Country Notes

Albania

- Following robust growth in early 2022, GDP is likely to decelerate in the remaining part of the year, as rising inflation affects real disposable income, and a slowdown in the global economy translates into tighter financing conditions and lower foreign demand.
- High food and energy inflation have prompted additional government support to households and SMEs, which are already benefitting from regulated electricity prices. This adds to the fiscal pressures.
- Medium-term prospects hinge on the global recovery and structural reforms, and on the launch of fiscal consolidation.
- Poverty is expected to continue declining but the continuation of inflationary pressures will decelerate the recent gains.

Recent Economic Developments

Following a strong rebound in 2021, Albania's economy expanded by 6 percent in Q1 2022. Albania's GDP growth rebounded to 8.5 percent in 2021, reflecting economic resilience following two exceptionally large shocks: the 2019 earthquake and the COVID-19 pandemic. Growth continued to be strong in Q1 2022; private consumption, exports and investment expanded, as business and consumer confidence remained strong despite increasing energy and food prices. Household consumption rose by 8.6 percent,[1] outpacing growth of the previous quarter. Net foreign demand contributed positively to growth as exports surged by 25.3 percent while imports increased by 17.6. After driving growth in 2021, gross fixed capital formation slowed to 15.5 percent (versus 16.9 percent in Q4 2021) as government capital expenditures declined. On the supply side, trade and construction led growth in Q1 2022. Business surveys indicate continued growth in the following trimesters on account of tourism, although business confidence indicators started to decline in the second half of the year.

Labor market conditions improved in early 2022. Annual employment growth accelerated to 3.4 percent in Q1 2022, from 2.7 percent in the previous quarter. At the same time, unemployment fell to 11.3 percent, while labor force participation increased. Business Surveys indicators suggest firms were expecting sustained employment growth from April to July,[2] with indicators being above historical averages. However, expected employment growth started to slow down in August for businesses operating in industry and services. Given the strong growth in GDP per capita in 2021, poverty is estimated to have dropped from 33 percent in 2020 to 23.1 percent in 2021.

Following the war in Ukraine, inflation pressures that started in H2 2021 intensified. The war in Ukraine and the sanctions imposed on Russia disrupted supply chains and were reflected in surging prices of food, energy, and key minerals used in various industries. These developments gradually affected Albania's inflation: the annual inflation rate rose to 7.5 percent in July 2022, the highest since March 2002. Food price inflation

1 All comparisons are year-on-year, unless otherwise stated.
2 The question refers to business employment expectations for the three upcoming months.

and transport inflation for the same month increased at 13.2 percent and 19.7 percent, respectively. Such increases are adversely impacting the poorest citizens given the higher weights these items have in the consumption basket of the poor. The exchange rate against the euro appreciated by 3.7 percent in July, which restrained the transmission of imported inflation into the domestic economy. In addition, regulated prices of energy for business and consumers as well as temporary controlled prices for transport fuels and key food items have redistributed the burden of global price increases and prevented a full transmission to domestic inflation. Yet, these also had a negative fiscal impact.

Persistent supply-side shocks have created second round effects, raising prices of all items in the consumption basket. In July 2022, core inflation stood at 7.3 percent against its long-term average of 0.8 percent during 2015-2021. Inflation expectations also have started to reflect these trends: expected inflation for the 12 months ahead reached 9.6 percent for businesses and 10.6 percent for consumers, the highest value recorded since 2016. Longer term inflation expectations are still anchored at below 4 percent.

The increase in inflation expectations prompted a faster monetary policy normalization. The central bank raised its key policy rate by 50 basis points to 1.75 percent in August, marking the third hike since the start of the war in Ukraine. As a result, government securities yields' have followed an upward trend since March, also reflecting expectations for a faster normalization of monetary policy.

Credit to the private sector continued its strong positive trend from 2021 for both enterprises and households. Outstanding credit to the private sector increased by 13.8 percent in Q2 2022. Non-performing loans stood at 5.3 percent, reflecting sound asset quality. However, the lending survey conducted by the central bank indicates that banks have started to follow more prudent policies for lending to enterprises in the Q2 2022. For the same period, total deposits grew by 10.2 percent, decelerating by 0.4 percentage points from Q1 2022. The growth of foreign currency deposits reflected higher service export inflows and a good performance of remittances in Q2 2022.

The current account deficit narrowed by 21.8 percent in Q1 2022 as compared to the same quarter in 2021, mainly driven by an increase in exports (by 58 percent) in particular tourism inflows (by 70 percent). Merchandise exports (especially minerals, metals, construction materials, energy, and crude oil), also recorded a high growth of 82.9 percent, largely explained by increased international prices. Imports grew by 32.1 percent, largely driven by the increase in imports of goods, of minerals, energy, refined fuels, and food. Remittances increased by 9.2 percent. Total direct investment inflows increased by 16 percent in Q1 and a double-digit increase was observed in real estate, extractive industries, energy, the financial and insurance sectors, and manufacturing. The foreign exchange reserve stock remained robust at the end of Q1 2022, covering 8.2 months of imports of goods and services, or 394 percent of short-term gross external debt.

The budget balance was positive in H1, at about 1.5 percent of GDP, reflecting, higher revenues, and cautionary spending given the uncertainties ahead. Fiscal revenues increased by 19.2 percent in H1 2022 on account of robust growth, increased inflation, formalization efforts, and higher profit tax revenues. VAT revenues contributed 10 percentage points to total growth. Revenues from profit tax generated the second highest contribution to total growth. Investment spending declined by 16.4 percent. In response to higher food prices stemming from the war in Ukraine the government increased budget allocations for support to vulnerable groups and increased subsidies to the energy SOEs, while keeping the tariffs for households and SMEs unchanged. Support for the energy sector since January to June reached 7.9 billion Albanian leks, out of the 28 billion Albanian leks planned for the year.

Outlook and Risks

Growth for the current year is expected to decelerate towards the fourth quarter of the year, despite the strong performance in the first quarter. Sustained price increases are likely to lead to a decline in domestic private demand while the government contribution is expected to be affected through the post-earthquake reconstruction program winding down. Foreign demand is likely to decelerate affecting net exports contributions.

The baseline scenario projects economic activity to expand at an average of 2.7 percent over 2024 following global conditions and persistent supply side shocks. This is below the pre-earthquake historical rate. Enduring geopolitical tensions could further increase inflation, disrupt supply chains, and disturb financial markets; all of which could further dim Albania's growth prospects. In turn, a sluggish labor market combined with diminished purchasing power could dampen progress on poverty reduction.

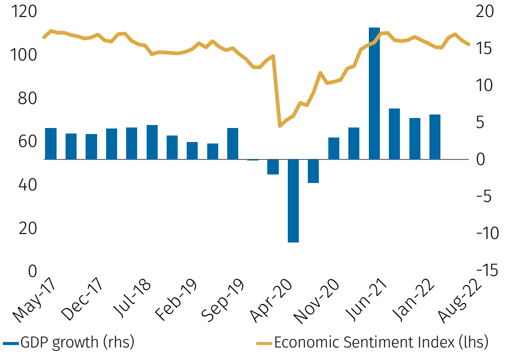
While the government plans to contain spending in line with fiscal consolidation plans, higher costs of public service provision create additional pressures on growth. Higher spending may be needed to guarantee the energy supply through more costly energy imports and support to the fragile energy SOEs. Public debt is expected to decline to 68.9 percent of GDP in 2022 from 74 percent in 2021, and more significantly over the medium term. However, the fiscal balance could further deteriorate in a worsening international context, forcing the government to cut public spending to prevent a hike in the debt-to-GDP ratio. Given Albania's growing reliance on external financing, interest rate and refinancing risks remain elevated. Contingent liabilities in the form of guarantees to cover energy purchases also represent a significant risk.

Regarding the external account, services exports, including tourism and fast-expanding business-process operations, should gradually recover. Following a reduction of the trade deficit on the first quarter, the current account deficit is expected to slightly expand for the year 2022 reaching 7.9 percent of GDP on account of lower remittances and incomes. The current account deficit is expected to reach 7.7 percent of GDP in 2024, reflecting high demand for infrastructure-related imports.

In the medium term, private consumption is projected to return as a key driver of growth. Private investment could provide further support to growth if business climate reforms are implemented. After a significant reduction in 2021, poverty is expected to continue declining in 2022, but persistent inflationary pressures could lead to smaller declines in the future or to reversals of past gains.

Growth continued to expand in early 2022, and surveys signal a slowing down in Q2 and Q3.

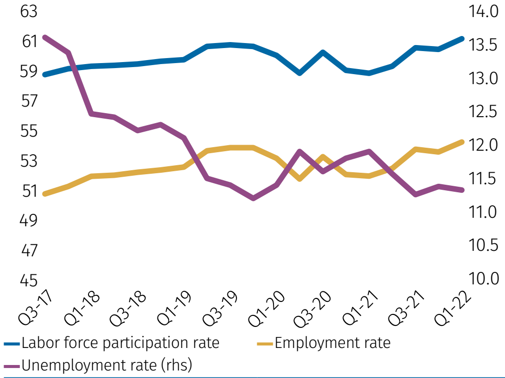
Economic Sentiment Index (lhs) and GDP growth (rhs)



Source: INSTAT and Bank of Albania.

Labor markets improved.

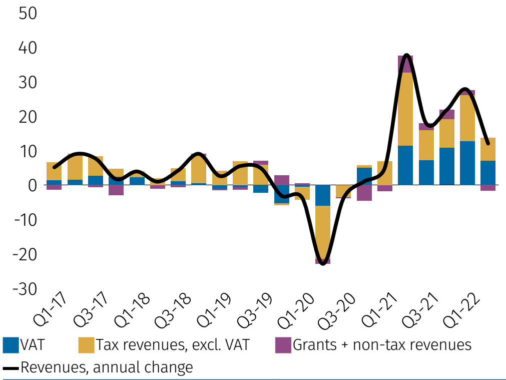
Percent



Sources: INSTAT.

Fiscal revenues grew strongly largely reflecting high transaction prices and formalization efforts.

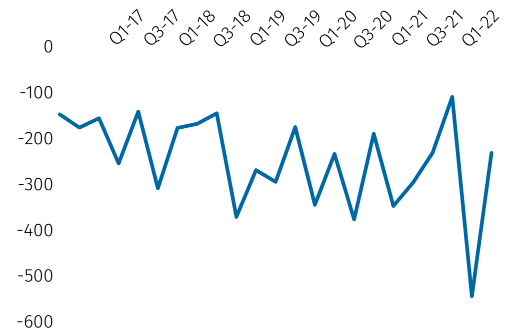
Contribution in total annual revenue growth



Source: Ministry of Finance.

The current account deficit narrowed in Q1 2022.

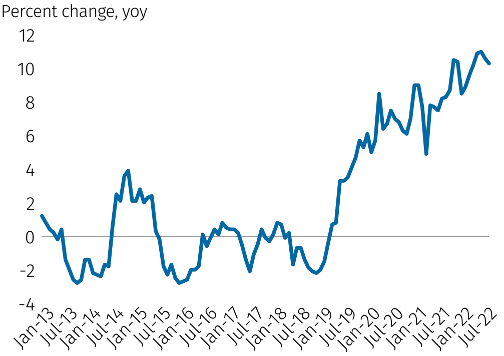
EUR million



Source: Bank of Albania.

Credit to the economy has supported growth.

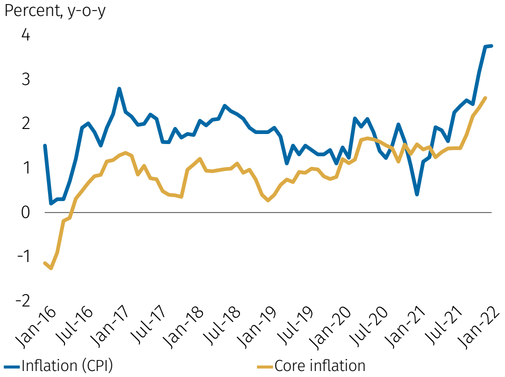
Percent change, yoy



Source: Bank of Albania.

