manufacturing struggles as external demand slows.
- Public finances are overstretched amidst a rise in borrowing costs. Fiscal consolidation needs to be prioritized to help accommodate new spending commitments on wages and public investments.
- Headline inflation is decelerating but is projected to remain high in 2023 and fall towards the long-term average by 2025. Yet, wage pressures may lead to protracted inflationary pressures.
- The medium-term outlook is positive, but downside risks prevail. Boosting growth and accelerating income convergence calls for much-needed reforms that are on halt due to a lasting parliamentary impasse.

Recent Economic Developments

Economic growth started decelerating in the second quarter of 2023. After growing by 2.1 percent in Q1 2023, output increased by only 1.1 percent on an annual basis in Q2 2023, led by private consumption while exports and gross capital investments fell as external demand slowed and stocks declined. Further, consumption eased to 1.6 percent (down by 1.1 pp from the quarter before) as continued high inflation and credit slowdown put a dent on household purchasing power. Overall, H1 growth turned at 1.6 percent compared to 3.1 in H1 2022. On the production side, output growth in H1 2023 was driven by services and industry, while construction and agriculture sectors continued to struggle. After a sharp increase in Q1, the construction output dropped by close to 22 percent in Q2.

High-frequency data point to a slowdown of growth in the third quarter of 2023. Industrial production declined by 1.8 percent[10] in July as mining and manufacturing lost ground while energy production intensified. A reduction in the number and value of building permits issued by June can slow construction activity over the coming months, while real retail trade declined by 3.9 percent in July 2023. Tourism observed steady improvement over the summer season.

External sector imbalances eased. The current account deficit declined to 1.1 percent of GDP by Q2 2023[11], largely due to an improvement in the merchandise trade balance. With energy import pressures abating, the trade deficit shrunk by more than 6 percentage points (pp) to 20.5 percent of GDP. At the same time, the services surplus softened to 4.8 percent of GDP owing to outlays for public infrastructure works. The primary income deficit remained broadly unchanged despite a rise in interest payments, while the secondary account surplus stood high supported by solid remittances. FDI inflows decelerated to 4.7 percent of GDP but financed the CAD and increased gross foreign exchange reserves. Gross external debt declined to an estimated 76.9 percent of GDP by March 2023.

10 On annual basis.
11 On a four-quarter rolling basis.

Despite sizeable government support, structural labor market challenges persist. In Q2 2023,[12] the participation rate slightly increased to 52.4 percent compared to a quarter earlier. However, the female participation rate, at 42.5 percent, remains 20 pp lower than that for men. Care for children and the elderly is cited as one of the primary reasons for inactivity of women but firms in North Macedonia are least prepared in the region to offer child-care benefits or flexible working arrangements.[13] The employment rate increased by 0.4 pp to 45.5 percent, while the unemployment rate declined to 13.1 percent, on account of more jobs for the younger cohort and the exit to inactivity of the older cohorts. The youth unemployment rate declined to 25.6 percent, still significantly higher than the EU average.

Sustained wage growth has outpaced inflation since April 2023. Wage growth was registered in all economic sectors in the first half of the year, led by a mandatory rise of the minimum wage. For construction, administrative and education workers wage growth was above average. Wages are set to rise even further as the Government signed a new collective agreement for the public sector that includes: a 10 percent wage increase as of September 2023; a revision to the wage-setting methodology in 2024 linking the base wage to the national gross wage; an annual leave bonus at 30 percent of the average net wage; and loyalty bonuses.

Headline inflation decelerated to single digits in June 2023 after reaching 19.8 percent in October 2022. Global pressures abating, monetary policy tightening, and the government support measures to control the prices of basic food products helped to contain the rise in prices responsible for half of the inflation increase in the first half of 2023. As food prices and energy prices eased, the inflation rate slowed to 8.3 percent in August 2023. However, second-round and spillover effects have kept core inflation high at around 8 percent. Inflation expectations measured in Q2 2023 stand at 9.3 percent for 2023, despite a mild improvement relative to the previous survey round from Q1 2023.

Monetary policy tightening continued as inflationary pressures persist. By August 2023, the central bank had raised the key policy rate to 6.15 percent up from a historical low of 1.25 percent before the beginning of the tightening cycle in spring 2022. The NBRM also aimed to bolster the denarization process in banks' balance sheets through raising the rate of mandatory reserves for foreign exchange liabilities from 19 to 20 percent. The pegged exchange rate has remained stable and FX reserves have recovered from losses incurred largely at the outbreak of the war in Ukraine, standing at more than 4 months of imports in June 2023. The stability of the banking sector was preserved with an increase in the capital adequacy ratio to 18 percent in Q1 2023 despite a drop in the liquidity rate to 19.1 percent that remains adequate. At the same time, the non-performing loans ratio declined to 2.8 percent. Credit growth slowed to 5.8 percent in July 2023 largely due to reduced borrowing by firms as financial conditions worsened.

12 The Q1-Q2 2023 data are not fully comparable to previous labor data due to methodological changes and the revision of the sample based on the 2021 census. All figures are on a quarter by quarter comparison.

