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No.19 | Spring 2021

Subdued Recovery

Western Balkans
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WORLD BANK GROUP
Macroeconomics, Trade & Investment

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 Edith Kikoni and Enrique Blanco Armas (Task Team Leaders). This issue's core team included World Bank staff working on the Western Balkan countries (with additional contributions to specific sections): Christoph Ungerer, Nicolo Dalvit (Growth section), Sanja Madžarević-Šujster, Filip Jolevski (Labor section), Trang Nguyen, Ana Maria Oviedo, Leonardo Lucchetti (Poverty section), Milan Lakićević, Besart Myderrizi (Fiscal section), Hilda Shijaku (Monetary section), Johanna Jaeger (Financial sector section), Sandra Hlivnjak (External section), Lazar Šestović (Outlook section) and Tania Ghossein, Sylvia Solf and Ahmed Nauraiz Rana (Spotlight). Additional contributions were made by: Stefanie Koettl-Brodmann (Spotlight); Collette Wheeler (Outlook Section); Carlos Gustavo Ospino Hernandez (Poverty section); Alena Kantarovich, Alper Oguz, Gunhild Berg, Keler Gjika and Qianye Zhang (Financial sector section) and Marc Schiffbauer and Asli Senkal.

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

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Subdued Recovery

1. Overview

In 2020 COVID-19 plunged the Western Balkan countries, like the rest of the world, into deep recession. Economic activity contracted by an estimated 3.4 percent—the worst downturn on record. The primary causes were the drop in both domestic and foreign demand and disruptions in supply chains, especially early in the year when activity in a number of sectors simply shut down. Countries like Montenegro that have a services or tourism-oriented economy, and those where more stringent containment measures and lockdowns were imposed fared the worst. The economy began to reactivate in Q3 2020, supported by a partial easing of stringent lockdowns and the revival of global demand as vaccine development advanced. However, in late 2020 restrictions were renewed in response to a resurgence of infections across most of the region; they have kept the recovery subdued.

The crisis has led to significant job losses and interruptions in welfare improvements, but the labor market is rebounding from the troughs of the recession. As noted in the Fall 2020 *Regular Economic Report* (RER), the pandemic halted a decade of progress in boosting incomes and reducing poverty: Since its start 139,000 jobs have been lost and between 165,000 and 336,000 people in the region were pushed into poverty. However, job support schemes and other government measures limited the labor market fallout and helped to prevent steeper spikes in poverty. By yearend, the labor market had recovered half its pandemic losses, but large numbers of people are still unemployed, and many dropped out of the labor force discouraged by the poor economic prospects. Moreover, workers with less education, women, youth, those in contact-intensive sectors, and those informally employed have suffered disproportionate livelihood and income losses.

In the near term, the recovery is expected to gather momentum, powered by vaccine rollout. The recovery, which has been dampened by a resurgence of COVID-19 cases, is expected to strengthen in the second half of the year as vaccinations continue and confidence, consumption, and trade gradually improve. Economic activity is expected to expand 4.4 percent in 2021 but it will still be about 6 percent lower than its pre-pandemic trend. In 2022 and 2023, growth is likely to moderate to 3.7 percent, weighed down by lingering damage from COVID-19, such as depressed investment particularly in contact-intensive industries and prolonged spells of unemployment.

However, a number of downside risks could still derail the economy. The pandemic could again accelerate, and further delays in vaccine deployment could limit the scope for its durable containment. Even if the pandemic is brought under control, damage to the economy could persist for longer than expected. Throughout the region, but especially in Montenegro and Albania, debt has increased and, although banking systems in the Western Balkans are generally well capitalized, a protracted pandemic could draw out recovery enough to erode bank buffers. Moreover, if policy support is withdrawn before the recovery takes firm root, bankruptcies of illiquid but still viable firms could mount, leading to further losses of jobs and income. Widespread social discontent and political instability could also complicate any resurgence in economic activity.

On the other hand, improved pandemic management could lead to stronger-than-expected growth, aided by a rapid rollout of vaccines which could trigger a surge in consumer confidence and unleash pent-up demand. A speedy recovery in the EU would also help confidence and boost exports. The exceptionally uncertain near-term outlook underscores how policy makers will have to keep raising the likelihood of better outcomes while warding off worse ones.

Policy efforts in the region therefore need to stay tightly focused on fighting the pandemic, limiting social damage, and nurturing recovery. Infection rates remain high and, except for Serbia, countries in the region have faced difficulty in procuring and distributing vaccines. Until they are widely available, strategies to contain the spread of COVID-19 effectively will be critical. All countries should ensure that their health care systems are adequately resourced. This means securing enough funding for vaccine purchases and distribution, testing, therapies, personal protective equipment, and investment in health care facilities. Public health efforts should continue to be reinforced with well-designed economic policies tailored to each country's epidemiological situation. Where infections surge and lockdowns are required, economic policy should continue to cushion losses of household income with well-targeted measures and provide support to firms suffering the consequences of mandated restrictions on their activity. As infections edge down and activity begins to normalize, targeted support should be gradually withdrawn, and policies should instead provide stimulus to support the recovery. Near-term policies to support the economy should also advance the medium-term objective of moving economies to paths of resilient and equitable growth. Among priorities should be education spending to remedy the setbacks to human capital accumulation, digitalization and other infrastructure investment to boost productivity growth, and green investment to accelerate the necessary transition to lower carbon dependence.

Because the pandemic and the government responses have caused major fiscal pressures, as recovery takes hold, throughout the region rebuilding fiscal sustainability will be a high priority. Falling revenues and rising spending needs together have strained fiscal balances. In 2020 all Western Balkan countries authorized massive economic packages; as a result, deficits in all six countries deteriorated drastically, reaching 6 to 8 percent of GDP for most and 11 percent for Montenegro. In 2021 deficits will stay high (although not as high as in 2020) because of continuing sizable budget needs, including for vaccine deployment; and public and publicly guaranteed debt will reach 64.7 percent in North Macedonia, 77.3 percent in Albania, and 93.8 percent in Montenegro. Throughout the region, tighter fiscal policy and vigilant debt management is central to ensuring committed—and ultimately accelerated—debt reduction once the health and economic crises caused by the pandemic are brought under control.

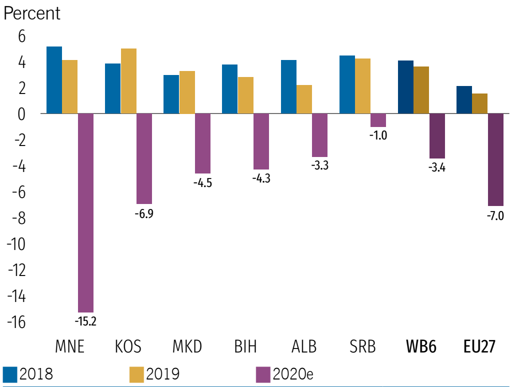
2. The Western Balkans endured a severe recession

The global COVID-19 pandemic severely disrupted economic activity across the Western Balkans in 2020, plunging the region into recession. Following the tight initial lockdowns of economic activity in Q2, in Q3 economies showed signs of recovery as restrictions were relaxed and tourism and other economic activity picked up. Although in Q4 infections rose again, the impact of this second wave of the pandemic was attenuated by higher public spending and less drastic lockdown requirements. As a result, aggregate growth in the region is estimated at -3.4 percent, 1.4 percentage points (pp) higher than was forecast in October 2020 in the Fall issue of this publication (Figure 2.1). This mirrors developments in much of the rest of the world: economies weathered the 2020 pandemic disruptions better than had been expected.

General trends for the region mask significant differences between countries. Albania, Kosovo, and Serbia outperformed the Fall 2020 forecast, though growth in the other three countries fell short of expectations (see Box 2.1 for discussion on revisions to the forecast throughout the crisis). Uncertainty remains high, with the region currently dealing with a third wave of the pandemic, and vaccine rollout is still at a very early stage in all countries but Serbia. In Q1 2021 restrictions on economic and social activity are still in place. With the global economy still grappling with disruptions caused by the pandemic, there seems little scope for a more robust recovery early in 2021.

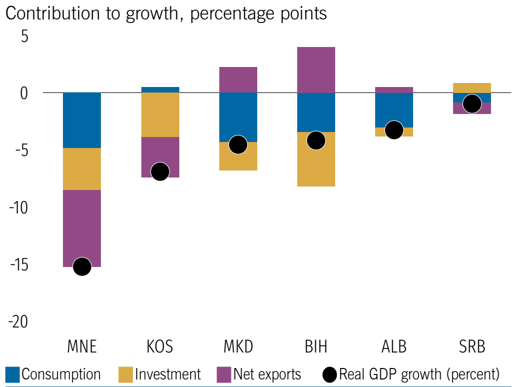
The recession was particularly severe in countries that rely on tourism and that were unable to adopt sufficiently large stimulus packages. Montenegro was the WB6 country hardest hit: it suffered a 90 percent collapse in tourism that drove the contraction of the entire economy, estimated at 15.2 percent for 2020. Serbia and Albania were able to outperform earlier growth expectations, thanks in part to a major stimulus package in the former and resumption of post-earthquake reconstruction in the latter. The economy in Kosovo is

Figure 2.1. The COVID-19 pandemic caused deep recessions in the Western Balkans.



Source: National statistical offices and World Bank staff estimates.

Figure 2.2. The economic contraction affected all components of aggregate demand.



Source: National statistical offices and World Bank staff estimates.

estimated to have contracted by 6.9 percent, but a substantial public support program helped avoid a deeper recession. Growth in North Macedonia and BIH was somewhat lower than expected, due to a strong second wave of COVID-19 infections.

A drop in private consumption was a major driver of economic contraction (Figure 2.2). Private consumption fell across the region as households cut spending on goods and services due to social distancing restrictions and general uncertainty about the future. As stimulus packages were adopted, public consumption increased, partly offsetting the drop in private consumption. Except for Kosovo, however, the additional public consumption was not enough to compensate for the plunge in private consumption, so that aggregate consumption fell, subtracting from aggregate growth in the region.

The uncertainty and economic disruption caused by the pandemic caused a major drop in private investment. Public investment went up across half of the region as part of an effort to stimulate the economy and minimize the magnitude of the economic downturn. This increase was particularly significant in Serbia, where a large government stimulus program more than offset the slump in private investments.

The disruptions to travel and international trade, coupled with a drop in domestic demand, reduced both imports and exports of goods and services. In Montenegro, Kosovo, and Serbia exports dropped more than imports and the decline in net exports subtracted from aggregate growth. The decline was particularly big in Montenegro, where the collapse in foreign tourism had a major impact on the net service trade account. The decline in net exports was the primary contributor to Montenegro's recession, accounting for a 6.7 pp drop in its economy's growth rate.

Among economic sectors, services suffered the most from social distancing restrictions. Tourism was particularly hard hit—across the region, foreign tourist stays collapsed. Wholesale and retail trade shrank, and in most countries it was unable to recover even in Q4 of 2020. Industry and construction were devastated during the first wave of the pandemic but started to recover in Q3 and Q4. Construction recovered particularly well in Albania thanks to the post 2019 earthquake reconstruction effort. Financial sectors so far have held up well, showing no major sign of stress, but the situation might worsen when fiscal and monetary support is eased.

A nascent recovery emerged but activity has since moderated. Following the slump in second-quarter output (down by 10.1 percent on a quarterly basis), Western Balkan economies experienced a firm bounce in the third quarter (up by 7.8 percent) as lockdown measures were lifted. Output was broadly stable in the final quarter, albeit amid a weakening trend as a spike in coronavirus cases late in the year led to a renewed tightening of restrictions. Key real sector indicators such as exports of goods, retail sales and manufacturing maintained positive but moderating trends in January 2021 mostly driven by a continued recovery of external demand, as well as private consumption.

Box 2.1. Forecasting growth in times of crisis.

The COVID-19 pandemic was an unexpected and unprecedented shock for the global economy. While in recent years some experts had warned policy makers of the risk of pandemics, no one could have predicted with certainty that in 2020 one would spread throughout the world. When producing forecasts of economic growth economists like to think about the main risks to the forecasts and how they could affect growth, but predictions in late 2019 about 2020 growth did not include the spread of a global pandemic that would bring most economies into deep recession.

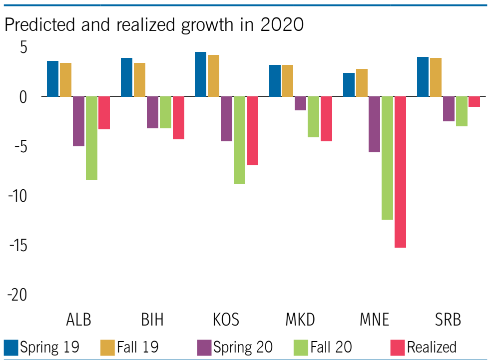
News of a new virus started to emerge in January and February 2020 and by the time predictions in the 2020 spring edition of this report were formulated, the pandemic had struck much of the world, forcing many countries to impose lockdowns and other social distancing measures. What would happen next was highly uncertain, with little information available on the nature of the virus and on the likely duration of the pandemic. Optimistic scenarios hoped for it to end by late Spring, but experts warned that it could last much longer.

In Europe, the drop in new infections over the summer fed hopes of a quick way back to normal, but expectations cooled in late September when infections again rose. Uncertainty over the strength and length of this second wave of infections and over the speed of vaccine rollouts was high when predictions for the 2020 Fall issue were drafted. New infections have since surged in the Western Balkans and, except in Serbia, vaccination has been limited, drastically narrowing the scope for a recovery in Q4 2020 and Q1 2021.

Looking back at the past year or so gives a good overview of the challenges forecasters have had to deal with recently. While demand for guidance was high, unprecedented levels of uncertainty made predicting the future more and more difficult. Economic forecasting is usually based on a mix of theory and past empirical evidence, but it ultimately must rely on expectations about future uncertain events. When uncertainty increases, so does the complexity involved in articulating expectations. Similarly, incorporating into forecasting exercises low probability "tail" events like market crashes, natural disasters, and pandemics is intrinsically challenging because such events can hardly be incorporated into "best guess" scenarios until they hit the economy. The manifestation of an unlikely and unpredictable event such as the current pandemic and the rise in uncertainty it caused thus represented an extreme circumstance, and a challenging test for forecasters.

Review of past RER forecasts for the Western Balkans region confirms that differences between predicted and realized growth tend to be larger when aggregate growth is less stable, usually around recessions when unexpected shocks are realized in the economy[1]. The left panel in Figure B2.1.2 plots the deviation between forecasted and realized growth for same-year forecasts since 2013 (y-axis). Deviations for a given year t are

Figure B2.1.1. The pandemic led to a major shift in growth expectations.



Source: Data from World Bank RERs.

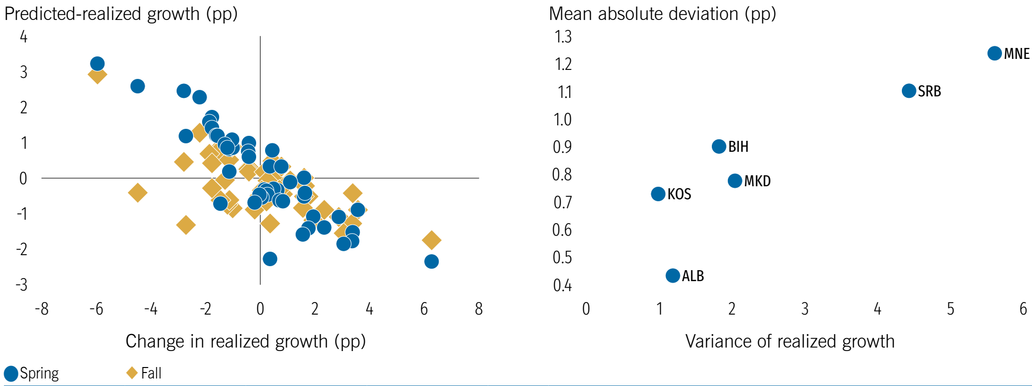
Note: The graph shows data from the World Bank growth forecasts for 2020 made in the Spring 2019, Fall 2019, Spring 2020, Fall 2020, as well realized growth in 2020. Growth forecasts from 2019 are based on forecasted GDP for both 2019 and 2020. Growth forecasts from 2020 are based on realized GDP in 2019 and forecasted GDP in 2020.