Headline and core inflation have accelerated since April.

Percent, y-o-y



Source: Bank of Albania.

ALBANIA Selected Economic Indicators	2019	2020	2021	2022e	2023f	2024f
Real GDP growth (percent)	2.2	-3.5	8.5	3.2	2.3	2.5
Composition (percentage points):						
Consumption	2.5	-2.6	4.5	1.6	1.6	1.9
Investment	-0.9	-0.9	4.8	1.0	0.0	0.0
Net exports	0.6	0.0	-0.9	0.5	0.7	0.6
Exports	2.0	-9.4	11.5	2.2	2.0	2.0
Imports (-)	1.4	-9.3	12.4	1.7	1.3	1.4
Consumer price inflation (percent, period average)	1.4	1.6	2.6	6.7	4.0	3.5
Public revenues (percent of GDP)	27.2	25.9	27.0	26.8	27.4	27.6
Public expenditures (percent of GDP)	29.2	32.6	31.6	30.7	32.1	31.4
Of which:						
Wage bill (percent of GDP)	4.6	4.7	4.4	4.1	4.4	4.4
Social benefits (percent of GDP)	11.9	12.7	11.8	10.4	10.8	10.8
Capital expenditures (percent of GDP)	4.5	6.2	6.8	5.1	4.7	4.0
Fiscal balance (percent of GDP)	-1.9	-6.7	-4.5	-3.8	-4.6	-3.8
Primary fiscal balance (percent of GDP)	0.1	-4.6	-2.6	-1.3	-1.1	0.0
Public debt (percent of GDP)	63.7	74.0	72.1	67.0	65.5	65.0
Public and publicly guaranteed debt (percent of GDP)	67.4	75.9	74.0	68.9	67.4	66.9
Of which: External (percent of GDP)	29.1	35.3	36.1	31.8	30.6	29.7
Goods exports (percent of GDP)	6.6	6.0	8.2	10.2	9.8	9.7
Goods imports (percent of GDP)	29.7	28.4	33.0	36.6	35.1	34.5
Net services exports (percent of GDP)	9.3	8.1	11.5	14.8	14.0	13.8
Trade balance (percent of GDP)	-13.8	-14.3	-13.3	-11.6	-11.3	-11.0
Net remittance inflows (percent of GDP)	5.2	5.1	4.9	4.7	4.4	4.4
Current account balance (percent of GDP)	-8.0	-8.5	-7.7	-7.9	-8.1	-7.7
Net foreign direct investment inflows (percent of GDP)	7.6	6.7	6.4	6.3	6.4	6.4
External debt (percent of GDP)	60.0	60.5	62.7	55.5	51.6	49.3
Real private credit growth (percent, period average)	1.5	5.2	5.5	—	—	—
Nonperforming loans (percent of gross loans, end of period)	8.4	8.1	5.7	—	—	—
Unemployment rate (percent, period average)	11.5	11.7	11.5	—	—	—
Youth unemployment rate (percent, period average)	21.5	20.9	20.9	—	—	—
Labor force participation rate (percent, period average)	60.4	59.5	59.8	—	—	—
GDP per capita, PPP (current international $)	15,393	14,888	16,183	16,733	17,118	17,546
Poverty rate (percent of population)	29.6	33.0	23.1	20.4	17.8	15.5

Sources: Country authorities, World Bank staff estimates and projections.
Note: Youth unemployment rate is for labor force aged 15–29. Statistical discrepancy contribution is divided at the ratio of 80 percent and 20 percent between Consumption and Investment respectively. Change in inventories is included in Investments. e= estimate; f = forecast; — = not available.

Bosnia and Herzegovina

- Robust economic activity continued in the first half of 2022. Nevertheless, employment improved only marginally; unemployment remains elevated and is especially high among youths.
- Headline inflation accelerated fueled by food and transport prices, raising inflation to 12 percent by July 2022. Fiscal revenues benefited from strong growth and inflation, with the deficit expected to reach 1 percent of GDP in 2022, on election year.
- Real output growth is expected to decelerate in the second half of 2022 as private consumption slows due to the erosion of real disposable income caused by high inflation, and a deterioration in net exports.
- Elections took place on October 2, 2022, potentially setting the scene for a return to much-needed and delayed structural reforms to boost potential growth in the medium term.

Recent Economic Developments

Growth in the first half of 2022 remained robust at 5.9 percent and was buoyed by strong investment and higher private consumption. Domestic demand grew at a rate of 5.5 percent, while negative net exports decelerated somewhat compared to the first half of the previous year. Domestic demand surged on the back of a boost in investment supported by infrastructure works and higher private consumption. The latter was driven by rising nominal net wages totaling 10.7 percent in the first half of 2022[1] (or a decline of 0.7 percent in real terms) and higher remittances, which expanded by 2.6 percent, in real terms. On the production side, industrial production slowed to 3.1 percent during the period January to July 2022, from 11.6 percent the year before. Meanwhile exports grew a remarkable 20.5 percent in H1 2022, outpacing imports, which grew 18.5 percent. This resulted in a compression of the net foreign deficit by 1.2 percentage points of GDP to 2.1 percent of GDP in H1 2022.

Price increases accelerated in the first half of 2022, with a disproportionate impact on the poor. In July 2022, headline inflation surged to 16.7 percent, which elevated inflation to over 12 percent during January–July 2022 due to soaring food and transport prices. Food prices continued rising to 25.5 percent in July, resulting in a food inflation rate of 19.3 percent during January–July 2022. In parallel, transport prices accelerated to over 26 percent during the same period as, for example, the price of diesel fuel grew 52 percent between January and July, with spillover effects to other products, bolstering inflationary pressures during the first half of 2022. The sharp increase in food and transport prices places disproportionate stress on lower-income groups and generates risks for poverty reduction in 2022.

Labor market conditions improved, especially for women, but the unemployment rate remains elevated. The labor market tightened somewhat, with the employment rate increasing to 40.1 percent in Q1 2022 from 38.4 percent a year ago, despite the concomitant rise in the labor force participation rate. This means that 42,000 individuals found work in

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

Q1 2022, more than two-thirds of whom were women. High unemployment, nevertheless, persists at 16.7 percent.[2]

Fiscal data were revised, substantially increasing the consolidated fiscal deficit in 2020. The latest consolidated data suggest a consolidated fiscal deficit of 5.3 percent of GDP in 2020 and only 0.3 percent in 2021, up from the previously published deficit of 1.8 percent of GDP and a surplus of 0.5 percent in 2021. In 2022, stronger tax revenues supported by high inflation were more than offset by higher spending, which is expected to result in a fiscal deficit of 0.9 percent of GDP in 2022.[3] Expenditures in 2022 are mainly driven by social measures softening the inflationary impact on households, which are estimated to result in social benefits expanding 3.4 percentage points to 18.7 percent of GDP in 2022. Higher expenditures also reflect pre-election spending, including wage hikes and sizable growth in capital expenditures. Public debt hovers around 35 percent of GDP.

Despite the deceleration in merchandise imports, the current account deficit widened sharply to 4.8 percent of GDP in the first half of 2022, from 2.8 percent of GDP in H1 2021. Adjusted for the capital account inflows of 0.7 percent of GDP, the external financing requirement amounted to 4.1 percent of GDP in the first half of 2022, two times larger than a year ago. Adverse terms of trade developments, among others, caused the sharp increase in the merchandise deficit by 48 percent in H1 2022 in nominal terms, or a widening of 4.6 percentage points, in GDP terms. Nevertheless, the deficit in goods and services narrowed to 14.3 percent of GDP, which is 2.2 percent of GDP less than in the same period a year ago, in part due to an increase in net travel receipts of 1.1 percent of GDP in 2022. The primary and secondary income accounts remained broadly unchanged in H1 2022 at around 9.5 percent of GDP, helping keep the external balance in check, with remittance inflows just below 8 percent of GDP. Net FDI inflows covered roughly one-third of the external deficit in the H1 2022, nominally the smallest amount since 2016. Foreign borrowing by the government and private sector, together with a drawdown on reserves, more than offset net portfolio outflows and helped finance the remainder of the borrowing requirement.

In 2022, the external deficit is projected to widen to 3.1 percent of GDP from 2.6 percent the year before. It is expected that the merchandise trade deficit will increase to 25.1 percent of GDP for the year as a whole. Meanwhile, services inflows should improve significantly to 12.5 percent of GDP, in part based on the doubling of overnight stays during January–July this year. At the same time, remittances are set to disappoint somewhat as net inflows are set to remain below 8 percent of GDP in 2022. The resulting net borrowing requirement is largely going to be financed by net FDI inflows of about 69 percent of CAD, which are expected to pick up during the remainder of the year, and external borrowing by the government and private sector, supporting a mild buildup in foreign exchange reserves by the end of 2022.

The banking sector is well capitalized, and its profitability has further improved in 2022. Asset quality has further improved compared to the previous years and pre-pandemic

2 The methodology of the Labor Force Survey was changed in 2021, which makes direct comparisons between 2021 and 2020 data difficult.
3 BiH draft Global Fiscal Framework for 2022–2024 and World Bank staff estimates.

period, with nonperforming loans to total loans declining to 5.2 percent at the end of Q2 2022 from 5.7 percent in same period last year and 8 percent in 2019. Capital adequacy, meanwhile, remains robust compared to last year as the Tier 1 capital ratio is steady at around 18.6 percent. The profitability of the banking sector has improved given the rise in the net interest income to gross income to 56.6 percent in Q3 2022 from 53 percent last year, and a modestly higher return on equity by 1.6 percentage points to 11.8 percent compared to last year. Lastly, foreign currency risk exposure has been reduced, with the share of indexed and foreign currency loans declining 6.9 percentage points to 45.7 percent compare to last year's outcomes.

Outlook and Risks

Real output growth is expected to decelerate to 4 percent in 2022 as private consumption slows due to the erosion of disposable income because of high inflation, and a deterioration in net exports significantly softening the rise in aggregate demand. By 2024, real output growth is projected to reach 3.2 percent driven largely by a pickup in private consumption supported by remittances and a tightening labor market. Investment in energy and infrastructure (such as windmills and Corridor Vc[4]) will add to the growth stimulus over the medium term, although not to the same extent as in 2021 and 2022.

Strong exports are likely to be offset by higher imports in part for infrastructure projects, keeping the trade balance to around 25 percent of GDP over the next two years. This, in turn, is likely to widen the current account deficit to over 5.3 percent of GDP in 2023 and just below 4.5 percent of GDP in 2024, despite a shift to fiscal surpluses over the medium term. As general elections are completed, fiscal policy is expected to result in a balanced budget in 2023 and a fiscal surplus of close to 1 percent in 2024. Public debt is, nevertheless, expected to hover around 35 percent of GDP due to the rollover of amortization payments coming due. Following the elections, the attention of policy makers could turn to the structural reform agenda for EU accession.

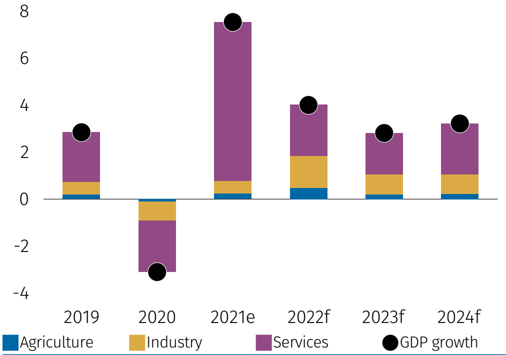
Considering energy market disruptions from the war in Ukraine, inflationary pressures are now assumed to last longer than initially expected. Hence, inflation is projected at 11 percent in 2022, stabilizing in 2023–24 at rates seen prior to the pandemic, at around 2 percent and lower. Phased out pre-election spending and one-off expenditures in response to the price shock will be in part offset by higher interest payments. However, a return to fiscal surpluses is expected by 2024.