13 Eurostat, Balkan Barometer Business Survey 2023.

Fiscal pressures continued. The public deficit in 2023 is likely to remain as high as in 2022. The general government deficit (with the Public Enterprise for State Roads finances included) is projected at 4.8 percent of GDP in 2023 after the budget technical reallocation that is needed to accommodate new wage spending commitments. The fiscal implications of the public sector collective agreement are estimated in the order of 0.7–0.8 percent of GDP on average per year and add to the earlier minimum wage adjustment and an upward correction of public officials' wages. By June 2023, the general government deficit reached an estimated 2.6 percent of GDP as VAT revenues declined while investment and social spending went up. At the same time, the collection of profit tax revenues increased as some of the TIDZ firms graduated from the tax exemption scheme. The recent adoption of the solidarity tax as well as CIT and VAT reforms will slightly ease the pressure for Q4 2023.

Public and publicly guaranteed and non-guaranteed debt stood well above the pre-crisis level. At 59.1 percent of GDP in June 2023, public debt is 10 pp above the level in 2019. Inflation helped reduce somewhat the debt-to-GDP ratio, but nominal public debt continues to rise. Expenditure arrears remain consistently above 3 percent of GDP, largely due to state-owned enterprise, health sector, and local government nonpayment. As part of the PLL arrangement with the IMF, the Government has committed to reduce payment arrears to the private sector.

Outlook and Risks

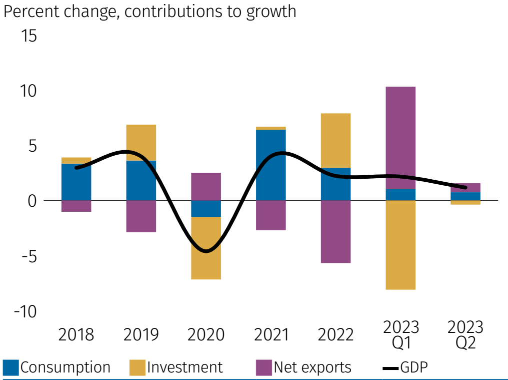
The medium-term outlook is positive, but downside risks prevail. Growth in 2023 is expected to increase modestly by 1.8 percent, reflecting a slowdown in the country's main trading partners as second-round effects from the war in Ukraine took force. Growth is expected to moderately accelerate in the medium term led by the rise in public investments and recovered consumption before slowing towards the potential growth trend thereafter. Public debt is expected to increase over the medium term owing to the Corridor VIII and Xd highway sections and wage spending commitments. Fiscal deficit is projected to drop below 3 percent of GDP only from 2027.

As commodity prices ease, the inflation rate is projected to decelerate to the long-term average by 2025. Assuming that the impact of crises subsides over the forecast horizon, inflation is estimated to decline to 9.1 percent in 2023 and to fall to the long-term average of 2 percent by 2025. Tightening monetary policy is expected to continue over the near term but to gradually ease as underlying price pressures subside.

While underlying risks remain largely skewed to the downside and reflect the outlook for the country's main trading partners, moving ahead with EU accession negotiations may accelerate critical reforms and unlock growth. However, heightened political uncertainty and a prolonged parliamentary impasse due to lack of consensus for constitutional changes and upcoming parliamentary and presidential elections in the first half of 2024 may delay reform implementation. Finally, policy slippages may weaken fiscal sustainability and strengthen inflation persistence in turn requiring additional monetary tightening that can further restrict financing options and decelerate economic activity going forward.

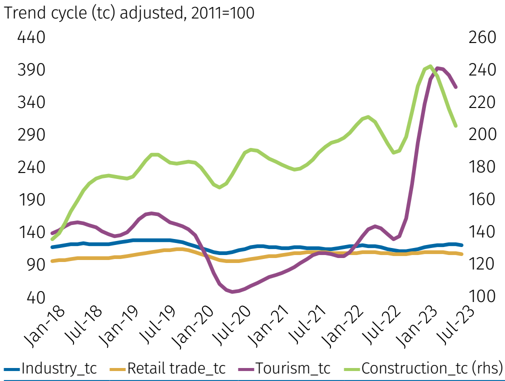
Overlapping crises have scarred the growth potential and further slowed convergence with the EU. Moving from middle- to high-income status requires following up on pending reforms and addressing critical impediments for future growth. Policy actions need to be geared to rebuild buffers and reduce vulnerabilities to future shocks. Boosting productivity, advancing on inclusion, and enhancing fiscal and environmental sustainability are critical for long-term steady growth in the context of pronounced and widespread uncertainty. Decarbonizing the economy and building resilience to climate change shocks is needed to maintain international competitiveness ahead of the EU Cross-Border Adjustment Mechanism implementation. Increasing productive capital expenditures as a share of the medium-term budget while maintaining fiscal sustainability would be crucial for boosting growth.

Growth started decelerating...



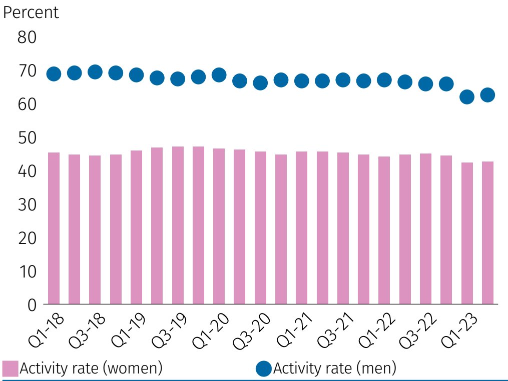
Sources: State Statistics Office; World Bank staff calculations.