Box 2.1 continued

plotted against a simple measure of instability in realized growth: the difference between growth at *t* and growth at *t-1* (x-axis). The panel shows a positive relation between these two variables, suggesting that larger changes in the growth rate of an economy were associated with larger deviations between predicted and realized growth.

Similarly, disaggregation by countries in the region suggests that correctly predicting growth tends to be more difficult when the economies are more volatile. The right panel in Figure B2.1.2 plots the mean absolute deviation between predicted and realized growth for same year forecasts for each country in the region between 2013 and 2019 (y-axis), against the variance of each country's realized growth over the same period (x-axis). Figure B2.1.2 displays a positive correlation between these two statistics and shows that absolute deviations between predicted and realized growth tended to be higher in countries experiencing a more volatile growth process.

Figure B2.1.2. Growth is more difficult to predict when the economy is more volatile.



Source: Data from World Bank RERs.

Note: Data are for GDP growth between 2013 and 2019 as forecasted by the World Bank in the Spring and Fall of the same year (e.g. growth in 2019 as predicted in the Spring of 2019). Deviations are expressed in percentage points. Change in realized growth is calculated as the difference between realized GDP growth in year *t* and in year *t-1*. The right panel pools data from Spring and Fall forecasts between 2013 and 2019 for each country in the region.

While the COVID-19 pandemic has illuminated the challenges of forecasting when uncertainty is high, macroeconomic predictions are nevertheless a useful tool for the policy maker. Besides providing an assessment of likely future economic developments, they can facilitate the policy dialogue between different stakeholders and promote a discussion of each party's expectations about future uncertain events. It will be important for forecasters to take stock of the lessons learned from the current unprecedented period of uncertainty. Supporting a best guess scenario with a more rigorous assessment of the uncertainty surrounding future events can certainly add value for policy makers[2].

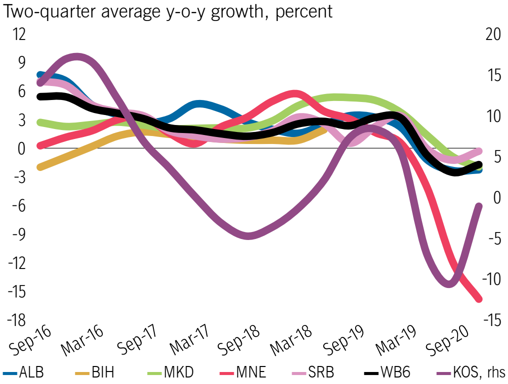
1. Assessments of forecast accuracy done by other institutions usually find ex-post forecast errors to be bigger around recessions. See for example the analyses by the IMF (Genberg, Martinez (2014)), OECD (OECD, 2014), and the European Commission (Fioramanti et al. (2014)).

2. See for example Alessi et al. (2014), Odendahl (2019) as well as some recent works by FED economists on the subject (e.g. Reifschneider, Tulip (2019) and Adams et al. (2020)).

3. The labor market is rebounding from the depths of the recession[1]

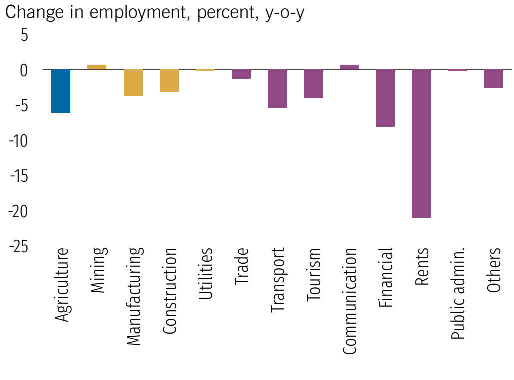
After several years of continuous improvement of labor market indicators, the COVID-19 pandemic swiftly reversed the hard-won gains. However, unprecedented government responses across the region (elaborated in the Fall *Regular Economic Report*) partly alleviated the pandemic's impact. By April 2020, all Western Balkan countries had introduced job retention measures through partial or full compensation for wage costs, in addition to health protection measures, tax relief, guarantee schemes, subsidized credit lines, and social assistance measures. These measures were mostly in place until end-2020, although less intensive and more targeted as economies started recovering. Several countries kept wage subsidies in place even in early 2021. Still, the employment rate (15+) declined, from 44.6 percent in December 2019 to 43.2 percent by end 2020. The largest declines were 7.9 percentage points (pp) in Montenegro and 1.8pp in Albania, where closures and travel bans caused serious damage to tourism. Nevertheless, at 52 percent, Albania still has the highest employment rate in the region; in Kosovo, at the other extreme, only about 30 percent of the working-age population have jobs.

Figure 3.1. Employment plunged but is slowly rebounding.



Source: National statistics offices and World Bank staff estimates.
Note: WB6 excludes BiH given the change in the LFS sample.

Figure 3.2. Most sectors were hit hard and job losses remain in many.



Source: National statistics offices and World Bank staff estimates.

In 2020 some 69,900 jobs were lost in the Western Balkans[2]—in Q2 144,000 jobs disappeared, but almost half were later recovered (Figure 3.1). Most of the losses were in tourism; Albania and Montenegro account for most of the losses. In Q3, employment rebounded in Albania, with tourism and reconstruction partly absorbing losses in manufacturing jobs. However, most new jobs

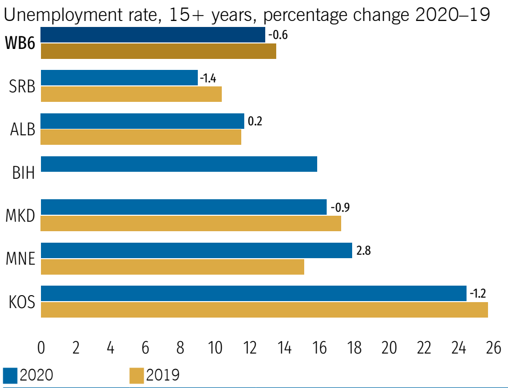
1 This analysis was affected by (1) delays in publishing Q4 2020 Labor Force Survey (LFS) data in Kosovo; and (2) a sampling revision in Bosnia and Herzegovina that improved labor market indicators in 2020 but made them no longer comparable with previous LFS data. Using administrative employment and unemployment data helped approximate what happened with labor in Q4 2020 in Kosovo.

2 This is without BiH, which given the change in the LFS sample saw a rise in the number of employed.

could not compensate for the earlier losses; In Montenegro, employment fell to a 7-year low, with losses primarily in tourism, construction, transport, manufacturing, and trade, and it has yet to rebound. Loss of jobs in the Western Balkans was greatest in construction, manufacturing, hotels and restaurants, trade, and transport (Figure 3.2), but by yearend several of these sectors had almost recovered, especially construction, which saw more activity throughout the region except in Montenegro. The ICT industry weathered the crisis well and became an important employer in Serbia and North Macedonia. Except in Kosovo and Montenegro, public sector employment grew in the region, cushioning the pandemic's impact but increasing the size of the already relatively large public sector in the Western Balkans.

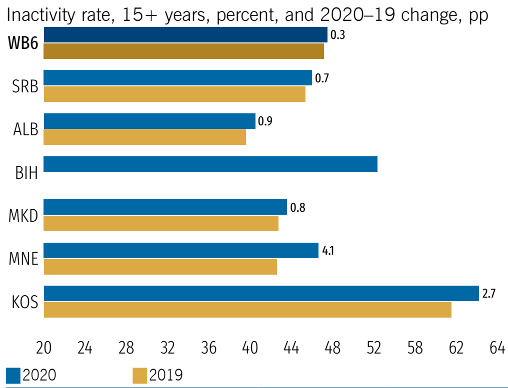
Although unemployment in the Western Balkans declined in 2020, the job losses disproportionately affected young people. Average unemployment was estimated at 12.9 percent, down just 0.6 pp from 2019, but youth unemployment rose to 33.6 percent, up 1.4 pp compared to 2019 and disrupting the 5-year declining trend. Except in Albania and Montenegro, in 2020 unemployment rates had declined across the Western Balkans (Figure 3.3). In Montenegro, the government provided wage subsidies and one-off cash transfers that helped to avoid even larger layoffs and increases in poverty, though vulnerable workers in the informal sector may not have received enough support. In Kosovo, according to administrative data from employment centers, unemployment increased as more people who were employed informally officially registered as unemployed to be eligible for certain pandemic policy measures. In North Macedonia, in Q2 at the peak of the crisis the unemployment rate had initially increased to 16.7 percent, but the government job retention subsidy program managed to contain the fallout and the rate slipped back to 16.4 percent (0.9 pp below 2019). Serbia's labor market showed resilience: In 2020 unemployment reached a record low of 9 percent, although youth unemployment kept rising until Q4, when it reached 32.4 percent, its highest level since Q1 2018. The NEET

Figure 3.3. Unemployment rates declined across the region, except for Albania and Montenegro...



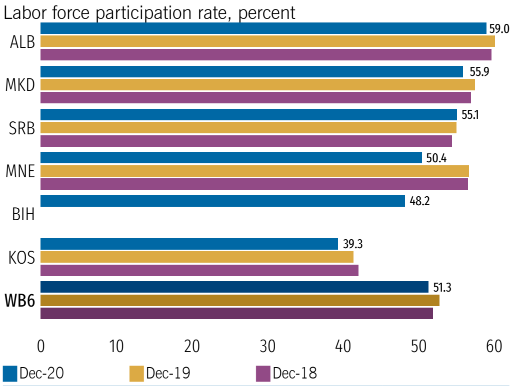
Source: National statistics office and World Bank staff estimates.
Note: A sampling revision in BiH improved labor market indicators in 2020 but made them incomparable with the previous releases of the LFS.

Figure 3.4. ...as people moved to inactivity.



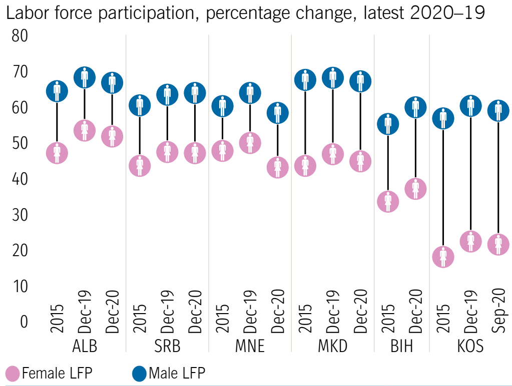
Source: National statistics office and World Bank staff estimates.
Note: A sampling revision in BiH improved labor market indicators in 2020 but made them incomparable with the previous releases of the LFS.

Figure 3.5. Labor participation declined sharply...



Source: National statistics office and World Bank staff estimates.
Note: A sampling revision in BiH improved labor market indicators in 2020 but made them incomparable with the previous releases of the LFS.

Figure 3.6 ...as more women moved to inactivity.



Source: National statistics office and World Bank staff estimates.
Note: A sampling revision in BiH improved labor market indicators in 2020 but made them incomparable with the previous releases of the LFS.

(Not in Education, Employment or Training) rate in Serbia amounted to 17.6 percent in Q4, up 1.8 pp relative to the same period in 2019.

However, except in Serbia the improvement in the unemployment rate was not due to more people having jobs but to a rise in inactivity (Figure 3.4).[3] The rise was largely due to unemployed people giving up their job search temporarily because the economic prospects were so poor, which removes them from the labor force. It was also driven by people retiring or emigrating abroad as seasonal workers. By yearend there were 121,000 more people inactive than in 2019, and 138,000 fewer people in the labor force. The inactivity rate in Kosovo again topped 60 percent. For the entire region, the labor force participation rate dropped by 1.5 pp to 51.3 percent—the lowest level since 2016, with women being more affected. While at end-2019 the labor force participation rate had gone up by 0.8 pp to 52.8 percent, mostly due to women entering the labor market, in 2020 the situation swiftly deteriorated (Figure 3.5). The largest declines were 6.2 pp in Montenegro and 2.1 pp in Kosovo. Female labor force participation fell to 40.8 percent for the region, although with large variations, from 51.6 percent of women participating in Albania to 21.5 percent in Kosovo (Figure 3.6). Serbia's labor market held up reflecting the magnitude of the country's policy response, less stringent pandemic restrictions and the structure of its economy: participation of men in the labor market rose 0.5 pp in 2020, and the female participation rate showed the smallest decline in the region.

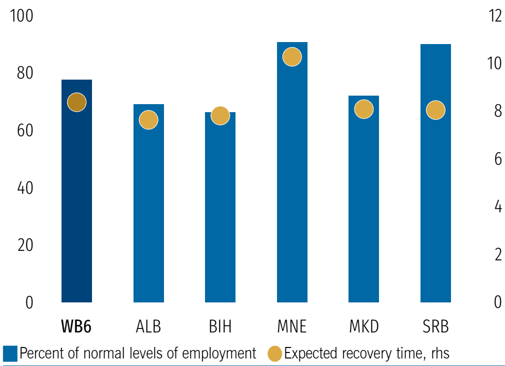
The pandemic's impact on the labor market has so far been cushioned by government support packages, though lagged effects are expected in 2021. Though the labor market now seems to be recovering, its pace will depend on how fast the economies in the region return to pre-crisis growth and how stable the recovery path is to encourage firms to start new hiring. However, the epidemiological situation remains difficult in the Western Balkans; some countries are reintroducing partial lockdowns, and except in Serbia vaccination rollout has been delayed and is still slow. This may prevent

3 The employment rate in Bosnia and Herzegovina increased by 3.8 pp but annual comparisons are hampered by a significant sampling revision.

a swift recovery of output and employment, especially in countries heavily dependent on seasonal tourism. Employment support programs have been extended in several countries, but with coverage more targeted than in earlier rounds because fiscal space has diminished. As these programs are scaled down, the employment adjustment will likely intensify, and recovery of the labor market may lose momentum. Moreover, if the pandemic is prolonged, delaying recovery of output, the programs would not prevent a more pronounced weakening of the labor market.

While some firms have adjusted to the new normal, many others expect a long recovery period and others are concerned about some permanent scarring. Close to 80 percent of businesses in the Western Balkans are at normal levels of employment (Figure 3.7), largely due to the wage subsidy support. However, firms do not expect a recovery of both sales and employment until at least eight months from the time the Enterprise Survey Update was conducted.[4] This is similar to the average expectation of the length of the recovery period for EU member countries.[5] Albania is the WB6 country that is most optimistic about a quick recovery; Montenegro and Serbia expect a much slower return to normalcy. However, a significant number of firms in the region do not expect to return at all to their previous level of sales. As elsewhere in the world, much of the labor market rebound in the region has consisted of temporarily furloughed people returning to their jobs and in-person services reopening after shutdowns. The remaining lost jobs, most formerly held by workers who have permanently lost their jobs, will be harder to replace.

Figure 3.7. Expectations for the return to normalcy.



Source: World Bank Enterprise Survey Follow-up on COVID-19.