Downside risks dominate the outlook. Protracted effects of the war in Ukraine could have a negative impact on aggregate demand through depressed consumer and business confidence. Furthermore, war-related uncertainties and sanctions can dampen the recovery in the EU, adversely impacting demand for BiH exports, except for energy. Adverse labor market developments across the EU could also 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.

4 Corridor Vc is a major north-south transit road between the countries of the region through Bosnia and Herzegovina.

GDP growth slowed in 2022.

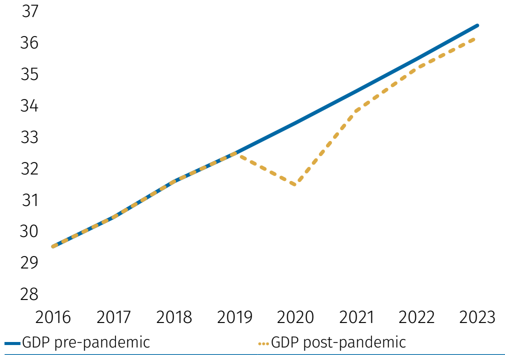
Contributions to growth, percentage points of GDP



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

Yet, postcrisis growth trajectory is unlikely to close the gap with respect to the precrisis growth path.

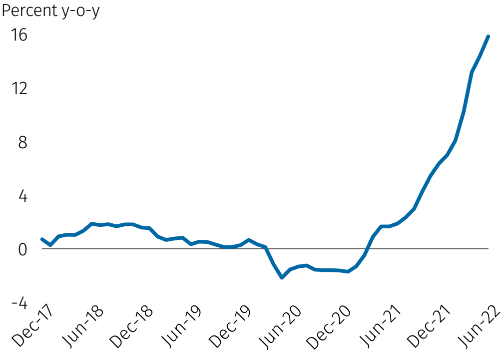
In 2015, thousand KM



Source: World Bank staff estimates.

Consumer price and food inflation surged to double digits in 2022...

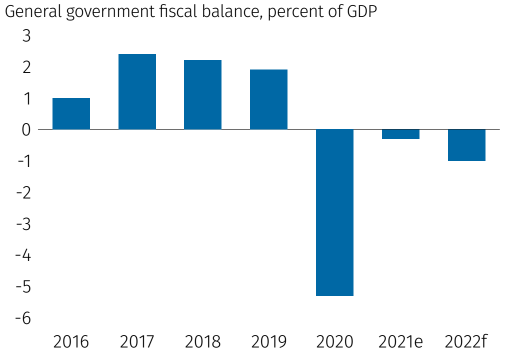
Percent y-o-y



Sources: BiH Agency for Statistics; World Bank.

...and despite higher revenues due to inflation, the fiscal deficit widened in 2022, an election year.

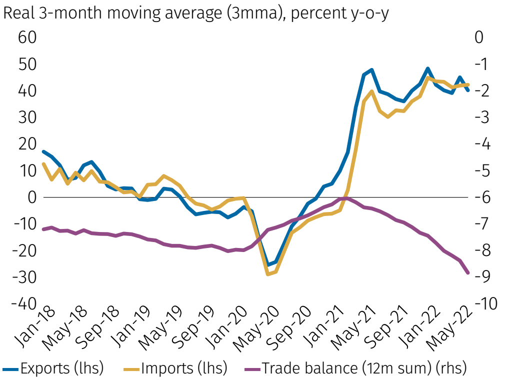
General government fiscal balance, percent of GDP



Sources: BiH fiscal authorities; World Bank staff estimates.

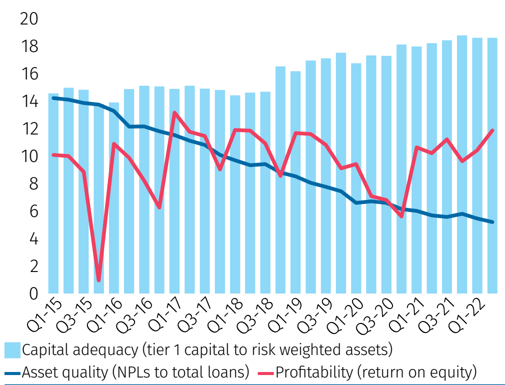
The merchandise trade deficit widened.

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



Sources: BiH Indirect Tax Office; World Bank.

Nonperforming loans in commercial bank portfolios declined steadily.



Sources: BiH Central Bank; World Bank calculations.

BOSNIA AND HERZEGOVINA Selected Economic Indicators	2019	2020	2021	2022e	2023f	2024f
Real GDP growth (percent)	2.8	-3.1	7.5	4.0	2.8	3.2
Composition (percentage points):						
Consumption	—	—	4.2	2.0	1.9	1.7
Investment	—	—	5.4	4.3	0.9	0.5
Net exports	—	—	-2.0	-2.3	0.0	0.9
Exports	—	—	1.8	3.5	2.7	2.8
Imports (-)	—	—	3.8	5.8	2.7	1.9
Consumer price inflation (percent, period average)	0.6	-1.1	2.0	11.0	2.0	0.5
Public revenues (percent of GDP)	42.5	42.1	43.0	41.4	41.9	41.9
Public expenditures (percent of GDP)	40.6	47.4	43.3	42.3	41.8	41.1
Of which:						
Wage bill (percent of GDP)	10.6	11.4	10.8	10.8	11.1	10.8
Social benefits (percent of GDP)	14.8	16.1	15.3	18.7	18.5	18.6
Capital expenditures (percent of GDP)	2.9	5.2	3.7	4.1	3.4	3.0
Fiscal balance (percent of GDP)	1.9	-5.3	-0.3	-0.9	0.1	0.8
Primary fiscal balance (percent of GDP)	2.6	-4.5	0.3	-0.2	1.0	1.7
Public debt (percent of GDP)	32.8	36.6	35.4	31.9	32.7	33.8
Public and publicly guaranteed debt (percent of GDP)	34.5	38.8	37.6	33.0	34.0	35.5
Of which: External (percent of GDP)	28.4	30.8	30.8	27.4	27.8	28.3
Goods exports (percent of GDP)	28.8	27.5	34.1	40.2	41.6	42.1
Goods imports (percent of GDP)	51.4	45.9	53.3	65.3	66.7	67.2
Net services exports (percent of GDP)	7.9	4.4	6.9	12.4	10.3	11.1
Trade balance (percent of GDP)	-14.7	-14.0	-12.3	-12.7	-14.8	-14.0
Net remittance inflows (percent of GDP)	8.5	7.4	8.2	7.3	7.1	7.0
Current account balance (percent of GDP)	-2.9	-3.9	-2.3	-3.1	-5.3	-4.4
Net foreign direct investment inflows (percent of GDP)	1.5	1.7	2.1	2.2	2.1	2.1
External debt (percent of GDP)	65.6	70.7	65.4	57.2	55.9	54.8
Real private credit growth (percent, period average)	5.2	1.3	-0.3	—	—	—
Nonperforming loans (percent of gross loans, end of period)	7.4	6.1	5.8	—	—	—
Unemployment rate (percent, period average)	15.7	15.9	17.4	—	—	—
Youth unemployment rate (percent, period average)	33.8	36.6	38.2	—	—	—
Labor force participation rate (percent, period average)	42.1	47.7	48.0	—	—	—
GDP per capita, PPP (current international $)	13,775	13,424	14,110	14,710	15,260	15,800

Sources: Country authorities, World Bank estimates and projections.
Note: e = estimate; f = forecast; — = not available.

Kosovo

- Kosovo's economic growth moderated in early 2022, with activity affected by broad-based price increases. Risks to the outlook remain high as the country continues to grapple with rising inflation pressures.
- The price shock will inevitably continue affecting demand and economic activity in 2022, and growth is expected to moderate to 3.1 percent, mainly on account of higher real exports.
- Strong tax revenue collection continues to favor the fiscal position, supported by higher inflation and tax compliance measures. The fiscal deficit is expected to reach 0.8 percent of GDP in 2022, amid significant capital underspending.
- In a context of high uncertainty, maintaining buffers to respond to the changing macroeconomic environment, particularly in the context of an ongoing energy crisis, is vital. Over the medium term, it is imperative to advance structural reforms to enhance competitiveness and private sector development in support of the current export growth momentum.

Recent Economic Developments

After experiencing a stronger-than-expected recovery in 2021, Kosovo's economic growth moderated in early 2022. Real output grew at a record high of 10.5 percent in 2021, supported by a rebound in domestic demand and strong export growth. During the first months of 2022, economic growth lost momentum, as the spike in inflation and the energy shock weighed significantly on economic activity. As a net importer of food and energy, Kosovo is particularly vulnerable to imported inflation, which in the current context started eroding consumer purchasing power and private sector competitiveness.

Growth in H1 2022 reached 3.2 percent, driven by domestic demand and exports. Consumption, which rose 5.2 percent, was the main contributor to growth, supported by credit growth, remittances inflows, and crisis-related fiscal support. Exports growth—particularly of manufactured, plastic, and mineral goods—continues to record a positive performance, and key seasonal indicators on border crossings and flight travel suggest a positive trend of services exports. However, imports surged led by a rise in commodity prices, substracting from growth. Capital execution stood at 17 percent of the original plan by August, leading to a lower contribution of investment to growth. The supply side was marked by continued support from the services sector, whereas the contribution of agriculture and industry was modest, due among other factors to the negative impact of a double-digit rise of input prices.

The labor market continues to reflect chronic weaknesses. Low labor force participation and employment, especially among women, is one of the key binding constraints to growth and poverty reduction. Although information on labor markets remains limited to 2021, administrative data for H1 2022 show an acceleration in formal employment and a decreasing trend in registered unemployment, reflected in a decrease of 32 percent[1] of the number of job-seekers registered at employment

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

centers. Moreover, the labor market continues to be characterized by significant gender imbalances (a 44 percent employment rate for males and 16 percent for females) and skills mismatches and labor outmigration, as firms increasingly report difficulties filling vacancies.

Crisis-induced commodity price increases led to a persistent increase in consumer inflation in 2022. The Harmonized Index of Consumer Prices reached a historic high of 13 percent in August 2022, a rise from 7.1 percent in January 2022, fueled by increases in the price of food (21 percent), energy (16.7 percent), and transport (25 percent) and disproportionally impacting the poor and most vulnerable. Import prices increased by an average of 21.8 percent between Q1 2021 and Q1 2022. Similarly, data from the agriculture sector show that in Q2 2022, the price of goods and services consumed in agriculture increased by 45 percent. Core inflation reached 4.5 percent in August, from 2.6 percent in January, signaling a gradual increase in inflation expectations.

Despite a sizable increase in exports, the current account deficit (CAD) deteriorated in 2022. Growth of merchandise exports reached 29.4 percent in July. In the meantime, the value of merchandise imports grew by 26 percent until July, whereas import volumes, particularly for fuel, followed a declining trend during Q2 2022, signaling weakened demand against the spike in prices. Remittances inflows have slightly declined (-0.3 percent), moderating their pace of growth after a record peak in 2021. In terms of financing sources, the CAD was financed primarily by FDI inflows, concentrated predominantly toward real estate and banking, and loans and trade credit to the private sector.

Tax revenue growth and capital underspending outpaced increases in current transfers by the summer of 2022. By August 2022, higher social transfers and expenditure associated with crisis-response measures and energy subsidies fueled a 17.6 percent increase in current expenditure. However, for the same period, total tax revenue—particularly VAT collected at the border—increased by 15.4 percent and, together with a considerable underexecution of public investment, kept the budget balance positive to date. Yet, a new package of inflation mitigation measures—worth 1.7 percent of GDP—announced in early September, and half of committed energy subsidies, remain to be implemented by year end.

Total public and publicly guaranteed (PPG) debt remains moderate. PPG debt stood at 20.7 percent of GDP in June 2022, on a decreasing trend from 21.9 percent of GDP at end-2021. The total stock of public and publicly guaranteed debt consists mostly of domestic debt (65 percent of total PPG debt), and is held predominantly by the Kosovo Pension Savings Trust, commercial banks, and the Central Bank of Kosovo.