...and high-frequency indicators point to a slowdown ahead.



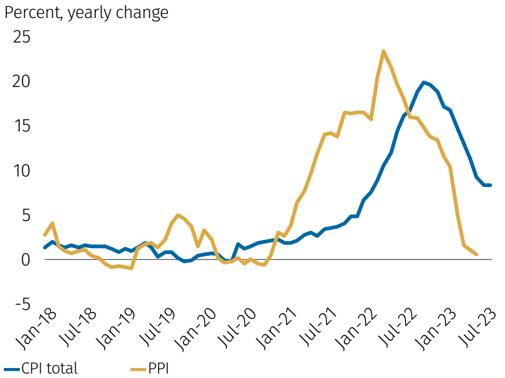
Sources: State Statistics Office; World Bank staff calculations.

Participation rates declined in 2023.



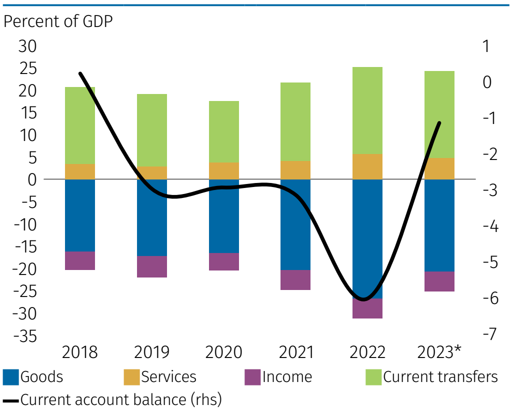
Source: State Statistics Office.
Note: LFS 2021 and 2022 make use of the 2021 census data, Q1 2023 contains a methodological change, thus making a break in the series.

Inflation hit a single digit bound over the summer...



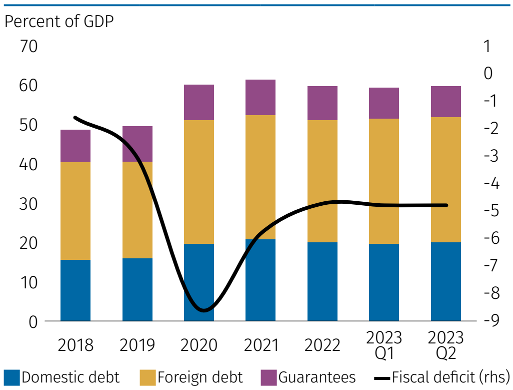
Source: State Statistics Office.

...and external imbalances eased as imports slowed.



Source: Central bank.
Note: 2023 is a rolling average until June 2023.

The public debt decreased with the help of inflation amidst a rise in expenditure arrears.



Sources: Ministry of Finance; World Bank estimates.
Note: Fiscal deficit includes Public Enterprise for State Roads

NORTH MACEDONIA Selected Economic Indicators	2020	2021	2022	2023e	2024f	2025f
Real GDP growth (percent)	-4.7	3.9	2.1	1.8	2.5	2.9
Composition (percentage points):						
Consumption	-1.5	6.4	2.9	1.2	1.2	1.9
Investment	-5.7	0.3	4.9	2.1	1.8	1.9
Net exports	2.5	-2.7	-5.7	-1.5	-0.6	-0.9
Exports	-7.4	7.4	9.2	4.6	4.3	4.1
Imports (-)	-9.9	10.2	14.8	6.1	4.9	5.0
Consumer price inflation (percent, period average)	1.2	3.2	14.2	9.1	3.0	2.0
Public revenues (percent of GDP)	29.9	32.5	32.4	34.9	35.0	35.7
Public expenditures (percent of GDP)	38.1	37.9	36.9	39.4	39.2	39.2
Of which:						
Wage bill (percent of GDP)	7.2	6.9	6.5	6.6	6.9	7.1
Social benefits (percent of GDP)	17.6	16.9	16.6	16.7	16.6	16.5
Capital expenditures (percent of GDP)	3.1	4.2	4.2	6.7	6.3	6.6
Overall fiscal balance (percent of GDP)	-8.2	-5.4	-4.5	-4.5	-4.1	-3.5
Overall fiscal balance with the Public Enterprise for State Roads included (percent of GDP)	-8.6	-5.8	-4.8	-4.8	-4.5	-3.8
Primary fiscal balance (percent of GDP)	-7.0	-4.1	-3.3	-3.2	-2.4	-1.5
Public debt (percent of GDP)	50.8	52.0	50.9	51.7	53.3	54.5
Public and publicly guaranteed debt (percent of GDP)*	59.8	61.0	59.6	60.2	61.5	62.2
Of which: External (percent of GDP)	39.9	39.9	39.1	38.7	38.8	38.3
Goods exports (percent of GDP)	44.4	51.3	57.0	56.8	57.5	58.5
Goods imports (percent of GDP)	61.0	71.6	83.7	82.3	82.5	83.1
Net services exports (percent of GDP)	3.9	4.2	5.7	6.9	7.3	7.6
Goods and services trade balance (percent of GDP)	-12.7	-16.0	-21.0	-18.6	-17.7	-17.0
Remittance inflows (percent of GDP)	3.1	2.9	2.7	2.9	2.8	2.7
Current account balance (percent of GDP)	-2.9	-3.1	-6.0	-3.7	-3.2	-2.8
Net foreign direct investment inflows (percent of GDP)	1.4	3.3	5.2	5.2	4.7	4.2
External debt (percent of GDP)	78.7	81.9	84.2	80.0	82.7	82.8
Real private credit growth (percent, period average)	5.6	2.8	-4.2	–	–	–
Nonperforming loans (percent of gross loans, end of period)	3.3	3.1	2.8	–	–	–
Unemployment rate (percent, average)**	16.4	15.4	14.4	–	–	–
Youth unemployment rate (percent, period average)	35.7	36.3	32.5	–	–	–
Labor force participation rate (percent, period average)	56.4	56.0	55.2	–	–	–
GDP per capita, PPP (current international $)**	13,562	14,096	14,398	14,657	15,024	15,459
Poverty rate (percent of population)	20.1	19.1	18.3	17.9	17.3	16.2