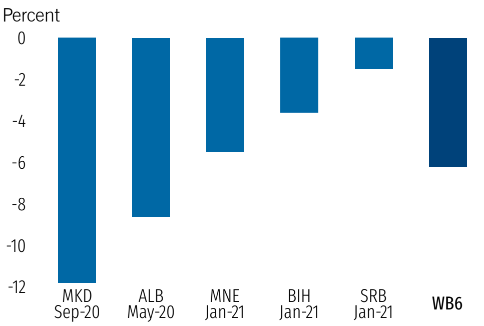
4 The Enterprise Surveys (ES) Follow-up was conducted in 2019 and between May 2020 and January 2021 for all Western Balkan countries except Kosovo, for which the Business Pulse Survey was carried out in June and July 2020, to gauge the economic impact on April 2020, compared to the same period the previous year. The objective was to check how firms were dealing with the crisis. The ES are nationally representative of privately owned firms with 5 or more employees operating in manufacturing and most services sectors. The weighting of the follow-up surveys were adjusted to account for any non-response to the survey.

5 The COVID-19 Follow-up on the Enterprise Survey was carried out in the following 16 EU member countries, which are used as a comparator: Bulgaria, Croatia, Cyprus, Czech Republic, Estonia, Greece, Hungary, Italy, Latvia, Lithuania, Malta, Poland, Portugal, Romania, Slovak Republic, Slovenia.

Box 3.1. Private sector employment and COVID-19.

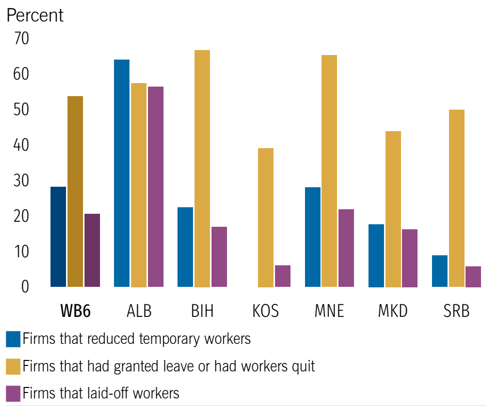
Since the outbreak of the COVID-19 pandemic, employment in privately-owned firms in the Western Balkans has been starkly affected. On average, private sector employment levels dropped by about 6 percent since December 2019. The largest falls were about 9 percent in Albania and 12 percent in North Macedonia. So far only in Serbia has aggregate employment almost returned to the pre-crisis level (Figure B3.1). However, Serbia also has the highest share of businesses that closed permanently, indicating employment adjustments on the extensive margin, unlike Albania and North Macedonia, where adjustment has been on the intensive margin.

Figure B3.1. Change in employment since COVID-19 broke out.



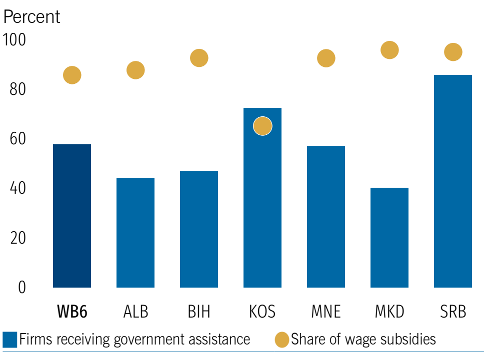
Source: World Bank Enterprise Survey Follow-up on COVID-19.

Figure B3.2. Labor adjustment in firms.



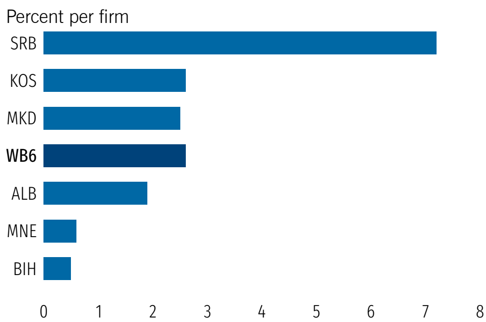
Source: World Bank Enterprise Survey Follow-up on COVID-19 and Business Pulse Survey in Kosovo.

Figure B3.3: Firms Receiving Assistance.



Source: World Bank Enterprise Survey Follow-up on COVID-19 and Business Pulse Survey in Kosovo.

Figure B3.4: Remote Workers.



Source: World Bank Enterprise Survey Follow-up on COVID-19 and Business Pulse Survey in Kosovo.

Beyond the erosion of permanent jobs in the private sector, businesses across the region have seen more workers taking leave or quitting. Moreover, rather than laying off permanent workers, nearly 30 percent of businesses have reduced the number of temporary workers, one of the most vulnerable groups, who also often lack social safety nets (Figure B3.2). In Albania close to 66 percent of businesses have cut temporary workers, though 56 percent also had to lay off workers; at the more

Box 3.1 continued

positive extreme, in Serbia and Kosovo only about 6 percent of businesses laid off workers. The biggest adjustment to the labor force in terms of leave granted or workers quitting has been in Bosnia and Herzegovina.

On average, about 58 percent of businesses in the region have received some form of government assistance to protect employment (Figure B3.3). The predominant form of assistance has been wage subsidies, which went on average to 92 percent of firms that received assistance. North Macedonia, while having the lowest share in the region of businesses that received government support, placed the most emphasis on wage assistance, Kosovo the least.

The crisis changed the way people in the region work. Around the world remote work has been one adjustment mechanism for businesses to adapt to mass closures. In the Western Balkans, however, only an average of 3 percent of workers in private sector firms works remotely (Figure B3.4). In North Macedonia, 84 percent of firms indicated that they have no capacity for remote work. In Serbia, which is leading the region, about 7 percent of workers on average work remotely, which is about the EU average, but in Montenegro and Bosnia and Herzegovina only about 0.5 percent do so.

4. Government responses softened the economic and poverty impacts of the pandemic

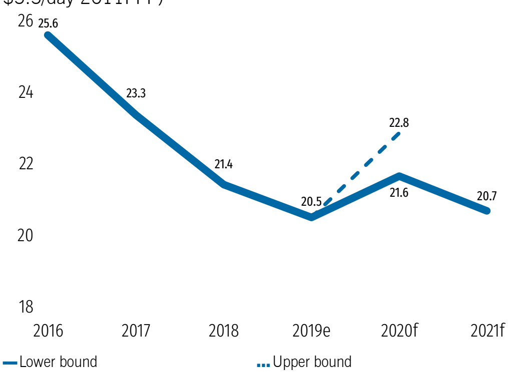
Welfare improvements in the Western Balkans were interrupted in 2020 as the COVID-19 crisis pushed economies into recession. Poverty reduction in the region came to a halt, and poverty[6] increased by an estimated 1.1 percentage points (pp), equivalent to about 165,000 new poor (Figure 4.1). A more conservative projection, based on detailed microsimulations of shocks and policy responses in all countries (Box 4.1 describes the two methods), suggests an increase of about 2.3 pp, or 336,000 new poor in the region (similar to our projection in the Fall 2020 issue).

The estimated impacts of COVID-19 on poverty varied across the Western Balkans, reflecting the considerable variation in economic impact. Projected changes in poverty vary by country in line with the depth of the recession, in both lower-bound estimates using sectoral GDP growth and upper-bound estimates, which are based on more complex microsimulations (see Box 4.1). In 2020 Serbia had the smallest estimated poverty increase (0.1 pp); the estimated increase in poverty for Kosovo was 3.9 pp and for Montenegro 5.5 pp. A more conservative estimate for Albania and North Macedonia is an increase in poverty of about 4 pp in both. In most WB6 countries, poverty went up because of a steep drop in the incomes of urban households close to the poverty line working especially in construction, services, and manufacturing.

Government responses to the crisis mitigated job destruction and provided some relief to workers newly unemployed. Governments across the region introduced stimulus measures to protect employment and incomes, among them expanded social assistance benefits, extended unemployment insurance, wage subsidies, and social security contributions for private firms. As a result, except for Montenegro, the region's labor market appears to have suffered less than expected (see the Labor section). Incorporating in the simulations response measures that can be directly mapped to the household surveys shows that they

Figure 4.1. In 2020 between 165,000 and 336,000 more people in the region may have become poor.

Poverty headcount (percent of population living on less than $5.5/day 2011PPP)



Source: World Bank simulations based on 2018 income data from the Survey of Income and Living Conditions (SILC) for North Macedonia; 2017 SILC income data for Albania, Montenegro, and Serbia; and 2017 Household Budget Survey (HBS) data 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 revised 2011 PPPs. The regional estimate excludes BiH due to lack of comparable data. Upper bound denotes the more conservative estimates for Albania and North Macedonia. See Box 4.1 for a description of the methodology.

6 In this section, poverty is defined as a person living on less than $5.5/day in revised 2011 purchasing power parity (PPP), with the exception of Bosnia and Herzegovina (BiH) due to lack of comparable data. In May 2020, the 2011 PPPs were revised (https://openknowledge.worldbank.org/bitstream/handle/10986/33623/9781464815300.pdf), resulting in revised estimates of poverty at $5.5/day. This revision reflects a reassessment of cost-of-living comparisons between countries but does not imply a real change in poverty within countries.

mitigated the impact on households and firms and helped to curtail poverty increases. Still, despite a large fiscal impact, these measures were not always effective in protecting the incomes of the vulnerable, especially those working in the informal sector. To strengthen protection against future shocks, alternative targeting mechanisms and more flexible and adaptive safety net systems will be important so as to cover a larger portion of new poor and vulnerable populations and reduce negative impacts on poverty cost-effectively.

Box 4.1. Estimating poverty without timely microdata.

For this issue of the *Regular Economic Report*, the World Bank used two methods to estimate the potential poverty and distributional impact of the COVID-19 pandemic in 2020 and the possible recovery in 2021: (1) projections based on sectoral GDP growth and (2) detailed microsimulation of shocks and policy responses.

For all Western Balkan countries, poverty in 2019 is estimated based on household survey data from previous years and constant GDP growth, assuming low (0.7), medium (0.87), or high (1.0) country-specific passthrough rates. The poverty impact of the pandemic in 2020 is based on the following two methods:

1. **GDP method**
   To model heterogeneity in income changes in 2020, labor income is assumed to change at the same rate as GDP in three sectors: agriculture, industry, and services. This method does not model any change in private transfers. It provides a lower-bound poverty projection in that it assumes that all wages were equally affected and therefore ignores inequality effects within each sector.

2. **Detailed microsimulation**
   This method considers the first-order approximation of the impact of the COVID-19 pandemic in 2020, by sector and employment type. Sectors are classified as highly impacted, moderately impacted, and relatively unimpacted by mobility and business restrictions. Further, the self-employed are assumed to have suffered an income shock twice as large as that of wage employees. Three scenarios are created for the duration of the crisis (1, 2, and 3 quarters) and the scenario that is most likely to reflect the observed severity of the crisis at the macro level is reported. It is assumed that annual private transfers were reduced by 10 percent to capture the shock to non-labor income. Finally, this detailed microsimulation considers the mitigating effect of selected government response measures.

Dimensions of Income	GDP method	Detailed Microsimulation (1, 2, 3 quarters of income loss)
Labor income		
• Sector of activity	Labor income falls at same rate as projected GPD for the sector	Differentiated impact according to lockdown and demand changes
• Type of worker	No distinction	Self-employed workers suffer a shock twice as high as wage workers
Non-labor income	No change	Annual private transfers reduced by 10 percent

Despite the continued uncertainty over the vaccine rollout and the end of travel restrictions, the recovery expected in 2021 should help reduce poverty slightly if labor markets remain stable. For 2021, poverty reduction of about 0.9 pp (equivalent to 139,000 people) is forecast for the region, based on the expected recovery of output, especially in industry and services. Given the seemingly large mitigating effect of the stimulus measures on jobs, the extent of poverty reduction will depend on whether the labor market remains relatively stable and employment creation resumes, including for low-skill jobs, as support measures are phased out. As fiscal space will remain limited for some years, promoting inclusive job creation and increasing the efficiency of social assistance to reach and support the most vulnerable will be cost-effective ways to ensure continued poverty reduction in a resilient recovery. Addressing any potential human capital losses due to disruptions in education and health, particularly for poor and vulnerable groups, will be important to avoid exacerbating inequality and limiting future social mobility.

Poverty developments by country

Albania: Albania has the largest poverty headcount in the Western Balkans; about one-third of its people live on less than US$5.5 per day (in 2011 PPP). Unemployment is structurally high in the country, hovering around 12 percent of the labor force, and it is twice as large for youth (15–24) as for adults (25–64). Between 2014 and 2019 poverty declined slowly, by about 1 pp a year, despite average annual GDP growth of 3 percent. The double shock of the 6.3 Richter-scale-magnitude earthquake that hit the country in November of 2019, followed by the COVID-19 pandemic, erased previous progress on poverty reduction. Government efforts to mitigate income losses through fiscal stimulus included a reconstruction program, higher social assistance benefits, extended unemployment insurance, and wage subsidies for the formal sector. Formal employment had a net increase, whereas total employment fell by 1.8 percent in 2020, showing that the formal sector was more resilient than the informal sector. Meanwhile, labor force participation declined, especially among youth, and unemployment increased steadily since Q2 2020, especially for adults 30–64 years old. In late 2019, monetary poverty and material deprivation increased in the seven municipalities most affected by the earthquake. In 2020, Albania's poverty rate is projected to have increased by 1 pp (28,000 new poor). Our more conservative method for estimating poverty predicts a larger income decline for workers in quintiles 2–4 of the income distribution relative to the standard projection based on GDP (See Box 4.1), resulting in an estimated poverty increase of 4 pp, equivalent to 112,000 new poor.

Bosnia and Herzegovina: The latest available data using the national poverty line of KM 205 per-capita/month is for 2015, when the poverty rate was estimated at 16 percent (very close to the 15 percent estimated for 2011). In 2020, the pandemic caused damage to firms and labor markets. According to official estimates based on administrative data, the number of people in paid employment was down about 2 percent y-o-y in January 2021, and the number of unemployed had gone up by about 2 percent. The slowdown in the economy and the consequent loss of jobs and earnings have eroded household welfare. The policy measures the government introduced to protect firms and households prevented a worse impact on the labor market. As the pandemic loses force in 2021 and the economy gradually recovers, improvements in labor market participation and employment will remain crucial if growth is to translate into poverty reduction.

Kosovo: Thanks to a sustained positive economic performance (per capita growth averaged 3.7 percent annually for 2017–19), the poverty rate fell from 24.4 percent in 2017 to an estimated 21.4 percent in 2019. In 2020, the crisis reversed this positive trend and GDP per capita is estimated to have shrunk by close to 7 percent. Employment sank in Q2 but recovered in Q3; however, working hours were down in the private sector, especially for women. Youth labor force participation has declined further. Poverty is estimated to have gone up by 4–5 pp (70,000 to 90,000 new poor), mainly because of steep job losses in services and industry, despite the fiscal stimulus and a net increase in remittances.

Montenegro: The COVID-19 pandemic reversed 6 years of gains in poverty reduction. COVID-19 containment measures and the collapse of tourism and related services depressed employment and earnings in Montenegro, especially for poorer and low-skill people, who are more likely to depend on seasonal and informal employment. Targeted wage subsidies and one-off cash assistance for vulnerable citizens helped the country to avoid even larger layoffs and increases in poverty, but vulnerable workers in the informal sector might not have received much support. Simulation analysis suggests that poverty increased from an estimated 14.5 percent in 2019 to about 20 percent in 2020.

North Macedonia: The country has considerably reduced poverty since the 2008 global financial crisis. The poverty rate was cut from about 35.8 percent in 2009 to 17.9 percent in 2018, driven primarily by greater employment opportunities and increased labor earnings. Because of the COVID-19 crisis recent progress in reducing poverty is likely to have halted. The government provided a variety of support measures, among them subsidies and social security contributions to private sector firms and cash benefits and vouchers for vulnerable people. These policies to some extent relieved the negative economic and poverty impacts of the COVID-19 crisis. A simulation analysis suggests that in 2020 poverty increased by 1 pp (about 25,000 new poor). The conservative approach for projecting poverty (See Box 4.1) predicts a larger income decline in quintiles 2–5, pushing up poverty by an estimated 4 pp (about 92,000 new poor). As the economy gradually recovers, poverty is projected to resume its decline.