The financial sector continues to be resilient. In July 2022, the annual change in loans was 18 percent, supporting consumption and investment activity. During the same period, deposits recorded double-digit growth (10.6 percent). Bank capital buffers and asset quality remain adequate, with the ratio of regulatory capital on risk-weighted assets standing at 15.8 percent and non-performing loans remaining stable at 2.1 percent in July 2022.

Outlook and Risks

Growth is expected to slow to 3.1 percent in 2022, affected by reduced purchasing power and higher input costs for households and firms. Real exports and government consumption are expected to be the main drivers of economic activity. On the production side, services—supported by higher diaspora demand, credit growth, and public transfers—are expected to be the main driver of growth. Reflecting broad-based inflationary pressures, private consumption and investment are expected to provide a modest contribution to economic growth. Investment activity, particularly in the construction sector, could be impacted by the postponement of investment projects due to rising input prices. In the meantime, public investment, impaired by among others factors, the inability to adjust for higher input costs in multi year contracts, is expected to subtract from growth.

Over the medium term, the outlook remains highly uncertain and risks are skewed to the downside. Real GDP growth is expected to pick up and reach 4.2 percent by 2024, assuming inflationary pressures and associated uncertainties subside, but the outlook could deteriorate further as a result of the continuation of the energy crisis and rising inflationary pressures. Higher energy consumption during the winter months and rising energy costs could add further pressure to both the import bill, as the outdated domestic capacity is unable to cover the country's needs, and the fiscal balance. Rising inflation in the European Union could also erode the income of the diaspora residing abroad, with a detrimental impact on remittances inflows and construction-related investment.

High import dependency exposes Kosovo to significant inflation risk, in a context of rising international food and energy prices. Consumer price inflation is expected to reach a record 12.1 percent in 2022, as impaired supply chains and rising international prices of food and energy continue to add pressures domestically. Upward wage pressures could also lead to further increase in prices. Moreover, high import dependence on several agricultural products such as vegetable oils and cereals, also exposes Kosovo to significant risks. As a result of the significant rise in the import bill, the trade deficit is expected to deteriorate and, coupled with stalling diaspora remittances, could lead to a temporary deterioration of the current account balance. In the medium term, the current account deficit is expected to be financed primarily by non-debt creating FDI and external private and public lending.

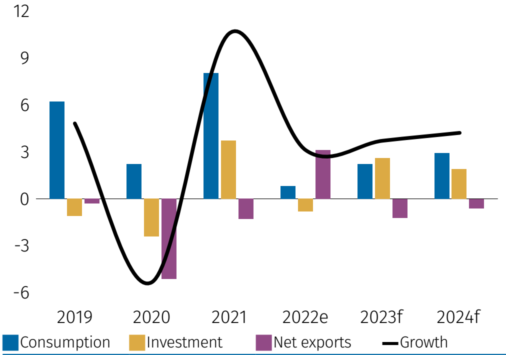
Over the medium term, the fiscal deficit is expected to increase and surpass 2 percent of GDP by 2024, but stay within the fiscal rule limit. After a low deficit in 2022 due to improved tax revenues and controlled spending, the increase in the deficit over the medium term will be driven by spending associated with compensation of employees amid new legislation on public wages, a rise in transfers and a gradual pick up in capital investment. Public debt is expected to reach 23 percent of GDP over the medium term, remaining below the 40 percent legal debt ceiling.

While financial sector deepening continues, financing costs are expected to rise in light of tighter financial conditions in Europe and rising inflation. This is increasing the vulnerability of sectors that have been highly exposed, such as construction, which may lead to a rise in nonperforming loans. Credit growth is expected to continue over the medium term, supporting consumption and investment.

The post-pandemic recovery has stressed the need to address key structural bottlenecks to enhance competitiveness and sustain inclusive growth over the medium term. Moreover, in the current context of high uncertainty maintaining adequate fiscal buffers to respond to the changing macroeconomic environment is key. Over the medium-term, advancing structural reforms is essential. Priority reforms should focus on increasing productivity growth and boosting competition; enhancing human capital development and closing the infrastructure gap.

Growth in 2022 will moderate.

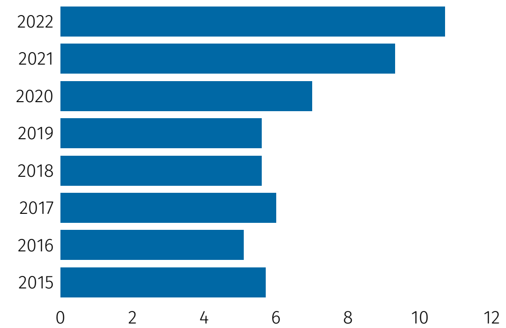
Contributions to growth, percentage points



Sources: Kosovo Statistics Agency; World Bank staff calculations.

Export growth momentum continues.

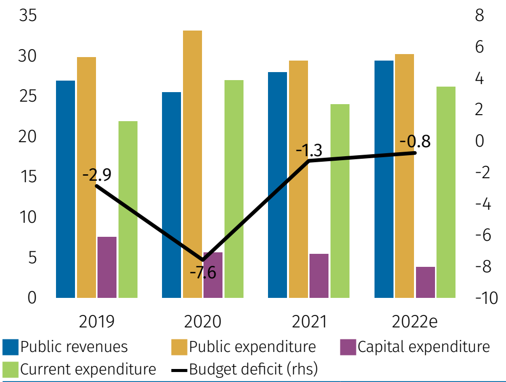
Exports of goods as a percent of GDP



Source: Central Bank of Kosovo; World Bank staff calculations.

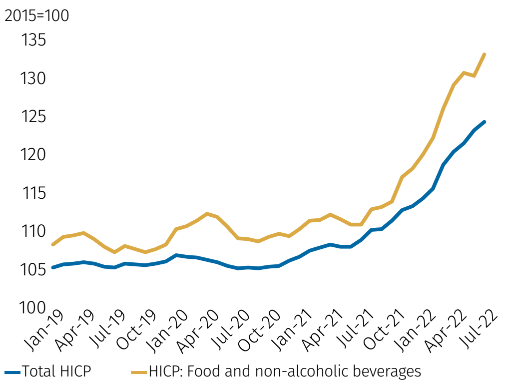
Higher revenue collection and capital underspending will offset a continued increase in current spending.

Percent of GDP



Sources: Ministry of Finance; World Bank staff calculations.

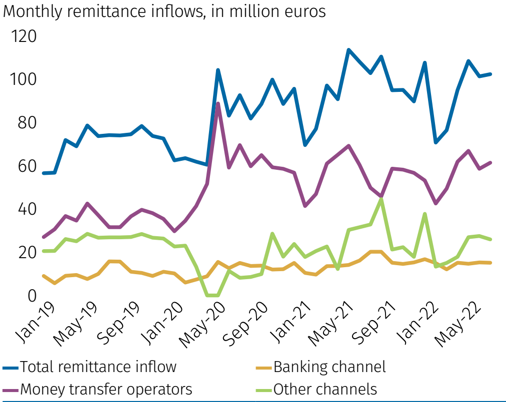
Inflationary pressures increased in 2022.



Source: Kosovo Statistics Agency.

After their 2021 peak, remittances have plateaued.

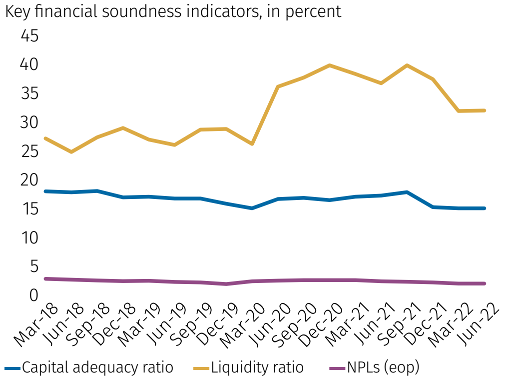
Monthly remittance inflows, in million euros



Source: Central Bank of Kosovo.

Financial sector performance remains sound.

Key financial soundness indicators, in percent



Source: Central Bank of Kosovo.

KOSOVO Selected Economic Indicators	2019	2020	2021	2022e	2023f	2024f
Real GDP growth (percent)	4.8	-5.3	10.5	3.1	3.7	4.2
Composition (percentage points):						
Consumption	6.2	2.2	8.0	0.8	2.2	2.9
Investment	-1.1	-2.4	3.7	-0.8	2.6	1.9
Net exports	-0.3	-5.1	-1.3	3.1	-1.2	-0.6
Exports	2.2	-8.4	16.9	4.0	2.3	3.1
Imports (-)	2.5	-3.3	18.1	0.9	3.4	3.7
Consumer price inflation (percent, period average)	2.7	0.2	3.4	12.1	4.0	3.0
Public revenues (percent of GDP)	26.8	25.4	27.9	29.3	28.9	29.0
Public expenditures (percent of GDP)	29.7	33.0	29.3	30.1	30.6	31.2
Of which:						
Wage bill (percent of GDP)	8.7	9.8	8.5	8.0	8.6	8.4
Social benefits (percent of GDP)	6.3	7.7	7.4	7.2	6.5	6.2
Capital expenditures (percent of GDP)	7.5	5.6	5.4	3.8	5.6	6.3
Fiscal balance (percent of GDP)	-2.9	-7.6	-1.3	-0.8	-1.6	-2.1
Primary fiscal balance (percent of GDP)	-2.6	-7.2	-0.9	-0.4	-1.1	-1.6
Public debt (percent of GDP)	17.0	22.0	21.5	20.9	21.9	23.2
Public and publicly guaranteed debt (percent of GDP)	17.6	22.4	21.9	21.2	22.1	23.4
Of which: External (percent of GDP)	5.8	7.8	7.4	7.1	7.2	7.7
Goods exports (percent of GDP)	5.6	7.0	9.3	10.7	11.3	11.4
Goods imports (percent of GDP)	45.8	45.1	53.4	58.9	58.3	57.8
Net services exports (percent of GDP)	13.1	5.8	13.4	15.5	11.8	11.2
Trade balance (percent of GDP)	-27.1	-32.3	-30.7	-32.7	-35.2	-35.2
Net remittance inflows (percent of GDP)	11.6	13.8	13.9	12.9	13.4	13.6
Current account balance (percent of GDP)	-5.6	-7.0	-8.3	-11.3	-13.1	-12.3
Net foreign direct investment inflows (percent of GDP)	2.7	4.2	3.9	3.7	4.9	5.0
External debt (percent of GDP)	31.2	37.2	37.3	—	—	—
Real private credit growth (percent, period average)	7.8	7.6	7.5	—	—	—
Nonperforming loans (percent of gross loans, end of period)	1.9	2.5	2.3	—	—	—
Unemployment rate (percent, period average)	25.7	25.9	—	—	—	—
Youth unemployment rate (percent, period average)	49.4	49.4	—	—	—	—
Labor force participation rate (percent, period average)	40.5	38.3	—	—	—	—
GDP per capita (US$)	4,433	4,295	5,209	5,212	5,381	5,706
Poverty rate (percent of population)	28.9	32.4	26.4	25.0	23.3	21.6

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; — = not available.

Montenegro

- While still recovering from the pandemic, the economy is facing renewed headwinds.
- Growth remains very strong, estimated at 6.9 percent in 2022, led by private consumption and a tourism recovery.
- Inflation surged to new highs, but its adverse impact on the cost of living was largely mitigated by an increase in real disposable income.
- The fiscal deficit is estimated to widen to 4.9 percent of GDP in 2022, due to the forgone revenues of the recent tax reform and increased social spending.
- High public debt and the deteriorating global environment require near-term fiscal consolidation.

Recent Economic Developments

Private consumption is driving growth. GDP growth was remarkably strong in the first half of 2022 at 10.3 percent,[1] driven by surging private consumption, underpinned by increases in real disposable income, household credit, employment, and remittances. Private consumption, further supported by a stronger-than-expected tourism season, is expected to lead growth in 2022, which is estimated to reach 6.9 percent. Despite a decline in the number of Russian and Ukrainian tourists, tourism continued recovering in 2022, boosting exports. However, an increase in imports alongside stronger domestic demand is expected to turn net exports negative for the year. Government consumption is projected to support growth, while investment is estimated to grow only marginally, still affected by higher costs of materials, supply-chain disruptions, and completion of a first section of highway.