Sources: Country authorities; World Bank staff estimates and projections.
Note: *Includes non-guaranteed debt of SOEs, as well. **Data from 2021 and 2022 are not fully comparable to previous labor data due to the change in the LFS sample based on the 2021 census. Data for 2023 is the latest available. Youth unemployment rate is for labor force aged 15–24. e = estimate; f = forecast; PPP = purchasing power parity; – = not available. Poverty rate calculations based on ECAPOV harmonization using SILC-C data. Nowcasted/projected values start at 2020. Income measures in the SILC and consumption measures in the HBS are not strictly comparable. Poverty is defined as living on less than $6.85/day per person in revised 2017 PPPs.

Serbia

- Even though some acceleration of the economic activity is expected in H2, results from the first half of the year suggest that annual GDP growth in 2023 will be around 2 percent.
- Inflation has started to decline, but it is still among the highest in Europe. It is expected that it will return to the NBS target band in mid-2024.
- Fiscal performance has been better than expected, with a lower-than-anticipated deficit, thanks to a strong performance of revenues, while public debt has plateaued at around 56 percent of GDP.
- The CAD will be lower than expected in 2023, at about 2.5 percent of GDP, and the strong inflow of FDI continues. As a result, foreign currency reserves have increased to a record high.
- While growth projections over the medium term (2024–2026) remain unchanged, those are still below potential growth rates. This underlines the importance of structural reforms to accelerate growth in potential output.
- A possible new source of growth could be FDI in high value-added sectors, but there are risks too, in particular those related to SOEs, both in terms of the impact of SOEs on fiscal balances and on market competition.

Recent Economic Developments

The Serbian economy grew slower than expected in H1 2022. The start of the year was particularly weak with growth in Q1 estimated at 0.9 percent only. In Q2, the situation improved somewhat as the construction sector started to recover, contributing to GDP growth that reached 1.7 percent, yoy. In the first half of the year, economic growth was supported heavily by net exports. While exports of goods saw an encouraging expansion (up by 9.4 percent in euro terms in H1), there was a noticeable decrease in imports (down 5 percent in H1), in particular imports of energy (down 24.5 percent) and raw materials (down 6.4 percent) which led to a significant positive contribution to growth in H1. Both consumption and investment had a negative contribution to growth in H1. Consumption is being hit by the effects of prolonged high inflation, while investment was impacted by a major decrease in inventories (while gross fixed capital formation had a positive contribution to growth). In the first half of the year, total investment decreased by 15.2 percent (yoy) in real terms, primarily as a result of a major decrease in inventories. On the production side, some agriculture products were hit by unfavorable weather conditions (fruits and vegetables in particular), but the wheat and corn harvest was better than expected, thus helping the agriculture sector as whole to grow by 9.9 percent in H1 2023. The construction sector started to recover with strong growth of 17.9 percent, yoy, in Q2 2023, after four consecutive quarters of decline. Industrial production increased by 1.7 percent (yoy) in H1, driven by an improvement in the energy sector (up by 6.4 percent), while manufacturing declined by 1 percent in H1. Value added in services sectors increased by just 0.7 percent (in real terms, yoy) in the first half of the year.

The labor market was, by and large, resilient to the shock caused by the pandemic, and the unemployment rate has remained stable at around 10 percent. In Q2 2023, the unemployment rate decreased to 9.6 percent, compared to 10.1 percent in Q1 (or 9.4 percent on average in 2022). Labor market improvements also resulted in a higher employment rate, which reached 50.4 percent in Q2 2023. Nevertheless, the youth unemployment rate remained structurally high at around 25 percent. Wages continued to rise, increasing by 15.4 percent in nominal terms in H1 2023.