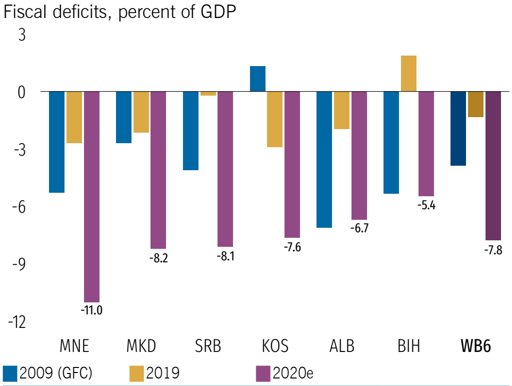
Serbia: In 2020 the COVID-19 pandemic pushed the Serbian economy into a mild recession of -1 percent and interrupted poverty reduction. The government's massive fiscal package of about 13 percent of GDP, including wage subsidies for all sectors and a universal cash transfer, helped to cushion the immediate impacts on the population and the economy. The labor market held up (there were few effects on employment), and agriculture grew by 4.9 percent. As a result, it is estimated that poverty stayed at about 17.4 percent in 2020, close to its 2019 level, and will resume its decline in 2021.

5. Fiscal support continues after unprecedented expansion

The COVID-19 pandemic has been a severe challenge for public finances. In 2020 WB6 countries had to deal with an unprecedented surge in fiscal deficits: the unweighted regional average was an estimated 7.8 percent of GDP—more than 6 percentage points (pp) above pre-pandemic levels (Figure 5.1). Deficits rose throughout the region primarily because of high public spending on crisis-related measures that have helped save lives and livelihoods and mitigated the effects of the pandemic on consumption and output (Figure 5.2). Across the region, most crisis response packages included substantial health sector support, wage subsidies to the most affected sectors, cash transfers to vulnerable households, credit lines with subsidized interest rates or guarantee schemes, both old and new (Albania, BiH, Serbia). To further help SMEs, all countries provided tax deferrals; Albania and Kosovo also introduced VAT exemptions. At a time when economic contraction was also reducing revenues, this support pushed government deficits beyond the levels recorded during the global financial crisis (GFC). The scale of support has varied according to the fiscal space available to each country. For instance, Serbia's successful fiscal consolidation before the crisis allowed it to offer a support package equal to 13 percent of GDP, of which 5 percent of GDP was in the form of loan guarantees and 8 percent of GDP was a range of revenue and expenditure measures. Albania's COVID-19 support was complemented by support for reconstruction after the earthquake.

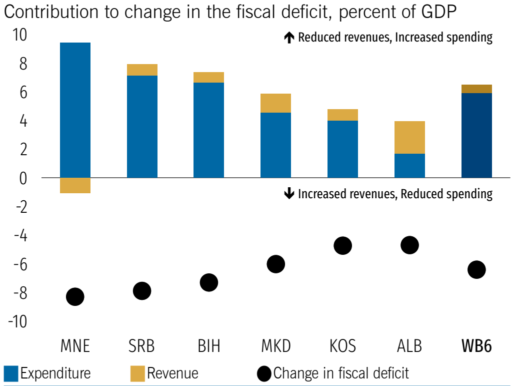
With revenue plummeting, in 2020 public spending made a historic leap, but public investment held back (Figures 5.3 and 5.4). Public revenue in the region averaged a nominal drop of 7.3 percent y-o-y, primarily driven by the contraction in economic activity. Serbia had the smallest drop, despite sizable tax revenue measures, and Montenegro's 13 percent drop was the largest. Public spending increased by an average of 6 pp of GDP y-o-y, above 9 percent

Figure 5.1. Fiscal deficit levels soared beyond levels recorded during the global financial crisis.



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

Figure 5.2. High public spending on crisis related measures drove rising deficits but was accompanied by a slump in tax revenue.



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

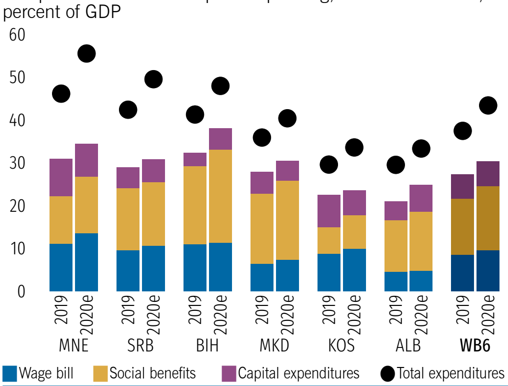
nominally, because of current spending and because of the magnitude of the fiscal stimulus measures adopted to counter the impact of pandemic-induced recession. In Serbia, BiH, and Albania capital spending went up relative to GDP, but elsewhere in the region it dropped, in part because of the emerging need for direct transfers and other current spending, but also because throughout the Western Balkans, capacity to execute capital budgets is chronically low. Spending on social benefits increased by an average of 2 pp of GDP; the rest of the increase can be attributed to wages and direct private sector support measures.

Public and publicly guaranteed (PPG) debt increased as countries ramped up borrowing to finance widening deficits. New borrowing, extension of guarantees to the private sector, and lower GDP are estimated to have pushed up the average PPG debt-to-GDP ratio of the Western Balkan countries by 11 pp to a historic high of 61 percent. And while in 2020 that ratio increased in all countries, only in Serbia and BiH have PPG debts been held below their historic peaks (Figure 5.5). Montenegro saw an increase in gross PPG debt of almost 30 pp in 2020, but to a large extent this can be explained by a very strong contraction of GDP (15.2 percent) and the Eurobond placement of €750 million (18 percent of GDP), which has been used to repay debt due in 2021 and is estimated to fully cover the 2021 financing needs. The PPG debt-to-GDP ratio of Albania rose to 77 percent of GDP and North Macedonia's to 60 percent—both rising about 10 pp. North Macedonia's debt rose also because the debt of its SOEs did. Kosovo's ratio hit a record high 23 percent of GDP but is still the lowest in the region. All Western Balkan countries except Serbia received support from the IMF Rapid Financing Instrument, which was used to leverage Macro-Financial Assistance (MFA) from the EU.

The crisis has temporarily reversed improvements made in recent years in bringing down external debt. Eurobond issues and international loans coupled with multilateral financing have covered a large share of the financing needs of Western Balkan countries but have pushed up external PPG debt

Figure 5.3. Use of cash transfers to cushion the pandemic impact has increased dominance of social benefits in government spending.

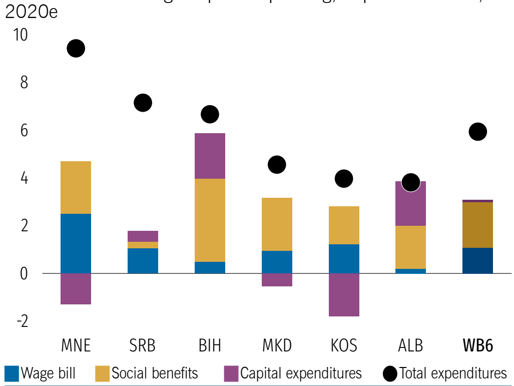
Composition of estimated public spending, 2019 and 2020e, percent of GDP



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

Figure 5.4. Capital spending declined in half of the Western Balkan countries.

Contribution to change in public spending, in percent of GDP, 2020e



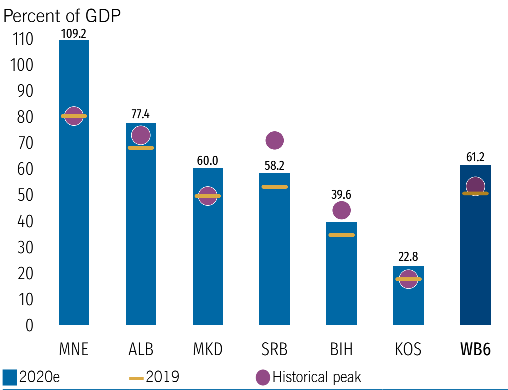
Sources: National statistical offices, Ministries of Finance, and World Bank staff estimates.

to historic highs in most of them. Montenegro's gross PPG external debt is estimated to have reached almost 97 percent of GDP as a result of new borrowing and a significant contraction of GDP. It is also estimated that in Albania, BiH, North Macedonia, and Serbia, external PPG debt as a share of GDP ranged from 31 to 40 percent of GDP, and that Kosovo's external PPG to GDP ratio, while the lowest in the region, went up by 2 pp, to 8 percent of GDP. On average, regional external PPG debt as a share of GDP is now estimated to have increased to 40.6 percent of GDP (Figure 5.6).

Exploiting ample liquidity and the higher appetite of investors in international financial markets, Western Balkan countries have placed Eurobonds at quite favorable rates. In 2020, Albania, Montenegro, North Macedonia, and Serbia raised a total of €5.1 billion in Eurobonds, which were used to refinance debt and finance widening deficits. In early 2021, buoyed by the benign conditions in the financial markets and higher demand from crossover investors, Serbia and North Macedonia placed Eurobonds, the former for €1 billion, the latter for €700 million. The 12-year maturity of Serbia's Eurobond is the longest of all the bonds Serbia has placed on international markets. All Eurobonds placed in 2020 and 2021 by the four Western Balkan countries were oversubscribed, which is to a large extent explained by current international market dynamics. The countries will use the Eurobond proceeds to refinance previous debt, with any balance used for general budgetary purposes. Although these placements have been successful, financing conditions might be affected by continuing uncertainty and volatility.

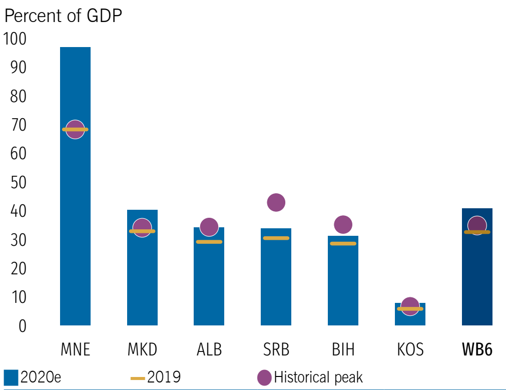
Western Balkan countries also turned to domestic markets, but in most domestic capacity is quite limited. Because they have little or no access to external markets, BiH and Kosovo relied mostly on external concessional debt and domestic borrowing. Most of the new BiH debt was from the IMF RFI disbursed in 2020. The largest increase in domestic debt, however, was in Albania, which had ample liquidity in the domestic market and borrowed from commercial banks. Kosovo financed a considerable part of its expanding needs by issuing domestic debt, using a private placement for the first time, and also drawing down privatization receipts and government deposits.

Figure 5.5. PPG debt increased to new highs in Albania, Kosovo, and Montenegro…



Source: National statistics offices and World Bank staff estimates.

Figure 5.6 …largely because of more external borrowing.



Source: National statistics offices and World Bank staff estimates.

The main holders of Kosovo's debt are Kosovo's pension savings trust, commercial banks, and the Central Bank. North Macedonia, Serbia, and to a lesser extent Montenegro have also relied on domestic markets.

Fiscal deficits will shrink in 2021 but remain elevated as Western Balkan countries grapple with the pandemic and its lingering impacts. All countries in the region except BiH are expected to carry deficits of 5 percent or more of GDP as budget needs remain sizable, especially resources for health care including for vaccine deployment and continued support to firms and households. Region-wide, the deficit is projected to remain more than triple the pre-pandemic level. Given a gradual and uncertain recovery in economic activity in most WB6 countries, and the use of tax exemptions as a policy lever, lower than pre-pandemic revenues will continue to exert pressure on financing needs. High deficits will be driven primarily by the need to maintain sizable and costly fiscal stimulus measures until the health crisis abates and output recovery is solid. Most countries extended their fiscal support into 2021: Serbia, BiH, and Kosovo prolonged previous measures; North Macedonia and Montenegro increased their support. While fiscal support is vital until recovery is firmly underway, any additional support should be targeted to the most vulnerable households and firms. Governments in the region, particularly those where debt is high and fiscal space largely depleted, will need to balance support for recovery and the need to preserve fiscal sustainability. Determining the right timing to scale down support measures will now be critical (Box 5.1).

As their economies stabilize after the COVID crisis, Western Balkan countries will need to rebuild fiscal space. While continued spending to support businesses and livelihoods is expected in 2021, thereafter government spending will likely be constrained by the shortage of fiscal space. Access to international markets could be

Table 1. Eurobond placements, 2020 and early 2021.

	Amount (€ million)	Maturity (years)	Interest rate (percent)	Date of placement
Albania	650	7	3.65	June 2020
Montenegro	750	7	2.875	December 2020
North Macedonia	700	6	3.675	May 2020
	700	7	1.625	March 2021
Serbia	2,000	7	3.125	May 2020
	1,000	10	2.125	November 2020
	1,000	12	1.65	February 2021

Table 2. Latest credit ratings by country and rating agency.

	Moody's	Standard & Poor's	Fitch
Albania	B1 (stable)	B+ (stable)	/
Bosnia & Herzegovina	B3 (stable)	B (stable)	/
Montenegro	B1 (stable)	B (negative)	/
North Macedonia	/	BB- (stable)	BB+ (negative)
Serbia	Ba2 (stable)	BB+ (stable)	BB+ (stable)

Note: Green denotes an improved rating and red a downgrade.

deterred by their volatility, a rise of financing costs, but also domestic developments. Rating agencies have mostly kept the credit ratings the same for all countries except Montenegro and BiH (Table 2). The anticipated improvement in the 2021 fiscal deficit in all countries relies on collecting more revenue as recovery takes hold. However, with uncertainty high, governments might have to rethink their spending plans to make more room to maneuver. Strengthening PFM (by improving medium-term budgeting, public procurement, public investment management, and assessment and management of fiscal risks); streamlining tax exemptions; and increasing fiscal transparency could build fiscal savings and stronger buffers.[7]

Box 5.1. Fiscal policymaking and COVID-19: A call for cautious optimism.

Most Western Balkan countries planned their 2021 budgets expecting eased pandemic conditions and a gradual economic recovery over the medium term (Figures B5.1.1 and B5.1.2). Montenegro, however, has delayed adoption of the 2021 budget and meanwhile is making temporary decisions on financing. Public revenues are projected to rise by an unweighted regional average of 7.1 percent y-o-y to 99 percent of the 2019 level; and spending to fall by an average of 1 percent y-o-y but still be high at 113 percent of the pre-pandemic level. Thus, fiscal deficits would be above those of 2019 but still be 3 pp of GDP less than in 2020. Most Western Balkan countries are budgeting for scaled-back support and social protection spending relative to GDP in 2021 because of expectations of recovery. In 2020 fiscal support and the cost of the pandemic in general more than doubled fiscal deficits and debt accumulation accelerated, narrowing the fiscal space for future support.

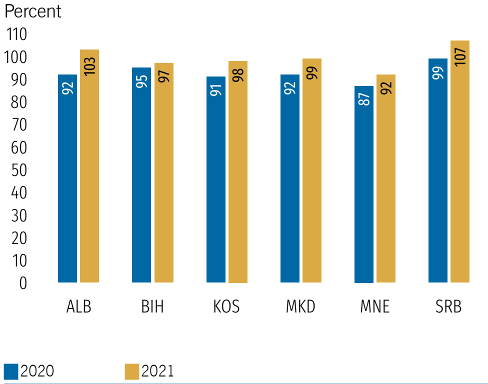
With the income elasticity of public revenue high, public resources are very sensitive to the path of the pandemic (Figure B5.1.2). In 2020, the percentage drop in public revenue outpaced the contraction in economic activity. Except for Montenegro, the magnitude of the erosion in public revenue collection was higher than the contraction of WB6 economies. This reflects the use of tax exemptions, deferrals, and policy changes as fiscal stimuli; the structural diversity of the countries; the asymmetrical impact of the contraction on high-tax-yield sectors; and a possible deterioration in tax compliance. In BiH, the drop in public revenue was in line with the size of the contraction. In North Macedonia, it outpaced the contraction; the drops in indirect tax and non-tax revenue were somewhat cushioned by increases in direct tax revenue and social contributions paid as part of the COVID-19 support aid.