Reviving tourism is stimulating economic activity. In the first seven months of the year, the number of international tourist overnight stays in accommodation facilities[2] reached 93 percent of the 2019 level, with the number of stays in July alone reaching their 2019 level. Tourism in turn supported retail trade, which expanded by 16 percent in real terms through July. However, in the same period, industrial production declined by 3.6 percent, as unfavorable hydrological conditions affected electricity generation. Similarly, construction declined by 3 percent,[3] but an increase in the number of building permits issued points to a likely resumption of construction activity in the near term.

The labor market shows continuous improvement. Labor Force Survey data reveal a 30 percent increase in employment in Q2 2022, which equally benefited male and female employees. The activity rate rose to 59.5 percent in Q2 from 46.8 percent a year ago, while in the same period the unemployment rate fell to 14.6 percent from 17.1 percent in Q2 2022. The administrative data show record-high employment in July of 235,343 employees, exceeding the July 2019 employment by 9.4 percent, with all sectors but public administration registering double-digit growth rates. The registered unemployment rate fell to 16 percent in July 2022 from 22 percent in July 2021. In the first seven months, the average net

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

2 Accommodation facilities include hotels, holiday facilities, boarding houses, tourist resorts, hostels, and motels. High-frequency private accommodation data are not available.

3 Measured as the number of effective hours worked on construction sites.

monthly wage increased by 21 percent in real terms, due to the reduction in labor taxes and an increase in the minimum wage.

Inflation has been galloping in 2022. Global inflationary pressures and higher wages have been driving a surge in prices. In the first eight months, inflation averaged 11 percent, peaking in August at 15 percent. Most of the inflation is explained by increases in the price of food and non-alcoholic beverages (19.4 percent) and fuel (30.5 percent). The cost-of-living crisis has been largely mitigated so far by an increase in real disposable income through the tax reform, which resulted in an increase in the net average monthly wage of 21 percent in real terms in the first seven months. The tax reform reduced labor taxes from a flat 39 percent of total labor cost to an average of 22 percent.[4]

The financial sector is well capitalized and liquid. In July 2022, outstanding loans were up by 4.4 percent, driven by lending to the private sector and households. At the same time, deposits were up by 20.4 percent, similarly led by increases in the private sector and households, but also nonresidents. As a result, the loan-to-deposits ratio declined to 77 percent, its lowest level ever. In the first seven months of 2022, new loans surged by 37 percent, outpacing new lending in the same period in 2019. The June average capital adequacy ratio was a healthy 18.9 percent, well above the regulatory minimum, while nonperforming loans increased to 6.9 percent of total loans from 6.3 percent in June last year. Overall, the financial sector seems to be in a good position, though at a time of high economic uncertainty and vulnerabilities to global shocks, added vigilance on the side of bank supervision is warranted.

External imbalances are expected to widen from their 18-year low in 2021. In the first half of 2022, exports of goods and services grew by 72 percent, based on equally strong performance on both goods and services. Transport and tourism services led service export growth, while exports of electricity and metals, benefiting from higher prices, supported merchandise exports. In the first seven months of 2022, Montenegro exported 62 percent more in value of electricity and metals than in all of last year. Owing to higher demand, import growth was also strong, expanding by 52 percent by June. Net primary and secondary incomes strengthened, primarily due to strong net remittances, which increased by 23 percent. Net FDI increased by 73 percent in the same period and financed more than half of the current account deficit. In July 2022, international reserves stood at €1.7 billion, covering seven months of merchandise imports.

Lower revenues as a share of GDP and higher social spending are estimated to widen the fiscal deficit to 4.9 percent of GDP. Total revenues as a share of GDP are projected to drop from 44.4 percent of GDP in 2021 to 40 percent in 2022. There was a solid increase in VAT and excise collection in the first eight months of 2022 despite the reduced VAT rate of 7 percent for the hospitality industry and a 50 percent reduction of the excise on fuel as a cost-of-living mitigation measure. But revenues from social security contributions and the personal income tax declined as part of the government's tax reform that removed healthcare contributions, which was planned to be financed by progressive income taxation and higher excises. At the same time, expenditures increased, led by higher social and capital spending. In December 2021, the Parliament

4 The labor tax wedge starts at 20 percent for the minimum wage and slowly increases with the rise of income.

increased minimum pensions by 36 percent, followed by another increase of 10 percent to be implemented in September. These adjustments, without complementary reform measures, are significantly increasing the pension costs and threatening pension system sustainability and equity. The Ministry of Finance has prepared a revision of the 2022 budget to account for new expenditures, including pensions, higher-than-planned social spending, and clearance of health arrears.

In August, there was a vote of no confidence in the government—the second government to collapse in 2022. The complexity and fragility of the political landscape in Montenegro exacerbates already high uncertainties, slows the reform process, and diverts the focus from imminent economic challenges. Prudent fiscal policy based on continuous public debt reduction and policies to support growth are of critical importance in such an environment.

Outlook and Risks

The unfavorable global economic outlook and high uncertainty are weighing on Montenegro's recovery prospects. Growth is expected to moderate to 3.4 percent in 2023 and further to 3.1 percent in 2024, as private consumption growth slows. The projections do not assume that the remaining sections of the highway will start by 2025, as fiscal space is limited. The projections do assume that investments will be recovering, driven by the energy and tourism sectors, but at a slower pace, as major public investments are finalized. Tourism is expected to continue improving in 2023, although deteriorating growth prospects in the EU and the region can slow its recovery.

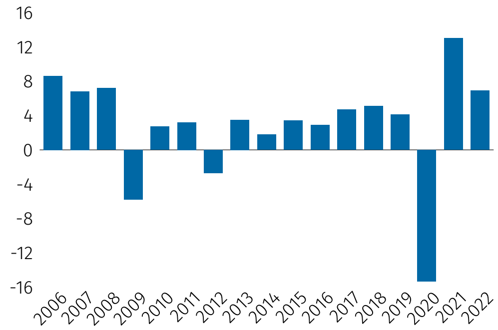
The current account deficit is projected to decline gradually until 2024. While higher energy prices are disproportionally affecting the poor, they are also supporting a reduction in the trade deficit as Montenegro's growing electricity capacity is used for energy exports. These, together with exports of tourism and transport services, are projected to support a reduction in the current account deficit to 9.7 percent of GDP in 2024. Inflation is projected to decelerate to 5.9 percent in 2023 and further to 2.6 percent in 2024 as global supply shortages ease.

The fiscal balance is expected to moderate over the medium term but will remain elevated. The fiscal deficit is projected at 4 percent of GDP in 2023 and 2.7 percent of GDP in 2024, unless additional measures compensate for the decline in revenues as a share of GDP. As a result, public debt is expected to stay high at 73 percent of GDP. Given the tightening of global financial conditions and Montenegro's sizable financing needs of around 9 percent of GDP per year in 2023–24, Montenegro will require careful debt management and stronger control over its expenditures.

The outlook is clouded with multiple downside risks. Prolongation of the war in Ukraine would further amplify geopolitical uncertainties and reduce growth prospects in Montenegro and its trading partners. Inflationary pressures are accelerating monetary tightening, which translates into more expensive external, but also domestic financing. Political instability and delays in government formation are major domestic risks. The severity of challenges ahead requires strong political commitment and actions to mitigate these risks.

GDP growth remains strong at 6.9 percent...

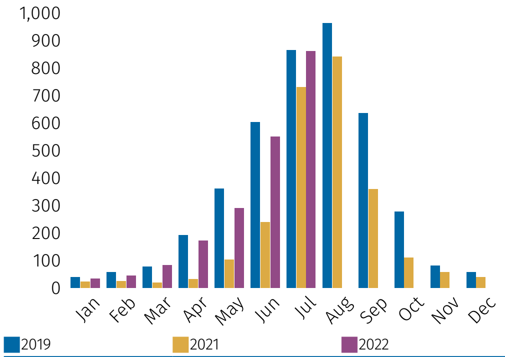
Real GDP growth, percent



Sources: MONSTAT data; World Bank staff calculations.

...supported by continuous tourism recovery.

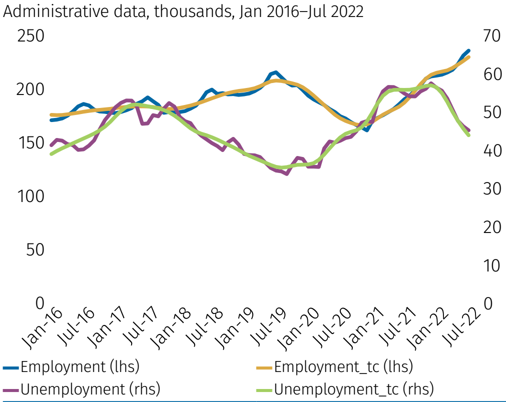
International tourist overnight stays, in thousands



Sources: MONSTAT; World Bank staff calculations.

Employment reached a record high in July...

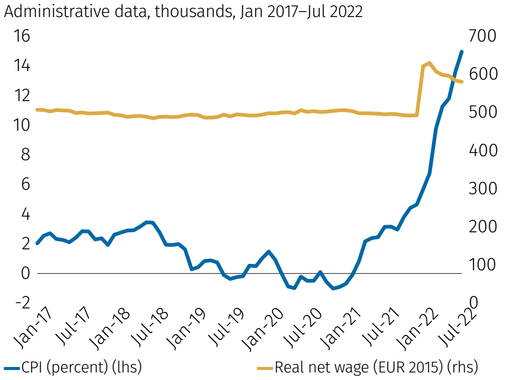
Administrative data, thousands, Jan 2016–Jul 2022



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

...as did inflation.

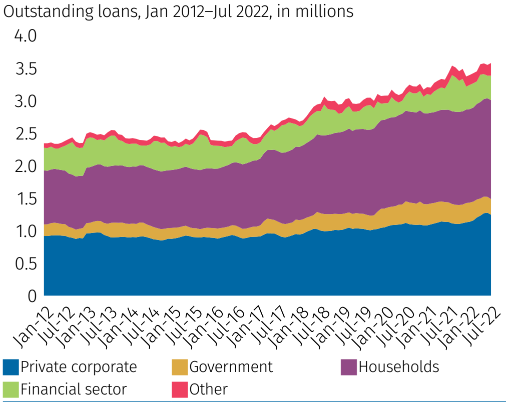
Administrative data, thousands, Jan 2017–Jul 2022



Source: MONSTAT data; World Bank staff calculations.

Outstanding loans are also at a record high.

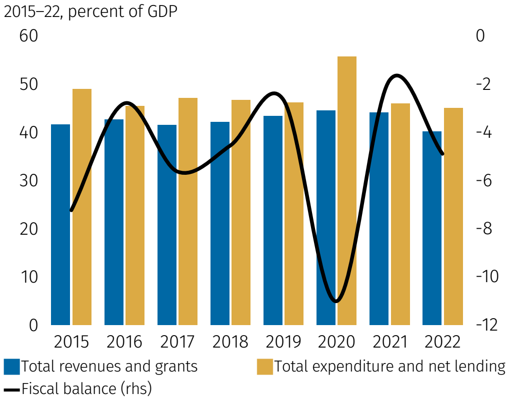
Outstanding loans, Jan 2012–Jul 2022, in millions



Sources: Central Bank; World Bank staff calculations.

The fiscal deficit is widening again.

2015–22, percent of GDP



Sources: Ministry of Finance; World Bank staff calculations.