The consolidated budget shifted to a small surplus of 0.6 percent of annual GDP over the first six months of 2023. Revenues posted a strong performance (up 12.5 percent in nominal terms, in H1, yoy), thanks to major increases in corporate income tax (CIT), social contributions and domestic VAT. High inflation, among others, drove VAT revenues, while improved CIT collection reflects the recovered profitability of businesses in 2022. Social contributions increased on the back of both higher formal employment (up 2.7 percent in H1, yoy) and nominal wages (up 15.4 percent in H1, yoy). Meanwhile, expenditures have been kept under control (up by 7.7 percent over the same period). According to the supplementary budget (in preparation) this year's fiscal deficit should be 2.8 percent of GDP, which could go even further down to 2.5 percent of GDP. Public debt remained broadly stable throughout 2023 and stood at around 56 percent of GDP.

As last year's extraordinary imports of energy stopped, there is a significant improvement in the BOP in the first half of the year. The CAD decreased by 82 percent in H1 (from EUR 2.9 billion in H1 2022 to EUR 0.5 billion in H1 2023). The trade balance shrank by 40 percent as imports of energy (both gas and electricity) decreased by 24.5 percent (or EUR 926 million) over the first six months of 2023, compared to the same period of 2022. As a result of a major decrease of the CAD in H1, it is now projected to decrease to around 2.5 percent of GDP for 2023 as a whole. Financing flows remain comfortable as net foreign direct investment inflows increased by almost 35 percent compared to the same period of 2022, to reach EUR 2 billion in the first half of 2023. Most importantly, inflows related to equity and investment fund shares increased by over 50 percent. As a result, there was a significant increase in official foreign currency reserves which stood at EUR 22.6 billion at the end of June, covering 6 months of imports.

Inflation remains stubbornly high, and has only started to fall later than in peer CEE countries. The consumer price index (CPI) peaked at 16.2 percent (yoy) in March, the highest level of inflation since the CPI measurement begun (in January 2007). Inflation has started to fall since then, and reached 11.5 percent in August. Notwithstanding the fact that inflation started and reached its peak at different times across countries, inflation in Serbia is still among the highest in Europe.[14] Food prices, notwithstanding the selective government price controls, drove this trend, increasing by 21.1 percent (yoy) in July 2023. It is expected that inflation will return to the NBS target band in mid-2024. Importantly, producer prices as measured by PPI went down significantly over recent months and in July were only 0.5 percent higher than a year earlier. The NBS decided to keep the key interest rate unchanged in both August and September at 6.5 percent after 16 months of continuous, gradual increases. The nominal exchange rate remains stable but there has been a significant appreciation of the REER over the first seven months of 2023 (by 4.4 percent).

14 Only Hungary has a higher inflation according to Eurostat July data.

The performance of the banking sector has continued to be robust. Based on 2023 Q2 data, banks remained profitable and liquid. The liquidity ratio increased from 2.2 at the end of 2022 to 2.4 in June, while the capital adequacy ratio increased to 22.3 percent at the end of June (compared to 20.2 at the end of 2022). Non-performing loans (NPLs) stood at 3.2 percent in June, a slight increase compared to 3 percent at the end of 2022. Credit growth has slowed down in 2023 due to tightening monetary conditions. The total stock of loans in June was only 2 percent higher than a year earlier. The highest increase in credit growth relates to loans to government (up by 6.7 percent, yoy) while loans to private companies increased by a mere 0.3 percent (yoy) and to households by 2.6 percent (yoy, as of June).

Outlook and Risks

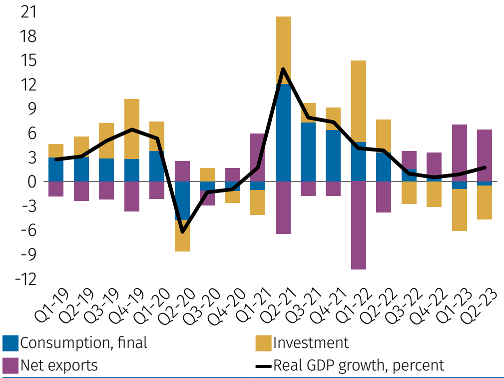
The growth outlook remains positive with risks tilted to the downside. The Serbian economy started to slow down in the second half of 2022, a trend that continued in the first half of 2023. However, in mid-2023 the construction sector started to recover, and some agriculture sectors (wheat and corn production in particular) scored better than expected results. Considering the impact of these factors, it is expected that growth will accelerate in the second half of 2023 thus leading to a growth rate of 2 percent for the year as whole. Going forward and over the medium term, it is expected that growth will be around 3–4 percent. These are rates that are below Serbia's potential and any acceleration in growth will be dependent on structural reforms.

Growth constraints could be removed by a more ambitious domestic reform agenda and its implementation. The recent crisis in the domestic energy sector has once again emphasized the urgency of improving the management of SOEs. Therefore, the government should embark on an even more decisive, comprehensive and thorough reform of SOEs to make them financially and operationally viable. There are other reforms related to governance, education, transport, municipal-level utility services, financial sector etc. that should help Serbia to grow much faster.

The risks to the baseline macroeconomic outlook that could materialize in 2023 and beyond are numerous. First, high inflation could persist for an unexpectedly long period and a more coordinated effort between fiscal and monetary policy would be needed to help to bring it down to the targeted level. High inflation hurts growth and diminishes gains in improved living standards, especially for the poor. Second, it is critical, given Serbia's levels of public debt, that scarce public investment resources are prioritized towards projects with high economic and social returns, and are balanced against fiscal risks over the medium to long run.