Government policy responses eased what was truly an exogenous shock. The support measures varied in size and scope, depending on each country's fiscal space; paired with the loss of tax revenue, they resulted in sizable fiscal deficits and more borrowing. And despite the expected, but far from certain, recovery, fiscal deficits in 2021 will again be larger than usual, pushing up financing needs. For most WB6 countries, in early 2021 the main support measures were wage subsidies, tax policy adjustments, and support to those who were vulnerable. Most of these are still survival measures, but they are eating up space needed for a stronger recovery that enhances potential growth. Finding the right time to begin withdrawing survival support will be critical; WB6 governments must therefore strike a delicate balance between supporting the economy and keeping public finances stable. Meanwhile, the need to speed up debt reduction is further reducing the scope for support.

7 For example, the Montenegrin government announced cuts of a significant share of inefficient current spending on goods and services.

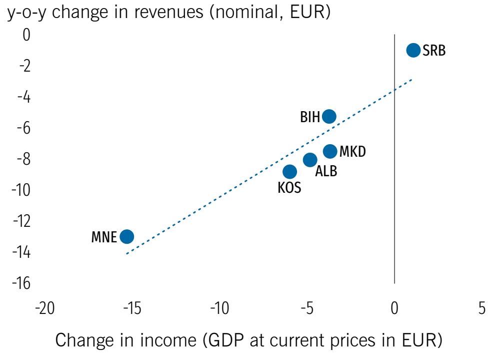
Box 5.1 continued

Figure B5.1.1. Public revenue is not projected to reach 2019 pre-pandemic levels in most WB6 countries.



Sources: National statistical offices, Ministries of Finance and World Bank estimates.

Figure B5.1.2. The drop in public revenue in 2020 outpaced the contraction of the economy in most WB6 countries.



Sources: National statistical offices, Ministries of Finance and World Bank estimates.

However, recovery is far from certain, and if the pandemic worsens, sizable support would be needed. Should such risks to the outlook materialize, the downward pressure on public revenue and higher demands for support measures may require revision of national budgets throughout the region. Against this background, Western Balkan countries—particularly those with financing constraints—should prepare contingency financing options and fiscal scenarios, and prudently assess new policies that are not targeted to mitigating the impact of the pandemic. Moreover, capacities to absorb bond issues differ by country, and financial markets have already begun to show signs of tightening.

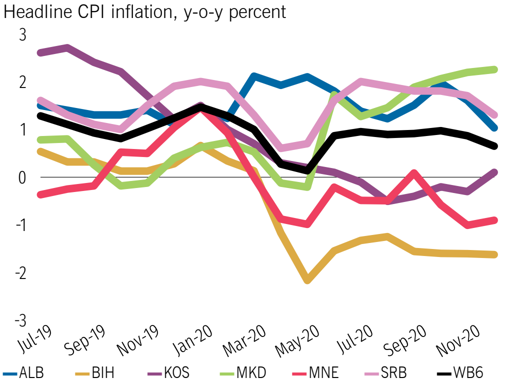
In the medium term, restoring fiscal sustainability will be critical. Although growth and deficits should stabilize in all Western Balkan countries, spots of fiscal vulnerability may persist. Even if borrowing costs hold steady, fiscal space will be limited. But if interest rates go up, the room for fiscal maneuver would narrow even more, forcing countries to consolidate to stabilize their debts. Debt levels in most WB6 countries are very high, leaving barely any room for the authorities to respond to future shocks. Where fiscal tightening may be needed to ensure debt sustainability and macro stability, changes in the composition and scope of spending can open up space for some fiscal savings. Focusing on more cost-efficient spending on goods and services and on investment projects that are highly productive and environmentally sustainable can increase the room for spending for recovery and have a stronger positive impact on growth. Attention to spending is even more important given the uncertainty of revenue recovery.

6. Inflation fell markedly because of the pandemic

During 2020, inflation slowed in most Western Balkan countries. The COVID-19 pandemic reduced domestic spending throughout the region, and the slide in international commodity prices added to the domestic pressures. Food inflation contributed most to headline inflation. In most countries the lifting of restrictive measures in the summer brought back domestic spending, but inflation dynamics differed markedly by country. In North Macedonia, inflation rose steadily during the year, closing at 2.25 percent, the highest in the region. For several months, deflation held sway in BiH (-1.6 percent at yearend), Montenegro (-0.9 percent at yearend), and Kosovo (0.1 percent at yearend). Finally, in Serbia and Albania, after prices went up in Q2 and Q3, inflation declined again, in Albania going under the lower limit of the target band of 2–4 percent.

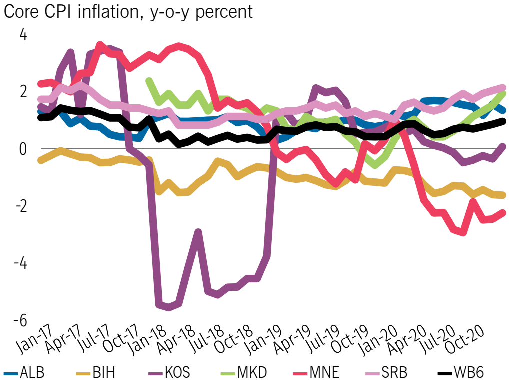
To alleviate demand shocks, in economies with exchange rate flexibility monetary policy was eased. In Albania, Serbia, and North Macedonia the central banks cut interest rates to support the economy: Albania's policy rate was cut to 0.5 percent in March, Serbia's from 2.25 percent in March to 1.25 percent by June and to 1 percent in December, and North Macedonia's was cut four times, ultimately to 1.25 percent in March 2021. All three countries announced new precautionary swap or repo lines with the ECB to access additional euro liquidity as needed. In Serbia, the central bank used swap and repo purchase auctions to provide liquidity, and it also bought dinar-denominated government securities. And all three central banks intervened significantly in foreign exchange markets during the lockdown to stabilize their currencies and minimize the impact of the pandemic on inflation dynamics. In Albania, the central bank lifted the limit on liquidity provision in domestic currency.

Figure 6.1. Inflation was subdued for most Western Balkan countries.



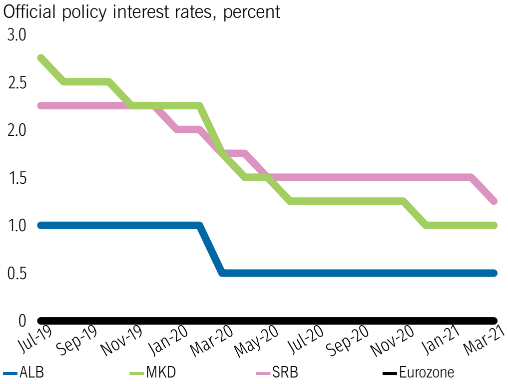
Source: Central banks and Agencies of Statistics.

Figure 6.2. Underlying long term inflationary trends suggest that domestic demand pressures are low.



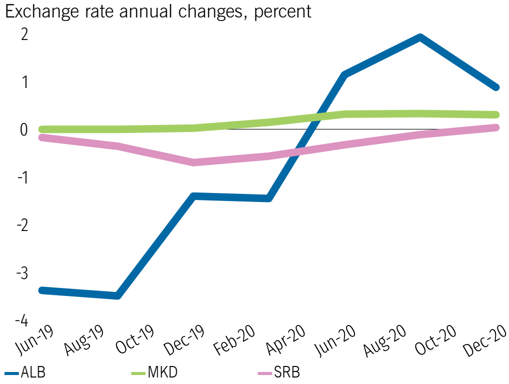
Source: Central banks and Agencies of Statistics.

Figure 6.3. Monetary policy was eased to support demand…



Source: Central banks and ECB.

Figure 6.4. …and for most of 2020 movements against the euro were limited.



Source: Central banks and World Bank staff calculations.
Note: Increase indicates depreciation.

Inflation in the region is expected to stay subdued in 2021 but gradually increase over the medium term as the output gap closes and imported inflation rises. Persistent low commodity prices and a slow recovery in domestic demand will continue to exert downward pressure on headline inflation.

7. COVID-19 is testing financial sector resilience

While in general financial conditions have been relatively stable throughout the pandemic, downside risks could materialize in the near future, warranting intensified monitoring. Financial systems in the region have entered the pandemic relatively stable as a result of regulatory and supervisory reforms. So far, they have sustained their resilience despite the prolonged impact of the crisis on economic activity and the increased pressures on bank balance sheets. Regulators and policymakers across the region have moved quickly to provide financial support to mitigate the impacts of COVID-19 on the real economy, and to ensure that their financial systems can withstand shocks.[8] The borrower relief and prudential measures in response to the crisis are now gradually being phased out or tightened, with some measures including moratoriums, loan restructurings and favorable loan classifications being carried over into mid-2021. As a result, the effects of the crisis are expected to become more visible on banks' balance sheets towards the second half of 2021, with a potential surge in NPLs, as measures mostly expire and weak economic prospects put further stress on asset quality. Close monitoring of risks as they arise will be needed for prompt detection of a buildup of vulnerabilities to allow for mitigation measures.

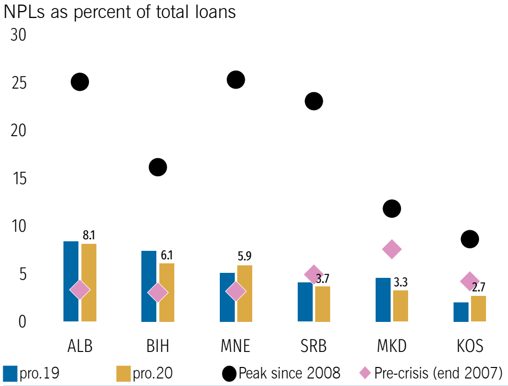
8 Policy actions included borrower relief programs and prudential measures taken by central banks and regulators, such as moratoriums on debt repayment and temporary changes in restructuring, classification, and provisioning for loans. WB6 governments have also launched programs for direct financial support to businesses through loans and credit guarantees, distributed via development finance institutions, new guarantee funds, and the banking system.

As of December 2020, credit had grown in most countries, though more slowly than in 2019 and with considerable variation by country. Serbia and Albania saw the strongest private sector credit growth, 9–10 percent (y-o-y), due to low funding costs and the uptake in measures to mitigate the impact of COVID-19 on borrowers; Kosovo saw a 3 pp decline in credit growth compared to a 0.7 pp decline end-2019. Also heading downward from 2019 were credit growth in North Macedonia, from 6.4 to 4.9 percent, and Montenegro, from 5 to 3.3 percent; loan growth in BiH had become negative in mid-2020, hitting -2.8 percent at the end of 2020. Lending to households in the region has declined slightly regionally by 1 pp compared to mid-2020 data. At the same time, credit to firms has seen a 2.7 pp decrease, with significant declines in BiH, North Macedonia, Serbia and Montenegro due to tightened supply conditions, decreased demand as a result of weak economic prospects and more limited availability as well as uptake of emergency support measures.[9]

While borrower relief measures prevented an immediate surge in NPLs, a decline in asset quality is expected as measures expire gradually. As of December 2020, the regional NPL average was 5 percent of total loans, down 0.3 pp from end 2019. Although trending upward slightly, Kosovo's NPLs are still the lowest in the region. NPLs are high in Albania at 8.1 percent; BiH at 6.1 percent; and Montenegro at 5.9 percent. NPL averages may mask pockets of vulnerability, especially in

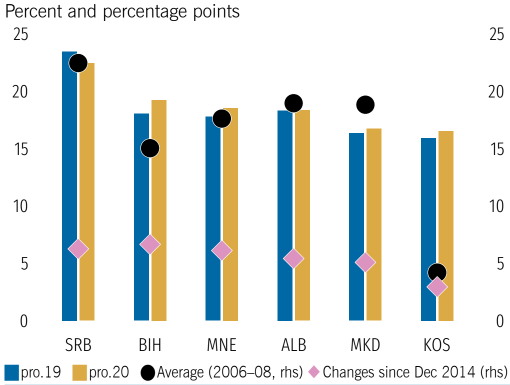
9 CESEE Bank Lending Survey for H2 2020.

Figure 7.1. The slight downward trend in NPLs has continued, with help from borrower relief and regulatory measures.



Source: IMF FSIs, national central banks and World Bank staff calculations.

Figure 7.2. Banks entered the pandemic with significant capital buffers.



Source: IMF FSIs, national central banks and World Bank staff calculations.

smaller and domestic banks, which regulators in the region need to monitor closely. (Figure 7.1) Recent reforms have helped reduce NPLs considerably in Albania, Montenegro, and Serbia, which continue to write off or sell old NPLs. Albania, the BiH entity Republika Srpska, and Kosovo have all passed new insolvency laws in recent years but they have yet to be tested. The Bank of Albania has extended its out-of-court NPL resolution framework till end 2021 to help deal with pandemic consequences. At the same time important challenges remained in the region related to (1) a weak financial condition of the largest corporate borrowers in the system (i.e., a disconnect between asset quality ratios and the financial health of the largest borrowers), and (2) loan write-offs by banks that removed NPLs from bank balance sheets but that left borrowers trapped with unsustainable debt burden (i.e., write-offs do not imply debt forgiveness for the borrowers).[10] Going forward, NPLs are expected to surge in all countries with its full reflection on balance sheets expected to be gradual in time due to ongoing measures in some countries and restructured loan portfolios in others.

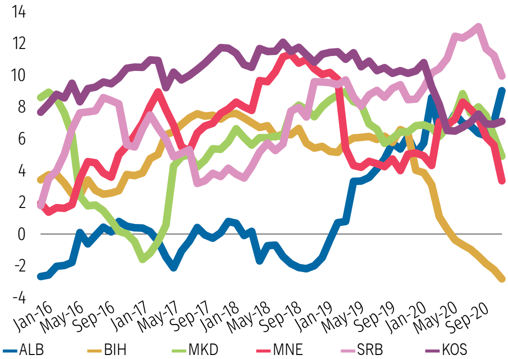
Capital buffers and bank liquidity in the Western Balkan countries were generally stable but over the first three quarters of 2020 profitability dropped. As of December 2020, bank capital adequacy averaged 18.6 percent, far above the regulatory minimum and slightly higher than the 18.3 percent in December 2019. The ratio of liquid to total assets averaged 28.2 percent, slightly lower than the 29.1 percent in December 2019, and loan-to-deposit ratios were below 100 across the board. But bank profitability is under considerable strain. From 1.6 percent at the end of 2019, profitability as measured by return on assets has slipped to 1.2 percent due to such factors as the increased cost of provisioning for impairment and borrower relief measures.

Going forward, authorities will need to maintain financial stability as they make an orderly exit from exceptional borrower relief measures. Based on careful monitoring,

10 See for further information: World Bank Policy Note on COVID-19 and Non-Performing Loan Resolution in the Europe and Central Asia region - Lessons learned from the global financial crisis for the pandemic, December 2020; http://pubdocs.worldbank.org/en/460131608647127680/FinSAC-COVID-19-and-NPL-Policy-Note-Dec2020.pdf

Figure 7.3. Except for BiH, credit growth has been positive throughout the region.

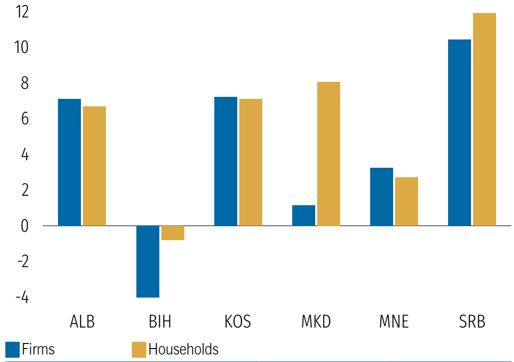
Change in nonfinancial private sector credit outstanding, percent, y-o-y



Source: IMF, IFS, Central banks.