MONTENEGRO Selected Economic Indicators	2019	2020	2021	2022e	2023f	2024f
Real GDP growth (percent)	4.1	-15.3	13.0	6.9	3.4	3.1
Composition (percentage points):						
Consumption	2.9	-3.9	4.1	8.2	2.9	2.7
Investment	0.9	-5.9	-4.7	1.4	1.1	1.5
Net exports	0.3	-5.5	13.7	-2.7	-0.6	-1.1
Exports	2.9	-24.2	25.7	13.7	3.1	2.5
Imports (-)	2.6	-18.7	12.0	16.4	3.7	3.6
Consumer price inflation (percent, period average)	0.4	-0.3	2.4	12.3	5.9	2.6
Public revenues (percent of GDP)	43.3	44.4	44.0	40.0	39.0	38.8
Public expenditures (percent of GDP)	46.0	55.5	45.9	44.9	43.0	41.5
Of which:						
Wage bill (percent of GDP)	11.0	13.5	12.2	11.1	10.7	10.1
Social benefits (percent of GDP)	11.2	13.4	11.5	12.0	12.1	11.7
Capital expenditures (percent of GDP)	8.7	7.5	5.7	6.2	5.6	5.8
Fiscal balance (percent of GDP)	-2.7	-11.0	-1.9	-4.9	-4.0	-2.7
Primary fiscal balance (percent of GDP)	-0.5	-8.3	0.5	-3.3	-2.2	-0.6
Public debt (percent of GDP)	76.5	105.3	84.0	73.4	72.7	71.9
Public and publicly guaranteed debt (percent of GDP)	80.0	108.7	86.8	75.5	74.7	73.8
Of which: External (percent of GDP)	68.1	97.3	78.3	67.3	66.1	67.1
Goods exports (percent of GDP)	9.4	9.8	10.6	13.0	12.6	12.0
Goods imports (percent of GDP)	51.1	49.0	49.3	57.6	57.1	57.1
Net services exports (percent of GDP)	20.6	4.2	19.3	25.7	26.8	28.1
Trade and services balance (percent of GDP)	-21.1	-35.0	-19.4	-18.9	-17.7	-17.0
Net remittance inflows (percent of GDP)	4.0	5.3	6.1	5.4	4.4	4.1
Current account balance (percent of GDP)	-14.3	-26.1	-9.2	-10.2	-10.3	-9.7
Net foreign direct investment inflows (percent of GDP)	6.2	11.2	11.7	10.3	9.0	7.9
External debt (percent of GDP)	169.0	224.1	—	—	—	—
Real private credit growth (percent, period average)	5.5	6.4	-0.2	—	—	—
Nonperforming loans (percent of gross loans, end of period)	5.1	5.9	6.8	—	—	—
Unemployment rate (percent, period average)	15.1	17.9	16.6	—	—	—
Youth unemployment rate (percent, period average)	25.2	36.0	37.1	—	—	—
Labor force participation rate (percent, period average)	57.4	53.3	50.9	—	—	—
GDP per capita, PPP (current international $)	23,073	19,990	22,795	26,143	28,280	29,878

Sources: Country authorities; World Bank staff estimates and projections.
Note: e= estimate; f = forecast; — = not available.

North Macedonia

- As the war in Ukraine and the energy crisis dim growth prospects, inflation is racing toward an all-time high, disproportionately eroding real incomes of the poor.
- With limited fiscal space, elevated public debt, and increased cost of financing, fiscal support needs to target the most vulnerable households and firms. At the same time, monetary policy tightening needs to strike a balance between containing inflation and avoiding stifling economic activity.
- The output growth over the medium term is expected to moderate and downside risks remain elevated, dampening growth and lifting inflation at the same time. Disruptions related to the war in Ukraine, overstretched global supply chains, mounting inflationary and wage pressures, and the intensifying energy supply crisis continue to weigh on the outlook and the economic prospects of the country.

Recent Economic Developments

The beginning of 2022 saw output growth slow to below potential as the recovery momentum of the previous year waned and the energy crisis loomed. After 4 percent GDP growth in 2021, output increased by 2.6 percent in H1 2022, driven by continued recovery in investment and robust consumption. At the same time, imports surged by 25 percent, leading net exports into negative territory. On the production side, growth in H1 was driven by services, as the industry struggled (owing in part to rising energy costs), and construction saw a further decline.

Recent high-frequency indicators point to a further deceleration of growth during the summer. Industrial production recorded a weak 0.2 percent growth in August 2022, as energy production dropped amidst a moderate increase in mining and manufacturing. At the same time, real retail trade growth increased by 3.1 percent in August 2022, following two months in a row of a real decline, something last observed during the Covid-19 pandemic. Tourism improved as travel demand surged, but tourist arrivals are still hovering below pre-pandemic levels.

With soaring imports owing partly to higher energy prices, the merchandise trade deficit deteriorated, further widening external imbalances. The current account deficit worsened to 6.3 percent of GDP (on a four-quarter rolling basis to June 2022), owing largely to a deterioration in the trade balance as import prices surged. The merchandise trade deficit widened to 22.8 percent of GDP, mainly because of the negative contribution of the energy balance, while the services surplus decreased to 3.7 percent of GDP, largely due to weaker travel and manufacturing services. Remittances declined very slightly, while net FDI stood strong at 3.4 percent of GDP. At the end of Q2 2022, gross external debt stood at 77.4 percent of GDP, down from 81.6 percent at end-2021, with the decline coming from higher nominal GDP in the denominator, lower public sector debt, amidst rising intercompany debt.

The labor market recovery is slow and fragile despite government support. After the release of the 2021 census data that revealed an approximately 9 percent decline in population and a smaller labor force, the participation rate settled at 55.3 percent in Q2 2022, drawn down by the low female participation rate that stood at 44.5 percent. At the same time, the employment rate remained below the pre-pandemic peak at 47.3 percent. The unemployment rate decreased to 14.5 percent,[1] but the youth unemployment rate remained high at 30.9 percent despite active labor market policies that target youth employment. Rising economic uncertainty lowered the share of fixed-term contracts to only 60 percent of all new employment contracts.

Nominal net wage growth averaged 9 percent by June 2022, but domestic inflation outpaced wage gains, and the real net wage turned negative. Nominal wage growth spread across all sectors. The growth for retail, accommodation, and entertainment services, in particular, was fueled by the 18.5 percent minimum wage hike agreed in February 2022. In addition, intensified pressures from labor unions prompted the government to agree on public sector pay increases (to align with the minimum wage increase) over the fall of 2022. Relatedly, the country agreed to open its labor market to the Open Balkan Initiative countries,[2] which might lead to further upward wage pressures as workers start exploiting opportunities across the border.

Headline inflation surpassed a decades-long peak with food, energy, and core inflation all contributing to the rise. Consumer price inflation reached a 25-year high at 16.8 percent in August 2022, as food and energy prices soared, with more than 20 percent annual growth, although the monthly increase decelerated. The cumulative inflation stood at 11.6 percent by August. The cost-of-living crisis unraveled, disproportionately eroding real incomes of the poor. Regulated heating and electricity prices were increased, but they remained below market prices. To respond to the rise in consumption and to widening electricity company losses, from July, the government introduced a block tariff system by progressively increasing the cost of electricity consumption across four consumption blocks for households and it increased the tariffs for small consumers that are supplied by the universal electricity provider.

To tame inflationary expectations, the central bank further tightened monetary policy. The policy rate was increased by 1.75 percentage points to 3 percent in five rounds to early September. The stability of the pegged exchange rate was preserved with regular FX interventions that led to a more than 20 percent loss of reserves since mid-2021, but signs of stabilization were visible by the end of the summer. The banking sector remained stable despite a decline in the liquidity ratio to 20.5 percent. The capital adequacy ratio increased to 17.3 percent in Q2 2022. Credit growth continued at 9.7 percent in July 2022, led by accelerated corporate and mortgage lending. To strengthen the resilience of the banking system, the central bank announced a countercyclical capital buffer rate of 0.5 percent to be applied from August 2023. In September 2022 the central bank increased the 7-day and overnight deposit rates to stimulate savings in domestic currency, and it reduced the RR base for new loans that secure financing for domestic renewable energy production.

1 The 2022 data are not fully comparable to previous labor data due to the change in the Labor Force Survey (LFS) sample based on the 2021 census.
2 Albania, North Macedonia, and Serbia.

A revised fiscal plan for 2022 left the fiscal deficit largely unchanged compared to 2021; deficit reduction is now postponed to 2023. By June 2022, the general government deficit stood at 1.2 percent of GDP as revenues surged by 13.6 percent y-o-y, current spending decelerated to 8 percent y-o-y, and capital spending increased by 16 percent. Still, the capital spending realization rate is at one-third of the revised annual plan and will likely be rationed as the government needs resources to further support the energy sector. Continued calls for fiscal support by households and firms led the government to allocate an additional EUR76 million euros (0.6 percent of GDP) for anti-crisis measures within the 2022 budget revision in May. There is a plan to close the 2022 financing gap with short-term external borrowing, the IMF's Precautionary and Liquidity Line, and domestic financing. The issuance of a new Eurobond has been delayed due to the high interest rate.

Public and publicly guaranteed and non-guaranteed debt dropped to 55.4 percent of GDP by the end of H1 2022. Nominal public debt remained elevated compared to the pre-crisis period, but it stabilized close to the end-2021 level. Expenditure arrears were high at 3 percent of GDP on account of overdue payments of the health sector, state enterprises, and local governments, limiting fiscal space for crisis response going forward.

Outlook and Risks

The output growth over the medium term is expected to moderate and downside risks remain elevated. The 2022 growth forecast is further adjusted down to 2.1 percent as the energy and Ukraine crises continue to take a toll on the domestic economy. Disruptions related to the war in Ukraine, overstretched global supply chains, mounting inflationary pressures, and the intensifying energy supply crisis continue to weigh on the outlook. As companies, including the electricity production company, build stocks to prevent production outages, imports are forecast to rise substantially, further deteriorating the current account balance. The baseline scenario is built on the assumption that the impact of the energy crisis and the war in Ukraine on the domestic economy will gradually subside while inflationary pressures tail off over the medium-term forecast horizon. However, underlying assumptions of the forecast are significantly tilted to the downside, simultaneously dampening growth and lifting inflation.

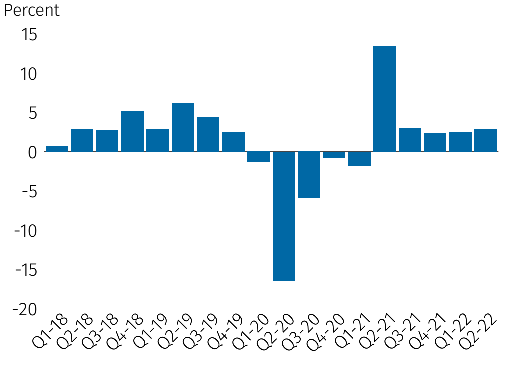
With looming stagflation risks, the country needs to start delivering on reforms that can reinvigorate the potential growth momentum over the medium term. Policy efforts need to be geared toward restoring fiscal sustainability while building social and climate resilience that will reduce the country's vulnerability to shocks and revamp the country's long-term growth prospects. Specifically, the focus of the country's reform agenda needs to be geared toward creating fiscal space to reduce debt (through boosting tax compliance, restructuring and reprioritizing spending), ensuring resilience of the financial sector, launching the green transition, and improving efficiency of public investment management.

Given limited fiscal resources, widespread state aid through direct budget transfers, temporary subsidies, and broad tax exemptions should be revised and redirected toward long-term, growth-supportive

spending. Efficient social protection will be critical in this transition. The draft Tax Reform Strategy is headed in the right direction in terms of keeping the tax system attractive while at the same time removing tax exemptions to increase progressivity. And while crisis support measures narrow, the launch of new highway construction from 2023 may stretch finances in the medium term and increase public debt.