Growth started to recover as of Q2...

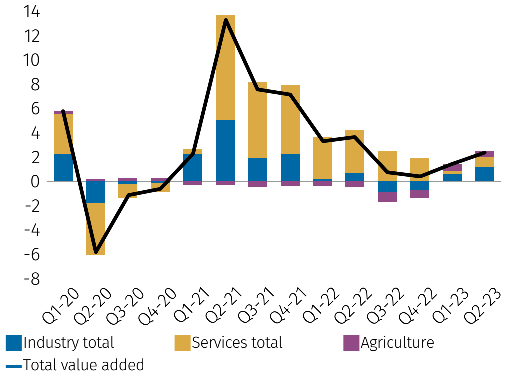
Contribution to growth, percentage points



Source: Statistics Office of the Republic of Serbia.

...with all three broad sectors contributing to growth.

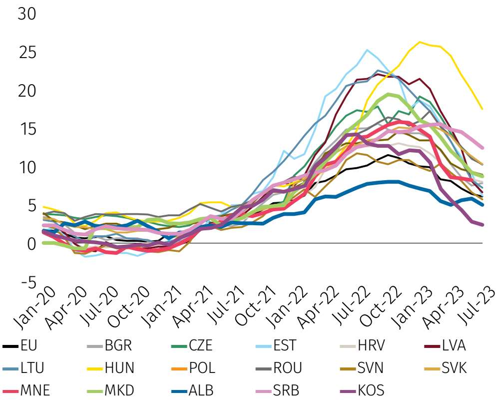
Contribution to growth of value added, yoy



Source: Statistics Office of the Republic of Serbia.

Inflation is currently higher than in peer countries...

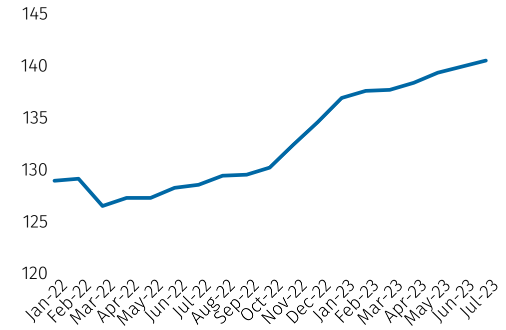
Annual change in percent



Sources: Statistics Office of the Republic of Serbia and Eurostat.

...leading to a strong REER appreciation.

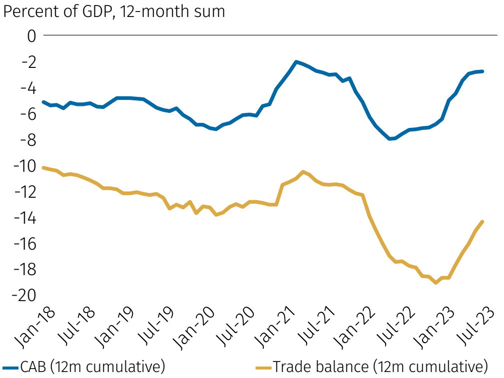
2005=100



Source: National Bank of Serbia.

The CAD and trade deficit decreased...

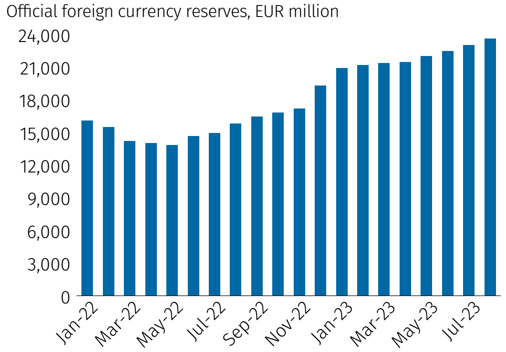
Percent of GDP, 12-month sum



Source: National Bank of Serbia.

...and reserves recovered.

Official foreign currency reserves, EUR million



Source: National Bank of Serbia.