Figure 7.4. Credit developments vary considerably by segment and country.

Change in credit outstanding, December 2020, percent, y-o-y



Source: Central banks.

they must be ready for prompt, proactive, and comprehensive policy responses to prevent the build-up of financial stability risks. It will be crucial to continue unwinding exceptional borrower relief measures as soon as circumstances permit, and with careful consideration for the financial impact on banks. Lessons learned in the global financial crisis call for authorities to focus on (1) robust banking regulation and supervision to ensure the proper identification of NPLs and provisioning for credit losses; (2) strengthening of banks' operational readiness to work out rising volumes of problem assets; and (3) a legal environment (i.e. insolvency and creditor's rights) that enables banks to work out bad loans and that avoids steering distressed but viable borrowers towards liquidation. More specifically, ensuring availability of economically meaningful data about banks' exposure to problem assets as well as adopting and preserving internationally harmonized regulatory definitions are key for transparency and comparability amongst banks and jurisdictions. In addition, it is vital that banks get operationally ready for resolving high volumes of bad loans through dedicated workout units. While unviable and uncooperative borrowers need to be dealt with resolutely, the depth of the recession puts a high premium on efforts to ensure that distressed but potentially viable borrowers are given an opportunity to be rehabilitated. As countries in the region have made good progress in overhauling legal frameworks, continued efforts are needed to bridge the gap that has emerged between modernized insolvency frameworks and actual practice. Lastly, given the many stakeholders involved, policy coordination is a critical element of any strategy to address high NPLs. Nationwide NPL reduction strategies, designed and implemented with the active participation of private and public sector stakeholders, can help to accelerate NPL reduction.

8. External imbalances widen but there are prospects for improvement

Current account deficits (CADs) in most countries widened reflecting countervailing effects of the pandemic. Merchandise imports shrank along with domestic private investments and consumption. Offset by the contraction in merchandise exports, this led to slightly narrower merchandise trade deficits. Tourism receipts plummeted, which considerably dented services surpluses; and income balances deteriorated, owing to a decline in remittances. As a result, CADs in the region expanded, largely because of a decline in services exports (Montenegro, Kosovo, BiH, and Albania) and falling remittances (Albania and BiH). The exception was Serbia, where in 2020 lower transfers of net income by foreign companies (down by 44 percent in euro terms compared to 2019), healthy manufacturing exports, and an improved services trade balance narrowed the CAD against the regional trend. Serbia's improved current account balance helped counterbalance widening deficits in its neighbors, bringing the regional CAD to 5.8 percent of GDP, not much below the 6.2 percent in 2019 (Figure 8.1). Except for North Macedonia and Montenegro, it is estimated that CADs in the region are below their averages for the last 10 years.

How the pandemic affected trade balances in the Western Balkans has varied with each country's trade structure; trade deficits expanded in countries dependent on services but narrowed in merchandise exporters. Exports across the region were affected by both depressed demand and value-chain disruptions. In the short term the cost to trade of the pandemic was greatest for WB6 economies whose manufacturing sectors are comparatively more integrated into global supply chains (Serbia, North Macedonia, and to a lesser extent BiH). However, trade volumes in these countries swiftly recovered as supply chains re-opened, helping to narrow their deficits. In contrast, countries more dependent on trade in services, like Albania, Kosovo, and Montenegro, saw their trade deficits worsen as rising infection rates and slow normalization of cross-border travel delayed the recovery of tourism and related service industries like food, entertainment, and retail. Of the three services-dependent countries, Montenegro suffered most from the slowdown in tourism, which accounts for about 25 percent of its GDP; it is expected that its chronically high trade deficit in 2020 reached 35 percent of GDP, the highest since 2008. For Kosovo, the restrictions on international travel were particularly damaging: because the country relies on diaspora-driven service exports; its trade deficit is therefore expected to widen from 27 percent of GDP in 2019 to 32 percent, making it the second largest in the region.

For most WB6 countries FDI continues to be the main source of external financing. Estimates for 2020 suggest that even during the pandemic some countries in the region, like Kosovo and Montenegro, saw net FDI inflows increase as a percentage of GDP owing to reduction in outward FDI and dividend repatriation. However, for Albania, BiH, North Macedonia, and Serbia net FDI (as a share of GDP) was somewhat lower than in 2019 (Figure 8.3). FDI covers a large share of CAD financing in the region, from about 42 percent in Montenegro to 55 percent in BiH and North Macedonia, 70 percent in Kosovo, and 100 percent in

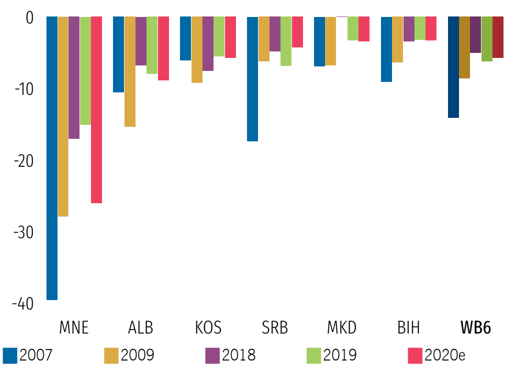
Serbia. FDI also supports growth by bringing into the country innovation, decent jobs, and sustainable production methods that can help attenuate the impact of pandemic. These positive spillovers have been realized to a greater extent in Albania, North Macedonia, and Serbia than in BiH and Kosovo.

The pandemic's effects on remittances put more pressure on CAD financing. Serbia, BiH, and Albania saw the deepest losses because they have the largest diasporas; many of their citizens are currently resident in Switzerland and the EU (notably Austria, Germany, Greece, and Italy), which is experiencing one of its worst recessions. In other countries remittances have proved somewhat resilient to the pandemic. In Montenegro, Kosovo and North Macedonia, recorded remittances rose, likely explained by the substitution from non-formal channels as border closures made non-formal remittances difficult. Although official remittances in these countries rose, total remittances may have fallen, and this formalization of remittances may unwind once tourism is revived. Remittances remain an important source of trade deficit financing in most Western Balkan countries; in 2020 they accounted for about 6.5 percent of GDP.

The slowdown in FDI and remittances in some countries has meant increased reliance on external loans to cover rising external financing needs. This has pushed up external debt across the region. In 2020, average external PPG debt as a share of GDP in the region rose from 32.4 percent in 2019 to 40.6 percent—the highest level on record (see Fiscal Section, Figure 5.6). International reserves worth 4.5 to 7.3 months of imports offer support should there be external volatility. However, those reserve buffers would come under pressure should the pandemic prove longer than expected. This is especially so in the region's Currency Board Arrangement (CBA) and euroized economies, which would be more vulnerable to pressures stemming from rising external financing requirements. Such requirements must be

Figure 8.1. Except for Serbia, current account deficits worsened in 2020.

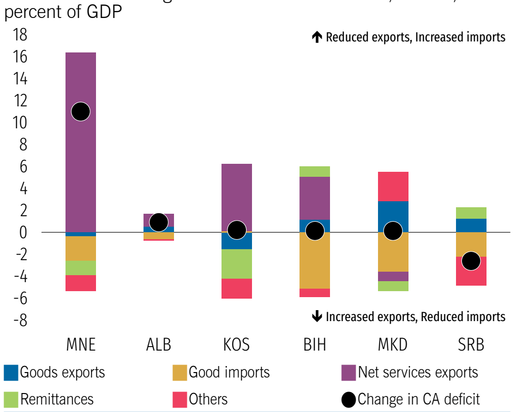
Current accounts balances, 2007–20e, percent of GDP



Source: National authorities and World Bank staff calculations.

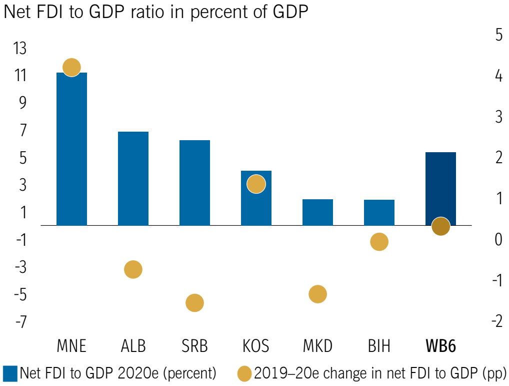
Figure 8.2. Weak services and investment income more than offset a stronger goods balance.

Contribution to changes in current account deficit, 2020e, percent of GDP



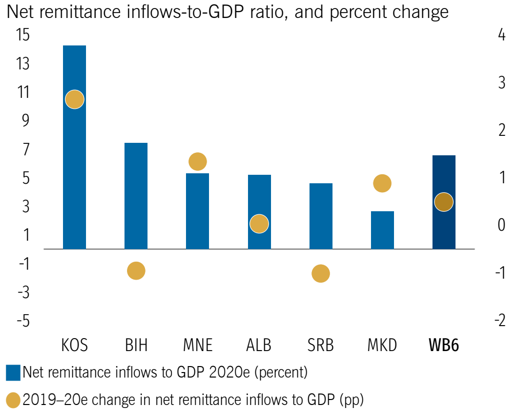
Source: National authorities and World Bank staff calculations.

Figure 8.3. Net FDI declined in several WB6 countries.



Source: National authorities and World Bank staff calculations.

Figure 8.4. Serbia, BiH, and Albania saw the largest remittance losses given their large diasporas.



Source: National authorities and World Bank staff calculations.

monitored closely, particularly in countries where those requirements are high, because they are much more vulnerable to possible shifts in investor sentiment and tighter conditions in international financial markets.

Looking ahead external balances are expected to improve in a majority of countries in the region as the pandemic is brought under control. Assuming that containment measures will not be prolonged in the EU, the region's main export market, recovery of merchandise exports is expected to continue. However, with the recent rebound of oil prices, a major import category, in international markets, followed by an increase of capital goods driven by the rebound in infrastructural work and private investment, merchandise imports will go up. A moderate rebound is expected in tourist revenues and the services account surplus which will lower the trade deficit in 2021. However, tourism is likely to recover only slowly and may not reach pre-crisis levels until after 2022. Although restrictions on international travel will continue to be lifted, fear of contagion will discourage travelers until vaccines have achieved wide coverage. Furthermore, still depressed economic activity in the region and Europe generally will mean less disposable income for spending on travel. Remittances will start to rebound as economic activity recovers across Europe, helping to sustain the surplus on secondary income accounts. Overall, however, current trends are expected to continue their reversal in 2021, and in most countries CADs should narrow.

9. Economic recovery hinges on the vaccine rollout

Following the pandemic-caused collapse in 2020, economic output in the Western Balkan is projected to expand 4.4 percent in 2021 and 3.7 percent in 2022 (Table 9.1). The estimate for 2020 is 1.4 percentage points (pp) higher than projected in the Fall 2020 forecast. This reflects the stronger-than-expected recovery across the region after lockdowns were eased in the second half of the year. The recovery, which has been subdued in the near term because of a resurgence of COVID-19 cases, is expected to strengthen in the second half of 2021, as confidence, consumption, and trade gradually improve, supported by acceleration of the vaccination rollout. However, it is also expected to be tempered by the worsening balance sheets of households, businesses, and banks and by depressed external demand, especially for tourism.

Recovery of the Western Balkans to the pre-pandemic GDP growth trajectory will take years (Figure 9.1). Real output in the Western Balkans is expected to return to its pre-pandemic level this year but with variation across countries: Serbia and Albania in 2021, Montenegro in 2024 and all others in 2022. Despite the recovery, however, output is expected to remain far below its pre-pandemic trends through the medium term. Near-term, consumption will contribute most to the region's growth, although all countries will also see a pick-up in investment, most notably Albania, North Macedonia, and Serbia. The pace of recovery in the region, and the risks to recovery, differ significantly from country to country. Recovery paths vary based on the extent of domestic disruptions to activity, which are related to the structure of each economy and its reliance on contact-intensive sectors. Tourism-reliant economies have particularly uncertain prospects; if tourism recovery is weak, economic recovery may be tepid for countries like Montenegro and Albania that rely heavily on a short summer tourism season. In Albania however, reconstruction efforts will fuel a rise in fixed capital investment, which will account for a third of growth during 2021. How well a country can sustain support to its economy will also influence the pace of recovery; early in 2021, for instance, Serbia and North Macedonia were already able to approve large support packages (in the case of latter about 1.4 percent of GDP). Progress on vaccinations also varies considerably, with Serbia emerging as a world leader but vaccination rates in the other countries in the region are among the lowest in Europe.

All countries in the region will continue to provide fiscal support to their economies in 2021. Fiscal balances in the region will improve somewhat, but in most countries the deficit will remain between 5 and 6 percent of GDP, and in several countries public debt will continue to rise. Deficits will be driven upward by continued demands on the budget for health care spending and higher social welfare payments, as well as additional spending on recovery packages. In the medium term, as growth firms up and fiscal space is further reduced, deficits are projected to narrow, with BiH and Montenegro expected to post a positive primary balance by 2022. Once a recovery is demonstrably underway, efforts to tighten fiscal policy and reduce debt will be particularly important because public

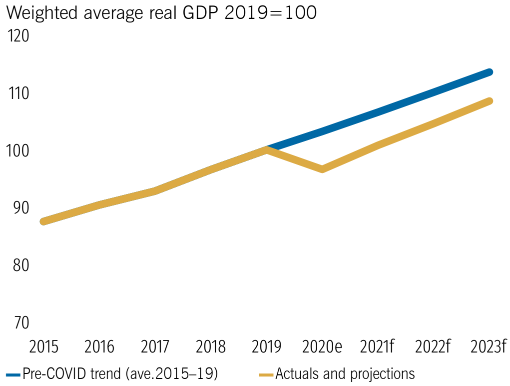
Table 9.1. GDP forecast.

Percent

	2019	2020e	2021f	2022f
ALB	2.2	-3.3	4.4	3.7
BiH	2.8	-4.3	2.8	3.5
KOS	4.9	-6.9	4.0	4.5
MNE	4.1	-15.2	7.1	4.5
MKD	3.2	-4.5	3.6	3.5
SRB	4.2	-1.0	5.0	3.7
WB6	***3.6***	***-3.4***	***4.4***	***3.7***
EU27	1.8	-7.0	3.7	4.0
CEE	4.0	-4.8	3.8	4.2

Source: World Bank (Global Economic Prospects January 2021), WEO October 2020, national statistical offices and World Bank estimates.
Note: CEE: Bulgaria, Croatia, the Czech Republic, Hungary, Poland, and Romania.

Figure 9.1. Despite projected growth, WB6 output is well below pre-COVID trends.



Source: National statistical offices and World Bank staff estimates and calculations.
Note: Pre-COVID trend is defined here as the 5 year growth average.

debt in Albania, Montenegro, and North Macedonia is far higher than previous historical peaks. External imbalances are projected to moderate in 2021 as trade balances narrow and remittances increase.

Risks to the outlook in the Western Balkans are markedly to the downside. Growth is projected to bounce back—but the risks are great, in line with risks to the global and regional outlook (Box 9.1). The main uncertainty relates to how effective pandemic management is and how fast vaccines can be deployed. Vaccine rollouts have begun across the region, but procurement problems have kept the number of doses administered low. External demand is projected to pick up in 2021, but by how much is uncertain, particularly with the resurgence of the virus globally in the Spring of 2021. With growth re-emerging in large advanced economies, there is an increased risk that normalization of monetary policy may spill over into financial markets. Volatility in financial markets in general is a major risk in the region given large financing needs. As for the fiscal outlook, relatively optimistic budget assumptions in North Macedonia and Serbia may result in lower fiscal outcomes than projected. If the economic crisis persists, the need for WB6 countries to continue providing fiscal support to their economies may stretch their budgets to precarious limits. Much of the support provided post-COVID was in the form of guarantees, which may affect fiscal outcomes if they are called.