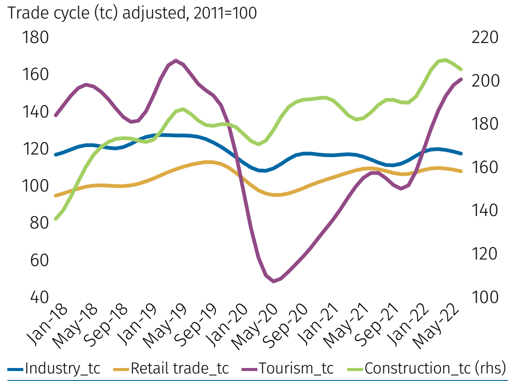
At the current juncture, a rising political divide makes policy coordination and implementation increasingly difficult, including on energy, climate, and fiscal sustainability issues that are critical for economic growth. Heightened political uncertainty and a parliamentary impasse following the results of the local elections, and a removal of obstacles for opening the EU accession negotiations, may lead to delays in reforms implementation needed to boost potential growth and consolidate public finances. Moreover, lower domestic and external demand, high input costs, and liquidity shortages could lead to layoffs and increase poverty, stretching already tight public finances. Finally, tightening financial conditions may affect financing options and costs going forward.

Economic growth slowed as new crises emerged...



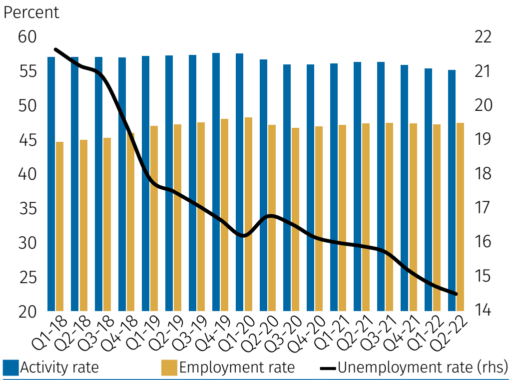
Source: State Statistics Office.

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



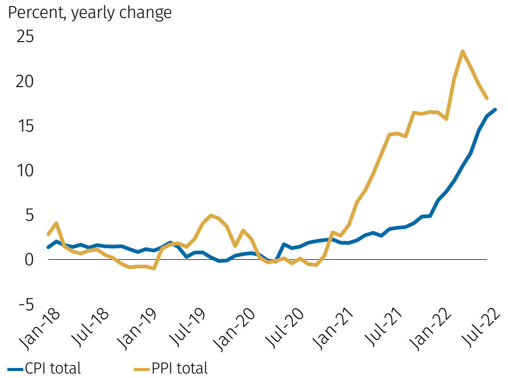
Source: State Statistics Office and World Bank staff calculations.

The labor market recovery is still fragile as activity rate continues to decline.



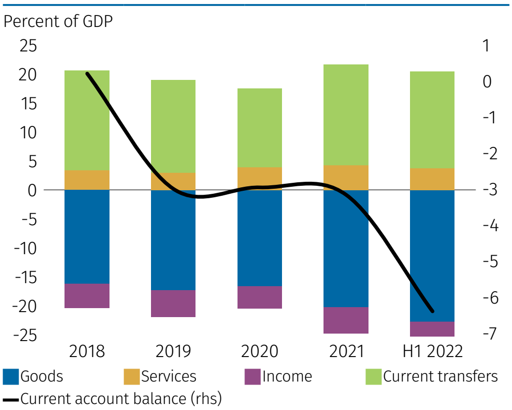
Source: State Statistics Office.
Note: LFS 2022 makes use of the 2021 census data, making a break in the series.

Domestic inflation reached a 25-year high...



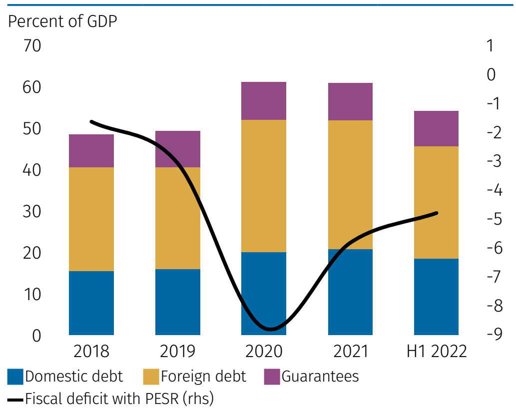
Source: State Statistics Office.

...and external imbalances widened significantly led by energy and food imbalances.



Source: Central bank.
Note: H1 balance of payments is a rolling average.

But public debt stabilized in early 2022 in response to tightened financing costs.



Sources: Ministry of Finance and World Bank estimates.
Note: *Deficit of the general government on a 12-month rolling basis.

NORTH MACEDONIA Selected Economic Indicators	2019	2020	2021	2022e	2023f	2024f
Real GDP growth (percent)	3.9	-6.1	4.0	2.1	2.7	2.9
Composition (percentage points):						
Consumption	3.1	-2.4	5.0	4.9	2.4	2.3
Investment	3.3	-5.3	2.2	5.1	2.4	2.5
Net exports	-2.4	1.7	-3.3	-7.9	-2.1	-1.9
Exports	5.8	-7.4	7.9	7.7	5.5	4.8
Imports (-)	8.2	-9.1	11.2	15.6	7.5	6.7
Consumer price inflation (percent, period average)	0.8	1.2	3.2	12.1	6.1	3.0
Public revenues (percent of GDP)	31.4	30.5	32.3	32.0	31.7	32.1
Public expenditures (percent of GDP)	33.5	38.9	37.7	37.2	35.8	35.7
Of which:						
Wage bill (percent of GDP)	6.3	7.3	6.9	6.5	6.3	6.1
Social benefits (percent of GDP)	15.6	18.0	16.9	16.1	15.3	15.1
Capital expenditures (percent of GDP)	3.4	3.2	4.2	5.2	5.3	5.6
Overall fiscal balance (percent of GDP)	-2.1	-8.3	-5.4	-5.2	-4.1	-3.6
Primary fiscal balance (percent of GDP)	-1.0	-7.1	-4.1	-3.9	-2.6	-2.2
Overall fiscal balance with the Public Enterprise for State Roads included	-3.1	-8.8	-5.8	-6.2	-5.0	-4.5
Public debt (percent of GDP)	40.4	51.9	51.8	50.4	50.9	52.4
Public and publicly guaranteed debt (percent of GDP)*	49.2	61.0	60.8	59.4	59.9	61.4
Of which: External (percent of GDP)	32.7	40.7	39.8	39.0	38.5	37.8
Goods exports (percent of GDP)	47.5	44.4	51.3	55.7	57.0	57.9
Goods imports (percent of GDP)	64.8	61.0	71.6	81.5	78.4	77.5
Net services exports (percent of GDP)	3.0	3.9	4.2	4.2	4.7	5.1
Trade balance (percent of GDP)	-14.3	-12.7	-16.0	-21.6	-16.7	-14.5
Net remittance inflows (percent of GDP)	2.0	3.1	2.9	2.9	2.9	2.9
Current account balance (percent of GDP)	-3.0	-2.9	-3.1	-9.5	-4.7	-2.7
Net foreign direct investment inflows (percent of GDP)	3.2	1.4	3.3	3.0	3.0	3.1
External debt (percent of GDP)	72.4	78.7	81.9	79.2	82.4	84.9
Real private credit growth (percent, period average)	6.5	5.6	2.8	—	—	—
Nonperforming loans (percent of gross loans, end of period)	4.6	3.3	3.1	—	—	—
Unemployment rate (percent, average)**	17.3	16.4	15.7	14.4	13.7	13.6
Youth unemployment rate (percent, period average)	35.6	35.7	36.3	—	—	—
Labor force participation rate (percent, period average)	57.2	56.4	56.0	—	—	—
GDP per capita, PPP (current international $)	14,230	13,360	13,890	14,181	14,564	14,987

Sources: Country authorities; World Bank estimates and projections.
Note: *Includes non-guaranteed debt as well. **Data from 2022 are not fully comparable to previous labor data due to the change in the LFS sample based on the 2021 census. Youth unemployment rate is for labor force aged 15–24. f = forecast; — = not available.

Serbia

- Growth continued to be strong in H1 2022, despite major domestic and external challenges.
- Inflation accelerated more rapidly than projected, and in line with developments in the region, reaching 13.2 percent y-o-y in August, driven by food and energy prices.
- The fiscal deficit turned lower than anticipated, thanks to a strong performance of revenues, while public debt plateaued at around 57 percent of GDP.
- While growth projections over the medium term (2022-2024) remain unchanged, risks to the outlook are clearly tilted to the downside.
- The most significant deterioration is expected on the external side, with the CAD widening to around 10 percent of GDP due to the major increase in imports.

Recent Economic Developments

The Serbian economy continued to grow at a solid pace in H1 2022. At 4.1 percent y-o-y, economic growth was almost entirely driven by a surge in private consumption, with only a marginal contribution from investment. A substantial increase in salaries and in lending to households, as well as transfers from the budget, helped private consumption to grow 5.3 percent (y-o-y, in real terms). In the first half of the year, total investment increased by mere 1.4 percent (y-o-y) despite a significant increase in government investment.[1] Although the export performance was strong (up 19.9 percent in real terms), the increase in imports was even higher (up 22.3 percent in real terms, and from a higher level) primarily related to the import of energy (electricity, coal, oil, and gas). Thus, the net balance in goods and services made a negative contribution to growth of 3.8 percentage points. On the production side, agriculture output shrank again in H1 2022 due a major drought (the second summer in a row) and significantly higher input prices. Agriculture output was 5.3 percent lower in the first half of the year compared to the same period of 2021. Conversely, industry performed well over the first seven months of 2022. Industrial production increased output by 2.7 percent (y-o-y), driven by improvement is several sectors including pharmaceuticals, oil, tobacco, and electronics and paper industry—which all grew between 5 and 15 percent, y-o-y. Value added in services sectors increased by 5.7 percent (in real terms/y-o-y) in the first half of the year. Over the same period construction sector posted a decline of 6.6 percent in real terms.

The labor market continued to improve in 2022. As a result of a solid growth in H1, the employment rate reached a record high level of 50.9 percent, well above pre-COVID levels of 47 percent (average in 2019).[2] Meanwhile, unemployment gradually declined to 8.9 percent in Q2 2022. The activity rate increased from 55.2 percent in Q1 to 55.8 percent in Q2 2022.[3] Overall, wages continued to increase, by a further 13.5 percent in nominal terms in the first half of the year compared to the same period of 2021. Unlike

1 Up by 43.8 percent in nominal terms over the first seven months of 2022 compared to the same period of 2023.
2 This was to some extent supported by increase in informal employment (up by 54,200 person), which is typical for this part of the year when the construction and agriculture season start.
3 Activity rate was around 53 percent in years prior to COVID pandemic.

in previous years, private sector wages increased faster than public sector wages. The former went up by 16.3 percent in nominal terms, compared to a 7.9 percent increase in public sector wages.

The consolidated budget shifted to a small surplus of 0.3 percent of GDP over the first seven months of 2022. Revenues posted a strong performance (up 14.4 percent in nominal terms, over the first seven months, y-o-y), thanks to the major increases in value added tax (VAT), corporate income tax (CIT), and social contributions. High inflation and the surge in imports drove VAT revenues; while improved collection under CIT reflects the advances made during the previous fiscal year. Social contributions increased on the back of raising formal employment and wages. Expenditures have been kept under control (up by 12.7 percent over the same period) despite major pressures to provide financial support to energy companies. To date, the support provided to energy companies for importing gas, coal and electricity was not shown as direct budget expenditures, rather as below the line items. However, as the winter season approaches, energy companies might require additional direct budget support, which could lead to a significant increase in the fiscal deficit (it is currently projected at 4 percent of GDP for 2022). Public debt remained broadly stable throughout 2022 and stood at around 57 percent of GDP. The cost of financing debt increased significantly, and some of the recent T-bill auctions remain significantly undersubscribed. As a result, the government eventually opted to direct sale of bonds to qualified investors, thus bypassing the market.[4]

Soaring imports, primarily related to energy, led to a significant deterioration in the current account deficit (CAD). Imports of energy increased by 278 percent (or EUR 2.2 billion) over the first seven months of 2022, compared to the same period of 2021. This increase, equivalent to 3.7 percent of annual GDP, was driven by oil (up by EUR 1 billion), gas (up by EUR 0.9 billion), coal (up by EUR 0.2 billion) and electricity (up by EUR 0.1 billion). As a result, the trade deficit nearly doubled to reach 7.7 percent of annual GDP in the first half of the year, while the CAD reached 4.4 percent of GDP.[5] The CAD is now projected to increase to around 10 percent of GDP in 2022 (compared to 4.4 percent of GDP in 2021). Net foreign direct investment inflows declined by 9 percent of GDP in euro terms in the first half of 2022, compared to the same period of 2021, and stood at 2.4 percent of GDP, still covering a significant portion of the external shortfall.