SERBIA Selected Economic Indicators	2020	2021	2022	2023e	2024f	2025f
Real GDP growth (percent)	-0.9	7.5	2.3	2.0	3.0	3.8
Composition (percentage points):						
Consumption	-0.8	6.0	2.5	0.2	1.7	2.8
Investment	-0.2	2.6	1.9	-0.1	0.1	1.5
Net exports	0.1	-1.0	-2.2	1.9	1.2	-0.5
Exports	-2.3	10.4	10.4	2.7	2.8	4.6
Imports (-)	-2.4	11.4	12.6	0.8	1.6	5.0
Consumer price inflation (percent, period average)	1.6	4.0	11.9	12.4	5.3	3.5
Public revenues (percent of GDP)	41.0	43.3	43.4	42.9	42.5	42.0
Public expenditures (percent of GDP)	49.0	47.4	46.4	45.6	44.5	43.5
Of which:						
Wage bill (percent of GDP)	10.5	10.0	9.6	9.7	10.0	9.9
Social benefits (percent of GDP)	14.7	13.6	13.1	13.4	13.9	13.3
Capital expenditures (percent of GDP)	5.3	7.4	7.3	6.9	6.7	6.9
Fiscal balance (percent of GDP)	-8.0	-4.1	-3.0	-2.8	-2.0	-1.6
Primary fiscal balance (percent of GDP)	-6.0	-2.4	-1.5	-1.0	0.0	0.3
Public debt (percent of GDP)	53.9	54.5	52.6	52.3	50.5	49.6
Public and publicly guaranteed debt (percent of GDP)	57.8	57.1	55.6	55.4	53.7	51.7
Of which: External (percent of GDP)	33.4	37.0	36.0	36.0	34.3	33.2
Goods exports (percent of GDP)	34.3	39.4	44.6	43.1	43.6	44.0
Goods imports (percent of GDP)	45.5	50.7	60.1	52.8	53.3	53.6
Net services exports (percent of GDP)	2.4	2.6	3.8	3.4	2.8	2.5
Trade balance (percent of GDP)	-8.8	-8.7	-11.7	-6.2	-6.8	-7.0
Net remittance inflows (percent of GDP)	4.5	4.7	6.1	5.5	5.1	4.9
Current account balance (percent of GDP)	-4.1	-4.2	-6.9	-2.5	-3.4	-4.3
Net foreign direct investment inflows (percent of GDP)	6.3	6.9	7.1	6.1	5.6	5.4
External debt (percent of GDP)	65.8	68.4	67.9	64.3	61.1	59.7
Real private credit growth (percent, period average)	9.2	3.7	-2.7	–	–	–
Nonperforming loans (percent of gross loans, end of period)	3.7	3.6	3.0	–	–	–
Unemployment rate (percent, period average)	9.7	11.0	9.4	–	–	–
Youth unemployment rate (percent, period average)	27.7	26.4	24.4	–	–	–
Labor force participation rate (percent, period average)	52.2	54.7	55.5	–	–	–
GDP per capita, PPP (current international $)	19,556	21,642	22,901	27,330	29,096	31,409
Poverty rate (percent of population)	10.1	9.1	8.5	8.0	7.5	6.9

Sources: Country authorities; World Bank estimates and projections.
Note: e = estimate; f = forecast; PPP = purchasing power parity; – = not available. Poverty rate calculations based on ECAPOV harmonization using SILC-C data. Nowcasted/projected values start at 2021. Income measures in the SILC and consumption measures in the HBS are not strictly comparable. Poverty is defined as living on less than $6.85/day per person in revised 2017 PPPs.

Key Economic Indicators

Key Economic Indicators	2020	2021	2022	2023e	2024f	2025f
Real GDP growth (percent)						
Albania	-3.3	8.9	4.8	3.6	3.2	3.2
Bosnia and Herzegovina	-3.0	7.4	3.9	2.2	2.8	3.4
Kosovo	-5.3	10.7	5.2	3.2	3.9	4.0
North Macedonia	-4.7	3.9	2.1	1.8	2.5	2.9
Montenegro	-15.3	13.0	6.4	4.8	3.2	3.1
Serbia	-0.9	7.5	2.3	2.0	3.0	3.8
WB6	*-3.0*	*7.8*	*3.3*	*2.5*	*3.0*	*3.5*
Consumer price inflation (percent, period average)						
Albania	2.2	2.6	6.7	5.0	3.5	3.0
Bosnia and Herzegovina	-1.1	2.0	14.0	5.8	2.5	0.9
Kosovo	0.2	3.4	11.6	4.8	3.0	2.5
North Macedonia	1.2	3.2	14.2	9.1	3.0	2.0
Montenegro	-0.3	2.4	13.0	8.4	4.0	2.8
Serbia	1.6	4.0	11.9	12.4	5.3	3.5
WB6	*1.0*	*3.2*	*11.8*	*9.1*	*4.1*	*2.7*
Public expenditures (percent of GDP)						
Albania	32.6	32.1	30.5	30.6	29.9	29.6
Bosnia and Herzegovina	46.8	41.3	39.7	41.5	40.9	41.5
Kosovo	33.0	28.8	28.2	29.2	30.1	30.1
North Macedonia	38.1	37.9	36.9	39.4	39.2	39.2
Montenegro	55.5	45.9	43.6	42.5	42.9	42.7
Serbia	49.0	47.4	46.4	45.6	44.5	43.5
WB6	*42.5*	*38.9*	*37.6*	*38.2*	*37.9*	*37.8*
Public revenues (percent of GDP)						
Albania	25.9	27.5	26.8	28.1	27.5	27.7
Bosnia and Herzegovina	41.6	41.1	40.1	40.7	41.0	41.5
Kosovo	25.4	27.4	27.8	28.7	28.2	28.3
North Macedonia	29.9	32.5	32.4	34.9	35.0	35.7
Montenegro	44.4	44.0	38.6	40.5	39.0	39.1
Serbia	41.0	43.3	43.4	42.9	42.5	42.0
WB6	*34.7*	*36.0*	*34.9*	*36.0*	*35.5*	*35.7*
Fiscal balance (percent of GDP)						
Albania	-6.7	-4.6	-3.7	-2.5	-2.3	-1.9
Bosnia and Herzegovina	-5.2	-0.3	0.4	-0.8	0.0	0.0
Kosovo	-7.6	-1.3	-0.4	-0.6	-1.9	-1.9
North Macedonia	-8.2	-5.4	-4.5	-4.5	-4.1	-3.5
Montenegro	-11.0	-1.9	-5.1	-2.0	-3.9	-3.6
Serbia	-8.0	-4.1	-3.0	-2.8	-2.0	-1.6
WB6	*-7.9*	*-2.9*	*-2.7*	*-2.2*	*-2.4*	*-2.0*

Source: World Bank calculations and projections on data from national authorities and World Economic Outlook.