Considering the magnitude of the risks, embarking on an ambitious reform program to strengthen resilience and firm up growth may be the best response to the current crisis. While the continuing pandemic poses a major risk to the baseline outlook, all governments could accelerate recovery by renewing their efforts to undertake needed structural reforms. In most countries in the region there are reforms pending to improve the business environment and accelerate growth. Particular attention should be paid to avoiding backsliding on previous reforms, such as the significant fiscal consolidation efforts of Albania, Montenegro, North Macedonia, and Serbia before COVID-19 struck. Many countries will also seek to support economic recovery by incentivizing private investment and ramping up public investment. In doing so, it will be important for them to take into account the slower-moving but equally pressing crisis that is climate change. In the medium and long term, recovery efforts that support more green, resilient, and inclusive growth are likely to deliver better results.

Box 9.1. Emerging global risks.

Global economic activity continues to firm up, but for some economies, headwinds generated by the pandemic have slowed the pace of recovery. Although in 2020 COVID-19 plunged the global economy into a steep recession, whose depth was surpassed only by the two World Wars and the Great Depression, global activity is showing signs of incipient recovery. Global industrial production and goods trade volumes have surpassed pre-pandemic levels, supported by firming demand, particularly from advanced economies and China (Figure B9.2.A). In early 2021, however, the pace of recovery has been subdued due to daily flareups of new COVID-19 cases, with the resurgence in some countries prompting their governments to sustain or even tighten pandemic restrictions (Figure B9.1.A).The continuing listlessness of international travel demand has also weighed on the recovery for tourism-dependent economies: in the Western Balkans tourist arrivals in early 2021 were barely 40 percent of arrivals a year earlier.

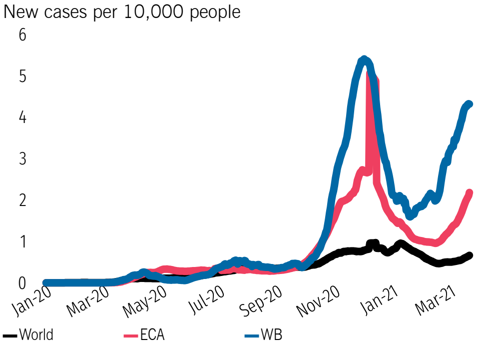
The outlook is so uncertain that in a downside scenario growth may be far weaker. The baseline forecast in January 2021 envisioned a 4 percent expansion of global GDP for the year, predicated on appropriate pandemic management and vaccination limiting the community spread of COVID-19 in several large economies.[1] Several risks, however, could derail global and regional recovery—including those related to the pandemic. In a downside scenario, recovery in Europe and Central Asia (ECA) could reach only 2.2 percent in 2021, which is 1.4 pp lower than the 2021 baseline forecast, and 1.1 percent in 2022, 2.7 pp lower than the 2022 baseline.[2] Even if downside risks do not materialize, the effects of the pandemic will weigh on ECA because the near-term recovery will not be sufficient to recoup the losses incurred in 2020—in the baseline, per capita GDP is forecast to remain 2.9 percent below pre-pandemic projections in 2022.

Downside risks associated with the pandemic, including acceleration of new COVID-19 cases and slow vaccine deployment, could disrupt the recovery. Spread of the virus could intensify if pandemic control measures fail—perhaps due to more transmissible variants of the virus—or if vaccine deployment is delayed. Since daily new COVID-19 cases abated late in 2021, ECA has seen a major resurgence of the pandemic because of the emergence of new variants and in some cases increases in mobility. Even before the recent resurgence, health care systems in the Western Balkans were already under strain: two of its economies (Bosnia and Herzegovina and North Macedonia) are among the 10 EMDEs with the highest total COVID-19 deaths per capita. Excess mortality statistics imply that the true death rate could be far more devastating. Intensifying these headwinds are logistical challenges related to vaccine deployment. Except for Serbia, economies in the Western Balkans have not yet rolled out vaccines widely because of delivery delays and a shortage of suppliers other than the World Health Organization's COVAX Facility (Figures B9.1.B and 1.C). However, even after the bottlenecks ease, vaccine administration could be hampered by consumer reluctance to be vaccinated, particularly after the temporary suspension of AstraZeneca's vaccine in several European countries (Figure B9.1.D).

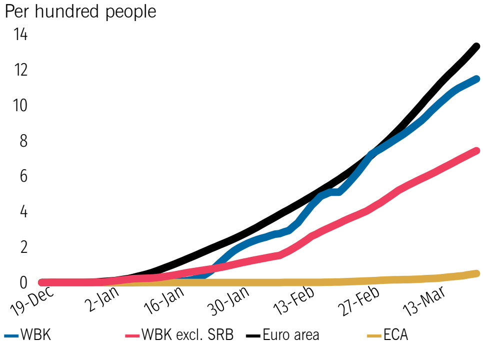
Box 9.1 continued

Figure B9.1

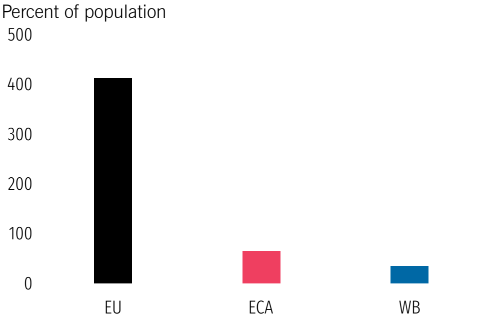
A. New COVID-19 cases, by region



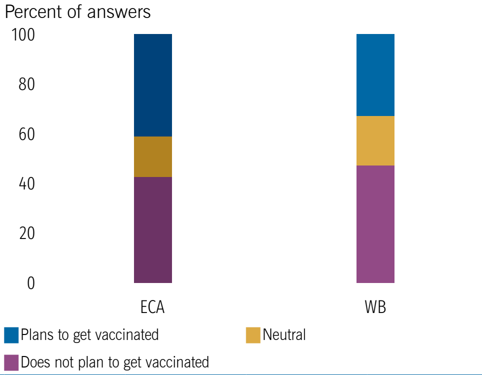
B. Vaccine doses administered, by region



C. Vaccine procurement by region



D. Vaccine reluctance survey by region



Source: Consensus Economics; Duke University; Levada Center; Marcec, Matja, Likic (2021); Our World In Data; World Bank.

Note: CA = Central Asia; CE = Central Europe; ECA = Europe and Central Asia; EE = Eastern Europe; EU = European Union; SCC = South Caucasus; WBK = Western Balkans.

A. Figure shows 7-day moving average of new cases. Last observation is March 24, 2021.

B. Figure shows 7-day moving average of total vaccinations. Last observation is March 24, 2021.

C. Figure shows confirmed doses purchases by countries in each region.

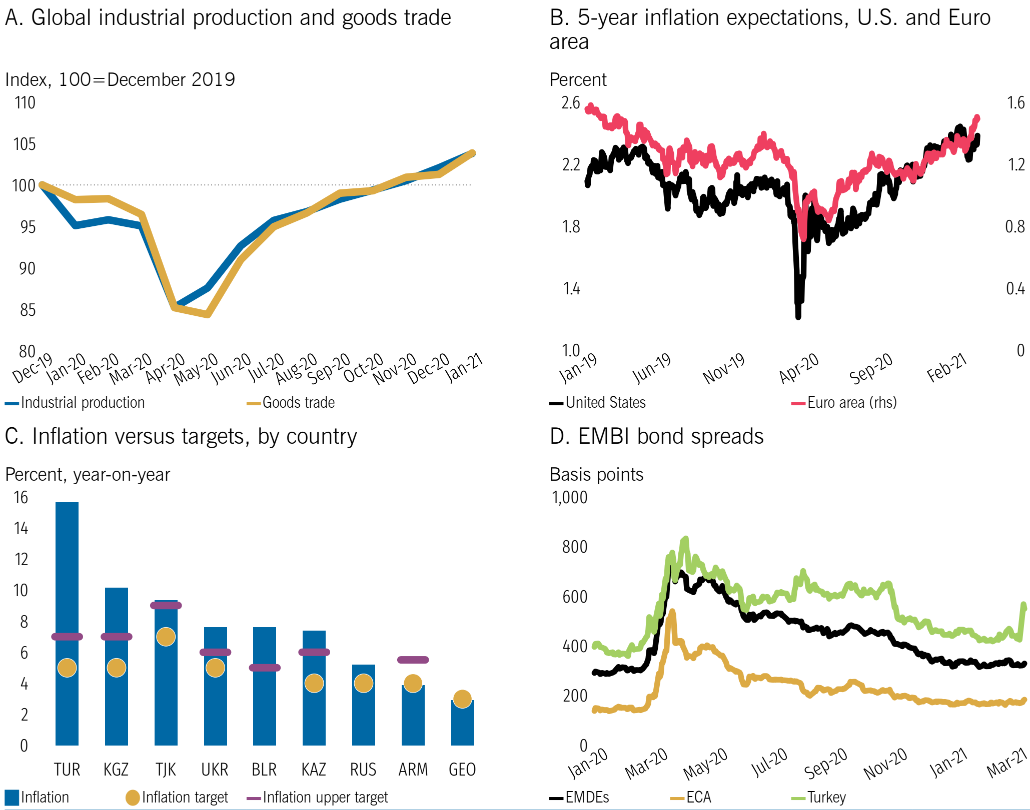
D. Figure shows the percentage of people willing/planning to get a SarsCoV2 vaccine.

A shift in investor confidence, rising inflation expectations, and worsening pandemic trends—exacerbated by a steep rise in policy uncertainty—could trigger tighter global financing conditions. Although such conditions were relatively benign in early 2021, inflation expectations are rising because of additional fiscal stimulus and higher commodity prices (Figure B9.2.B). These trends are quite obvious throughout the euro area, which will have implications for Western Balkans exchange rates that are anchored to the euro. Despite this increase in euro-area expectations, the market expects inflation will remain below the 2 percent ECB target over the forecast horizon. Nevertheless, because of rising inflation expectations globally, combined with a thorough reassessment of investor confidence—perhaps triggered by worsening pandemic developments or a spike in policy uncertainty—global financing conditions could suddenly tighten. In ECA, these risks are already materializing: early in 2021 inflationary pressures triggered policy interest rate hikes in one-third of ECA economies (Figure B9.2.C). Although EMBI bond spreads for some large ECA economies widened in 2021 when policy uncertainty spiked, the initial impact has been somewhat contained (Figure B9.2.D). Nevertheless, these developments illustrate the risk of sudden shifts in investor

Box 9.1 continued

sentiment. A tightening in external financing conditions could put additional strain on public balance sheets, particularly in countries where debt is mainly in foreign currencies, as in the Western Balkans. A more severe deterioration of the pandemic would also intensify other pressures, especially where policy buffers are depleted: prolonged economic weakness could trigger a wave of bankruptcies; bank balance sheets could be further impaired; governments might be unable to continue providing support; and in some circumstances temporary unemployment and business shutdowns could become permanent.

Figure B9.2



Source: CPB Netherlands Bureau for Economic Policy Analysis; Bloomberg; Haver Analytics; J.P. Morgan; World Bank.

Note: ECA = Europe and Central Asia; EMDEs = emerging markets and developing economies; WBK = Western Balkans.

A. Trade is the average of export and import volumes. Last observation is January 2021

B. Figure shows 5-year EUR and USD inflation swap rates. This rate is a common measure, which is used by central banks and dealers, to look at the market's future inflation expectations. The rate is calculated using the following formula: EUR: 2*EUSWI10 Curncy - EUSWI5 Curncy; USD: 2*USSWIT10 Curncy - USSWIT5 Curncy.

C. Inflation is seasonally adjusted. Last observation is December 2020 for Armenia and Tajikistan, February 2021 for Ukraine and Turkey, and January 2021 for others.

D. EMBI bond spread refers to the J.P. Morgan Emerging Market Bond Index. EMDE and ECA aggregates show median values. Last observation is March 24, 2021.

Note 1: World Bank. 2021. *Global Economic Prospects*. January 2021. Washington, DC: World Bank.
Note 2: World Bank. 2021. *Europe and Central Asia Economic Update, Spring 2021*. Washington, DC: World Bank.

10. Spotlight: Informality in the Western Balkans

All six Western Balkan Countries (WB6) have large informal sectors, which account for an estimated 25–35 percent of both the GDP and the number of people employed (Table 10.1); in EU member states, informality averages 15–20 percent of GDP[11]. Unfortunately, there are still no consistent methods for accurately measuring informality in the region[12], but recent research[13] suggests that informal activity was on the increase in the region even before COVID-19. When the COVID-19 pandemic and the ensuing economic crisis hit the region, it exposed how informal firms and workers are more vulnerable to shocks and the difficulty of providing support to businesses operating in the shadow (informal) economy.[14]

Table 10.1. Informality in the Western Balkans, percent

Country	Informal employment as percent of total employment	Informal sector contribution to GDP
Kosovo	>35	30–35
Albania	30–35	30–35
Bosnia and Herzegovina	30–35	30–35
Montenegro	30–35	30–35
Serbia	20	25–30
North Macedonia	<20	20–40

Source: European Commission 2019.
Note: The informal sector includes agriculture.

11 IMF Working Paper. "Explaining the size of the shadow economy in Europe." 2019.
12 European Commission. "Economic Reform Programmes of Albania, Montenegro, North Macedonia, Serbia, Turkey, Bosnia and Herzegovina, and Kosovo." Institutional Paper 107. 2019.
13 SELDI. 2020. "Hidden economy in the Western Balkans 2020: Trends and Policy Options." Policy Brief No.11.
14 OECD. "The COVID-19 Crisis in the Western Balkans." 2020.

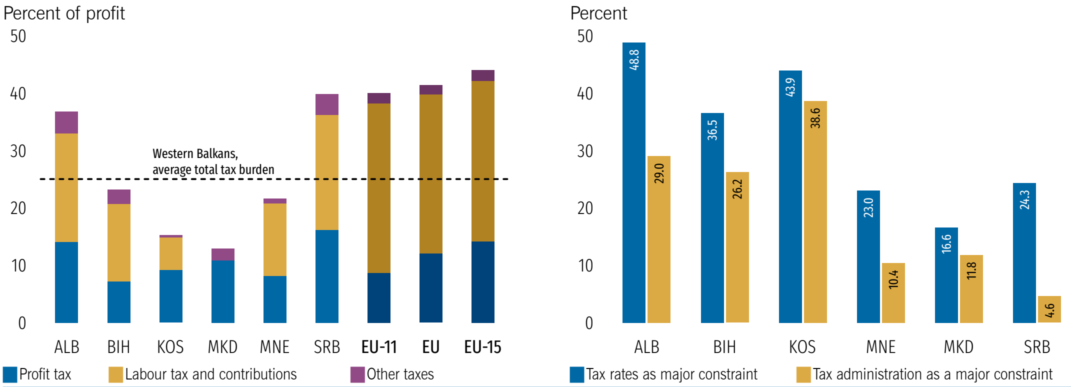
Informality in the Western Balkans

There are different degrees of informality involving different dimensions, including legal, fiscal, and labor informality. Informal activities circumvent government regulations on registering business, paying taxes, and hiring employees, respectively. Unregistered firms hide all their output, but registered firms may also choose to hide a fraction of their output to reduce their tax liability. Similarly, workers might work entirely without a contract or understate their actual earnings.