Inflation increased sharply, in line with developments in other CEE countries. The consumer price index (CPI) peaked at 13.2 percent (y-o-y) in August, the highest level of inflation since January 2013. Food prices, notwithstanding the selective government price controls, drove this trend, increasing by 20.9 percent (y-o-y) in August 2022. In response to mounting inflation pressures, the National Bank of Serbia (NBS) increased the key policy rate several times, reaching 3.5 percent in September. The nominal dinar

4 Serbian government started using this option as of August by issuing three bonds: a 53-weeks bond worth EUR 350 million with fixed interest rate of 2.4 percent; a three-year bond worth EUR 250 million with interest rate of: 3.75 percent + 6-month Euribor, and a four-year bond worth EUR 90 million with interest rate of: 3.95 percent + 6-month Euribor. In September the government secured another loan from the UAE to serve as a budget support in the amount of 1 billion dollars with 3 percent interest.

5 The CAD reached EUR 2.7 billion in the first half of 2022, compared to EUR 0.6 billion in the same period of 2021.

exchange rate was stable throughout 2022, with only a minor depreciation in late February 2022.[6] NBS official foreign currency reserves declined by EUR 2.6 billion over the first five months of 2022, before recovering to close to EUR 15.9 billion by the end of August, which covers 4.9 months of imports.

The performance of the banking sector continued to be robust. Based on 2022 Q2 data, banks remained profitable and liquid. The share of liquid assets in total assets stood at 33.1 percent, while capital adequacy ratio stood at 19.8 percent at the end of June. Non-performing loans (NPLs) stood at 3.3 percent in June. Nevertheless, credit growth has slowed down in 2022. The total stock of loans in July was only 6.4 percent higher than a year earlier. The highest increase in credit growth relates to SOEs (up by over 50 percent, y-o-y) while loans to private companies increased by 8.3 percent (y-o-y) and to households by 9.1 percent.

Outlook and Risks

The growth outlook remains positive with risks tilted to the downside. Before the outbreak of the war in Ukraine, the Serbian economy was expected to grow at around 4–4.5 percent annually. However, the war in Ukraine, increase in international prices and breakdowns in operations of EPS in winter 2021/22 brought projected growth downwards. Considering the impact of these shocks, growth for 2022 is projected at 3.2 percent. Further downward revision may be warranted depending on: (i) the performance of the energy sector and energy availability; and (ii) the impact of the poor agriculture season on the sectoral output, exports and food prices. Over the medium term, the economy is expected to grow steadily at around 3 percent annually.

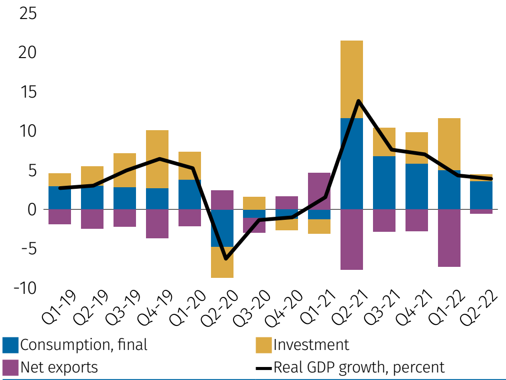
The outlook also crucially depends on the domestic reform agenda and its implementation. The ongoing crisis in the domestic energy sector has once again emphasized the urgency of improving the management of SOEs. In addition, contingent liabilities (currently covered by guarantees issued by the central government) could affect public finances, particularly those related to the deterioration in the performance of SOEs, as demonstrated recently by EPS and Srbijagas. As a remedy, the government should embark on a comprehensive and thorough reform of SOEs to make them financially viable while improving corporate governance. In addition to growth-oriented reforms, the government should reassess the effectiveness of the anti-inflationary measures used so far and to prepare the legal framework for assistance to energy vulnerable customers.

The risks to the baseline macroeconomic outlook that could materialize in 2022 and 2023 are numerous. First, although the peak of inflation is expected in Q3 2022, it could increase further depending on changes in international food and energy prices. Second, the 2022 fiscal deficit could be higher than the one projected under the base case scenario, notably if additional support to energy companies is provided. Consequently, public debt could start rising again as a share of GDP. Third, possible disruption in energy supply (electricity and gas in particular, e.g., power outages) could slow down growth. Finally, the CAD might deteriorate faster than projected if international prices of energy continue to rise, rendering its financing more expensive.

6 Since May the NBS is net-purchaser of FX, buying EUR 1.4 billion.

Growth remained strong in H1 2022...

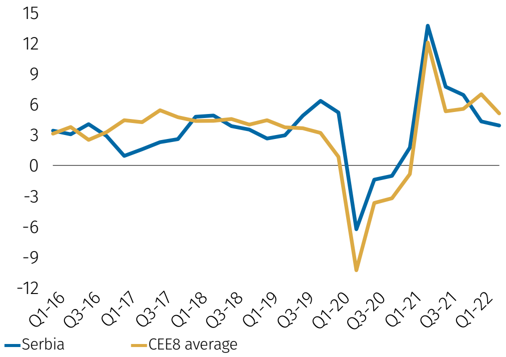
Contribution to growth, percentage points



Source: Statistics Office of the Republic of Serbia.

...but started to lag behind other CEE countries.

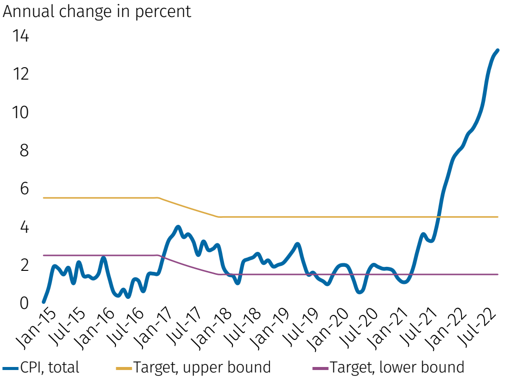
Growth rates, y-o-y



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

Inflation is on rise...

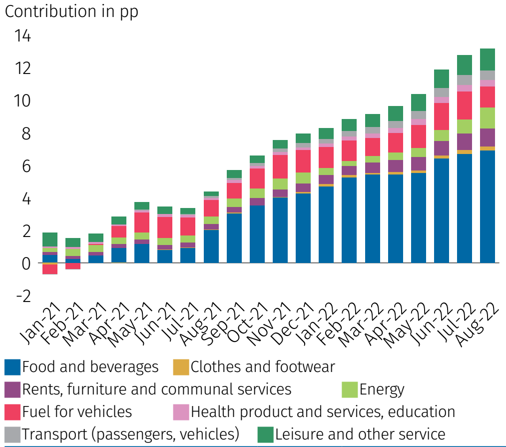
Annual change in percent



Source: Statistics Office.

...mainly because of food prices.

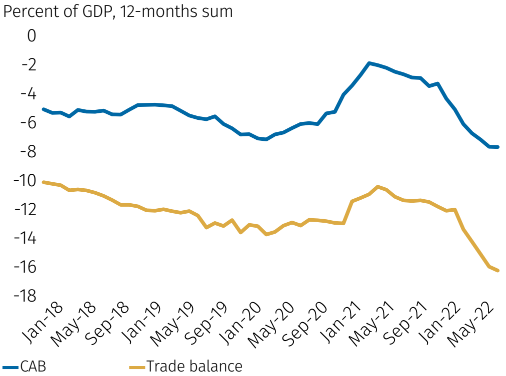
Contribution in pp



Source: Statistics Office.

The CAD and trade deficit recently started to increase...

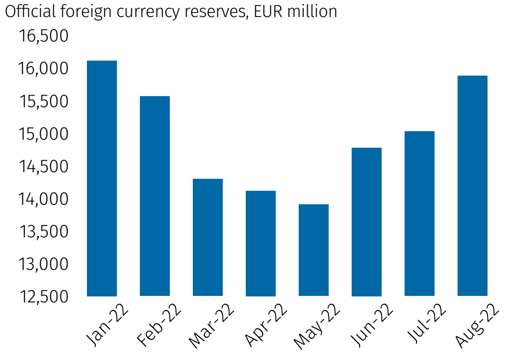
Percent of GDP, 12-months sum



Source: National Bank of Serbia.

...but reserves recovered as of June.

Official foreign currency reserves, EUR million



Source: National Bank of Serbia.

SERBIA Selected Economic Indicators	2019	2020	2021	2022e	2023f	2024f
Real GDP growth (percent)	4.3	-0.9	7.4	3.2	2.7	2.8
Composition (percentage points):						
Consumption	2.9	-0.9	5.7	3.5	3.2	3.1
Investment	4.0	-0.1	3.8	1.5	0.9	0.9
Net exports	-2.6	0.1	-2.1	-1.7	-1.4	-1.2
Exports	4.1	-2.3	10.3	4.7	3.3	3.4
Imports (-)	6.7	-2.4	12.4	6.4	4.7	4.6
Consumer price inflation (percent, period average)	1.9	1.6	4.0	11.5	9.2	3.7
Public revenues (percent of GDP)	42.0	41.0	43.3	43.1	43.0	42.9
Public expenditures (percent of GDP)	42.2	49.0	47.4	47.1	45.7	44.6
Of which:						
Wage bill (percent of GDP)	9.5	10.5	10.0	10.0	10.2	10.3
Social benefits (percent of GDP)	14.4	14.7	13.6	14.0	14.0	14.2
Capital expenditures (percent of GDP)	4.9	5.3	7.4	7.2	6.7	6.6
Fiscal balance (percent of GDP)	-0.2	-8.0	-4.1	-4.0	-2.7	-1.7
Primary fiscal balance (percent of GDP)	1.8	-6.0	-2.4	-2.2	-0.7	0.2
Public debt (percent of GDP)	48.8	53.9	53.9	52.8	53.2	51.8
Public and publicly guaranteed debt (percent of GDP)	52.8	57.8	57.1	58.1	58.1	56.5
Of which: External (percent of GDP)	30.3	33.4	37.0	38.0	40.0	40.0
Goods exports (percent of GDP)	35.7	34.4	38.9	36.2	35.6	36.1
Goods imports (percent of GDP)	47.9	45.5	50.0	51.7	50.0	48.5
Net services exports (percent of GDP)	2.3	2.4	2.7	2.3	1.9	2.3
Trade balance (percent of GDP)	-9.9	-8.8	-8.5	-13.2	-12.5	-10.1
Net remittance inflows (percent of GDP)	5.6	4.5	4.7	4.3	4.0	3.8
Current account balance (percent of GDP)	-6.9	-4.1	-4.4	-10.2	-9.4	-7.9
Net foreign direct investment inflows (percent of GDP)	7.7	6.3	6.8	5.5	5.8	5.6
External debt (percent of GDP)	61.8	65.8	68.5	67.1	63.2	61.0
Real private credit growth (percent, period average)	6.9	9.2	3.7	—	—	—
Nonperforming loans (percent of gross loans, end of period)	4.1	3.7	3.6	—	—	—
Unemployment rate (percent, period average)	11.2	9.7	11.0	9.0	9.1	9.0
Youth unemployment rate (percent, period average)	28.6	27.3	26.6	—	—	—
Labor force participation rate (percent, period average)	52.9	52.2	54.7	—	—	—
GDP per capita, PPP (current international $)	19,025	19,168	21,243	22,901	24,599	26,271
Poverty rate (percent of population)	10.1	10.2	9.8	9.6	9.3	9.1

Sources: Country authorities, World Bank estimates and projections.