Key Economic Indicators (continued)	2020	2021	2022	2023e	2024f	2025f
Public debt (percent of GDP)						
Albania	73.0	71.5	62.1	60.3	59.4	58.5
Bosnia and Herzegovina	36.1	34.0	29.3	27.6	27.0	26.3
Kosovo	22.0	21.2	19.6	18.5	19.3	19.8
North Macedonia	50.8	52.0	50.9	51.7	53.3	54.5
Montenegro	105.3	84.0	69.3	62.1	66.1	62.3
Serbia	53.9	54.5	52.6	52.3	50.5	49.6
WB6	*56.9*	*52.9*	*47.3*	*45.4*	*45.9*	*45.2*
Public and publicly guaranteed debt (percent of GDP)						
Albania	75.8	75.4	65.4	63.1	62.1	60.8
Bosnia and Herzegovina	38.8	37.6	31.5	29.5	29.2	28.5
Kosovo	22.4	21.6	19.9	18.6	19.5	20.1
North Macedonia	59.8	61.0	59.6	60.2	61.5	62.2
Montenegro	106.8	86.8	71.7	64.2	68.1	64.2
Serbia	57.8	57.1	55.6	55.4	53.7	51.7
WB6	*60.2*	*56.6*	*50.6*	*48.5*	*49.0*	*47.9*
Goods exports (percent of GDP)						
Albania	6.0	8.3	10.8	9.3	9.3	9.3
Bosnia and Herzegovina	27.1	32.5	35.4	36.9	36.4	35.8
Kosovo	7.0	9.5	10.4	8.8	9.0	9.2
North Macedonia	44.4	51.3	57.0	56.8	57.5	58.5
Montenegro	9.8	10.6	12.9	12.0	12.2	12.4
Serbia	34.3	39.4	44.6	43.1	43.6	44.0
WB6	*21.4*	*25.3*	*28.5*	*27.8*	*28.0*	*28.2*
Trade balance (percent of GDP)						
Albania	-14.3	-13.5	-10.4	-9.7	-9.8	-9.7
Bosnia and Herzegovina	-13.7	-11.8	-14.2	-13.9	-14.0	-14.3
Kosovo	-32.2	-31.8	-32.6	-29.1	-28.3	-27.7
North Macedonia	-12.7	-16.0	-21.0	-18.6	-17.7	-17.0
Montenegro	-35.0	-19.4	-22.8	-19.2	-18.2	-17.8
Serbia	-8.8	-8.7	-11.7	-6.2	-6.8	-7.0
WB6	*-19.5*	*-16.9*	*-18.8*	*-16.1*	*-15.8*	*-15.6*
Current account balance (percent of GDP)						
Albania	-8.5	-7.8	-6.0	-5.6	-5.8	-5.6
Bosnia and Herzegovina	-3.2	-2.4	-4.5	-4.7	-4.8	-5.1
Kosovo	-7.0	-8.7	-10.5	-6.5	-6.0	-5.5
North Macedonia	-2.9	-3.1	-6.0	-3.7	-3.2	-2.8
Montenegro	-26.1	-9.2	-12.9	-11.5	-11.3	-10.9
Serbia	-4.1	-4.2	-6.9	-2.5	-3.4	-4.3
WB6	*-8.6*	*-5.9*	*-7.8*	*-5.8*	*-5.7*	*-5.7*

Source: World Bank calculations and projections on data from national authorities and World Economic Outlook.

Key Economic Indicators (continued)	2020	2021	2022	2023e	2024f	2025f
External debt (percent of GDP)						
Albania	60.5	62.7	54.3	51.8	50.0	49.0
Bosnia and Herzegovina	69.7	62.4	60.5	60.0	59.1	57.4
Kosovo	36.9	37.6	38.2	38.4	39.0	39.9
North Macedonia	78.7	81.9	84.2	80.0	82.7	82.8
Montenegro	221.6	190.0	158.6	144.0	137.5	132.6
Serbia	65.8	68.4	67.9	64.3	61.1	59.7
WB6	*88.9*	*83.9*	*77.3*	*73.1*	*71.6*	*70.2*
Unemployment rate (period average, percent)						
Albania	11.7	11.5	11.0	-	-	-
Bosnia and Herzegovina	15.9	17.4	15.4	-	-	-
Kosovo	25.9	20.7	12.6	-	-	-
North Macedonia	16.4	15.4	14.4	-	-	-
Montenegro	17.9	16.6	14.7	-	-	-
Serbia	9.7	11.0	9.4	-	-	-
WB6	*16.3*	*15.4*	*12.9*	-	-	-

Source: World Bank calculations and projections on data from national authorities and World Economic Outlook.

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Western Balkans Regular Economic Report
No.24 | Fall 2023

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