Although the informal sector consists of both informal businesses and informal workers, this spotlight will focus on informal businesses and explore interventions that are likely to promote formalization. Hidden employment (labor informality) is particularly common in the region. It refers to the practice of working, or employing, without contracts, and also to under-reporting of income or wages earned. The EU estimates that in the Western Balkans hidden employment averages more than 30 percent. In the last five years, only Serbia has been able to bring it down, by 5 percentage points (pp). In Kosovo 35 percent of those employed engaged in informal work, either partly or completely.[15] In Albania, 34 percent of workers earn more than they declare ("cash-in-hand payment).[16] These statistics are of concern as informality tends to be linked to low-income jobs, and often jobs that cannot be done from home—situations exacerbated by the global pandemic.

15 World Bank. "Jobs Diagnostic Kosovo." 2017.
16 Ibid.

Figure 10.1. Tax burden and fiscal and labor informality.



Source: EBRD 2016, Enterprise Surveys 2019.

Note: While both figures present data for BiH, labor tax rates in Republika Srpska are different those in Federation (FBiH). Republika Srpska has already undertaken measures to reduce the rates, while in FBiH, reforms to cut down labor tax rates are currently before parliament.

Fiscal informality relates to the lack of tax compliance, to which tax administration and structure both contribute. For example, the tax wedge on labor in Montenegro is among the highest in Europe.[17] This reduces competitiveness because it incentivizes firms to engage in not only fiscal but also labor and legal informality. High taxation can affect profitability, which discourages compliance and affects business growth prospects.[18] Furthermore, higher tax rates are associated with fewer formal businesses and lower private investment[19], although the relation between tax rates and informality is highly dependent on the country context. The relationship is not entirely linear either, simply lowering the tax rate might not be effective in addressing informality—holistic interventions are necessary. Burdensome tax adminstration and processes, frequent changes in tax policy, and lack of trust in institutions all erode tax morale and encourage firms to stay informal (Figure 10.1).

A high tax burden on labor might discourage formal employment and cause businesses to elude full income disclosure. In Montenegro, for instance, 53.6 percent of businesses state that they report lower income, and 54 percent of the citizens report never having received fiscal receipts[20]—one of the most common practices for evading tax. Businesses in countries with a large difference between the total labor cost in the official economy and after-tax earnings may have incentives to reduce the tax wedge and work in the shadow economy.[21]

Legal informality refers to lack of registration or compliance with official requirements (e.g. obtaining licenses). While legal informality is lower than labor informality in the Western

17 Brookings. "A low-wage, high-tax trap in the Western Balkans." 2019.

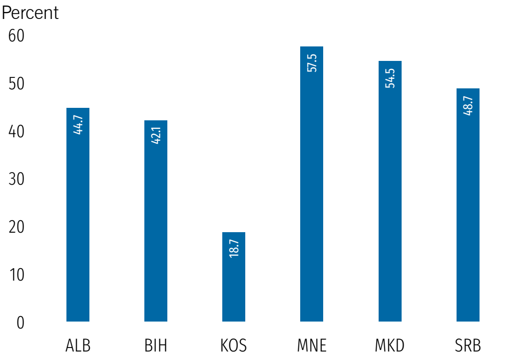
18 Ihrig, Jane. Karine S Moe. "Lurking in the shadows: the informal sector and government policy," Journal of Development Economics. 2004.

19 Djankov, Simeon, Tim Ganser, Caralee McLiesh, Rita Ramalho, and Andrei Shleifer. "The Effect of Corporate Taxes on Investment and Entrepreneurship." American Economic Journal: Macroeconomics 2. 2010.

20 CRPM. "Undeclared Tax Haven – The Hidden Economy and Tax Evasion in Macedonia, Albania, and Kosovo." Skopje: Center for Research and Policy Making. 2017.http://www.crpm.org.mk/wp-content/uploads/2017/05/11.-PB2-RHEM-17.05.2017-MK1.pdf

21 Schneider, F, Buehn, A. "Estimating the Size of the Shadow Economy: Methods, Problems and Open Questions" 2016.

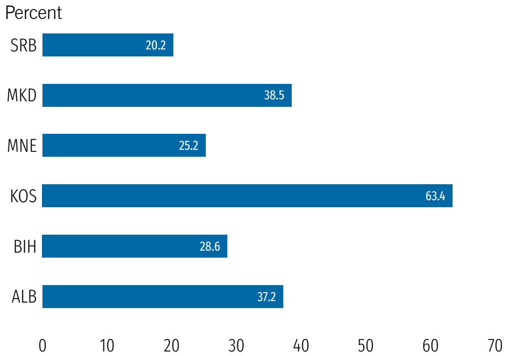
Figure 10.2. Firms competing with unregistered or informal firms.



Source: Enterprise Surveys 2019.

Note: Enterprise Surveys indicators on unregistered start-ups shows the percentage of firms that started operation without begin formally registered. It is an approximation to the prevalence of informality.

Figure 10.3. Firms identifying practices of informal competitors as a major constraint.



Source: Enterprise Surveys 2019.

Balkans, the practice of running a business unregistered continues (Figure 10.2).[22]

Many countries at earlier development stages have large informal sectors. Although informality is prevalent throughout the region, it affects different sectors in each country given different economic structures. Agriculture is most affected, particularly in BiH, Serbia, and North Macedonia. In Kosovo, Albania, and Montenegro, informality is more common in the trade, services, manufacturing, and construction. Also affected in Albania are the fashion, footwear, and garment industries, and in Kosovo, call centers and construction companies (SELDI 2020). Many emerging economies have large informal sectors, which provide employment and preserve economic dynamism in sectors that may not be able to formalize because of low productivity and high costs of formalization. As countries transition to higher income status they embark on efforts to improve productivity and incentivize the formalization of the economy, as the costs of formalization decline and the benefits increase.

Informality and Private-led Growth

High informality can hold back growth, creates unfair competition, and for the WB6 delays convergence with the rest of Europe. Informal firms are only about 25 percent as productive as formal firms, and formal firms that must compete with informal ones are only about 75 percent as productive as those with no informal competition.[23] This suggests that competition from the informal sector can erode formal firms' market share and the resources available to boost productivity. On average, 35 percent of WB6 firms identify practices of competitors in the informal sector as a major constraint (Figure 10.3). These practices range from offering bribes to circumvent regulatory processes to underreporting wages—all of which distort a level playing field. The unfair competition, in addition to its detrimental

22 Enterprise Surveys data show that well over 90 percent of the firms reporting were formally registered when they started operations—legal informality may therefore not be highly prevalent. Nonetheless, it is important recognize the possibility of selection bias: the data are mainly data from manufacturing firms, most of which are too big to be part of the informal sector; the findings may be different for agriculture or services.

23 Amin, Mohammad, et al. "Casting a Shadow Productivity of Formal Firms and Informality." World Bank. 2019.

effects on formal businesses, negatively affects employment, working conditions, and wages of formal workers. The severity of impact, however, varies across countries in the WB6 due to sectoral and firm-level characteristics, although it tends to affect more manufacturing than services.

The costs associated with informality for governments include but are not limited to distortions in the labor market and forgone revenue due to underreporting of wages and output. Firms that operate informally circumvent government regulations with respect to tax and legal accountabilities and quality assurance—which all breed unfair competition and corruption and inhibit formal enterprises from growing and innovating. Lost public revenue is another cost. For example, Albania's tax-to-GDP ratio is far below the regional average because of widespread tax evasion, including in the informal economy. VAT evasion is estimated at 30–40 percent of potential VAT.[24] Informality also has a significant social cost, since informal sector workers have no access to social security, unemployment benefits and other benefits and are therefore more vulnerable to swings in the economic cycle. Like in other regions, COVID-19 has particularly impacted the most vulnerable businesses, including informal ones and informal workers (Box 10.1).

Determinants of Informality in the Western Balkans

Studies on the informal economy in the region list several key factors which can drive one or all three dimensions of informality concurrently. Prominent factors include regulations and business environment, taxation, credibility and quality of institutions, corruption and trust in government service delivery, and lack of deterrence (inspection) mechanisms. Some drivers could be more prominent in some countries than others, and impact economies differently depending on existing gaps and modalities. For example, Transparency International rankings suggest that North Macedonia and Bosnia and Herzegovina are most affected by corruption in the WB6 while the Doing Business ranking suggests that Albania's businesses find tax administration particularly constraining.

Overregulation, lengthy and sluggish procedures, and high compliance costs (both official and unofficial) throughout the business lifecycle may incentivize entrepreneurs to operate informally. In Montenegro businesses are undermined by slow administrative responses and lack of deadline compliance; in Kosovo contract enforcement is weak and the energy supply unreliable.[25] Senior management in Kosovar firms reported spending more than 10 percent of their time dealing with government regulatory requirements.

Improving the regulatory environment can contribute to the formalization of businesses that have the capacity to transition out of the shadow economy. Drivers of informality are generally interlinked. For instance, corruption and lack of trust in public institutions, which negatively impact tax morale, are linked with regulatory burden. Findings and analysis from firm-level surveys reveal that bribery rates

24 European Commission. "Economic Reform Programmes of Albania, Montenegro, North Macedonia, Serbia, Turkey, Bosnia and Herzegovina, and Kosovo." Institutional Paper 107. 2019.

25 Doing Business. 2020. https://www.doingbusiness.org/en/reports/global-reports/doing-business-2020.

Box 10.1. COVID-19 in the Western Balkans has exacerbated an already vulnerable informal sector.

The pandemic has hit micro and small businesses the hardest given their inability to absorb shocks due to plummeting demand in goods and services, and their limited capacity to deal with supply chain disruptions. This inability to cope is in part driven by their lack of access to credit and limited savings. Furthermore, enterprises employing undeclared workers, and also those who are self-employed (operating undeclared) have not been able to benefit from emergency and recovery government measures, including Instrument for the Pre-Accession Assistance (IPA) funds for post-COVID-19 economic recovery.

Businesses operating in the informal economy make up a large share of the self-employed who lack basic social protection that could provide a buffer against economic shocks. They are also over-represented in sectors most impacted by the crisis—such as agriculture, garments, and services. According to the ILO, 1.6 billion informal economy workers have been significantly impacted globally by the economic crisis created by COVID-19. They have experienced a 60 percent decline in their earnings, just within the very first month of the crisis.

The pandemic has also led to an increase in formal unemployment in the region, with employment losses amounting to seventy-six thousand jobs—a lower impact than initially expected thanks to the extensive job retention schemes implemented across the region which informal firms have not been able to take advantage of. It has therefore exposed how the current structure of Western Balkans labor markets, with its high share of informality, leaves people vulnerable to shocks. There is global evidence that lockdowns have hit informal workers especially hard, as they tend to work in sectors such as agriculture and services where informal firms and employment are more common and they have no access to social protection and little or no savings to fall back on. As most countries, Western Balkans countries responded to the COVID-19 pandemic by putting in place lockdown measures, leading to decreases in labor demand and thus a reduction in working hours or job losses. While not uniformly poor, informal workers are vulnerable to shocks because they are not able to access protection afforded to formal workers and also oftentimes are not eligible for social assistance support, which tends to be targeted to the poorest people or, as is common in the Western Balkans, to those with disabilities who are unable to work.

In addition to actions taken to protect informal economic operators, the lessons emerging from the pandemic also suggest the need to take targeted actions to protect informal wage workers and informal self-employed from shocks and prevent their slide into (deeper) poverty. In most cases, the best way to quickly support them during crises is through cash transfer and social assistance systems, whose scope and benefit amounts can be quickly expanded when there are mechanisms in place to identify and register potential beneficiaries. Some countries in the Western Balkans, notably Bosnia and Herzegovina, Kosovo, and North Macedonia, used their social assistance programs to extend coverage of social assistance to prevent poor people, who were not eligible for other types of support, from falling deeper into poverty. Montenegro instead provided a one-time assistance to all unemployed persons registered with the Public Employment Services who did not receive other government transfers, and Kosovo introduced a temporary unemployment assistance for workers who lost their jobs due to COVID-19. Governments in Albania, Kosovo and Montenegro incentivized the formalization of work relationships during the pandemic by providing wage subsidies to newly registered workers. Despite the quick response to COVID-19 across Western Balkan countries

Box 10.1 continued

through a range of measures, gaps in coverage have persisted, exposing the vulnerability of informal workers to shocks.

Some countries are experimenting with how to extend social insurance mechanisms to informal workers in a more sustained manner. Often, this involves promoting voluntary saving by low-income workers, who tend to be informal, through establishing dedicated financial products, sometimes accompanied by matching grants from the Government and behavioral nudges, such as automatic reminders.

Given limited coverage and not very generous unemployment benefits in most Western Balkan countries (for example, only 1.8 percent of unemployed Albanians are eligible for benefits), governments could consider expanding access to the formal social protection system to a greater proportion of the population. Innovative options include, e.g., individual accounts to which employers and employees contribute but which are portable across jobs and later in life can be used to complement pensions.

While informal business and workers have been disproportionally impacted, on the flip side informality may have presented the newly unemployed an opportunity for pursuing alternative livelihoods—providing flexible ways for people with very little capital to earn a living. While at this time there is lack of readily available data to quantify and validate the increase in informal firms because of the pandemic, the ensuing crisis and joblessness signal a probable increase in the size of informal economy.v

increase by 0.03 percentage point for each percentage point increase in the regulatory burden.[26]

While the business environment is an important driver of informality, it should not be perceived as the only, or the most important, driver. Other contributors to informality are low access to finance, skills, markets, and technology. For example, lack of financial literacy is common in Albania, undermining financial inclusion: only 40 percent of adults and about 75 percent of SMEs have a bank account. This combined with such factors as burdensome tax administration and limited skills, fuels informality. In Serbia and other WB6 countries, high tolerance for the gray economy in inspectorates, customs, and the courts also encourages informality.

26 Amin, M. Soh, Y. "Does Greater Regulatory Burden Lead to More Corruption?" World Bank, 2020.

Efforts in the Region to Tackle Informality

A number of countries in recent years have adopted programs that are specifically designed to target informality or encompass informality within a broader action plan (Table 10.2).

Albania has implemented a number of action plans targeting broader economic reforms, with a strong focus on tax policy and administration. In 2015, in close collaboration with the IMF, Albania drew up a series of Action Plans targeting broader economic reforms but also addressing legal, fiscal, and labor informality. By 2017, Albania had an average of 56 registered firms per 1,000 people, up from

Table 10.2. Country programs to address informality.

Country	National Programs	Focus (Informality-specific)
Kosovo	Strategy and Action Plan (2014–18)	Implementing fiscal measures
	Revised Strategy and Action Plan (2019–22)	Simplifying legislative framework Enhancing monitoring and inspection
Serbia	National Programme for Countering the Grey Economy (2015–18; extended to 2019/20)	Reforming tax administration Reducing administrative burden Raising public awareness
Albania	Economic Reform Programme (2020–22)	Targeting revenue mobilization Targeting tax evasion
Montenegro	Distinct strategic plans (2016–18)	Improved monitoring of informal economy Building institutional capacity
	Economic Reform Programme (2020–22)	Creating new regulatory framework Introduction of e-procurement and e-fiscalization Improving business environment
	Ministry of Labour and Social Welfare Programme "Stop informal economy"	Hiring graduate students to support government activities against informality during the tourism season (for inspections. tax administration, customs administration and police)
North Macedonia	Strategy for the Formalization of the Informal Economy (2018–22)	Increased monitoring Improving business environment Strengthening tax morale
BiH	Joint Socio-Economic Program (2020–22)	Implementing labor market adjustment based on labor cost subsidization Reforming unemployment benefits scheme Lowering tax burden
	Federation Development Strategy (2021–27)	**under approval procedure*

40 in 2014[27].[28] Furthermore, between 2014 and 2019 informal employment fell from about 50 to 37 percent according to Enterprise Surveys. However, during the same period 100,000 businesses deactivated or initiated closing procedures. Albanian businesses have raised concerns with tax rates, rent-seeking by public officials, and minimal access to financing[29]—factors contributing to informality or deterring survival of informal firms that formalize. Tax administration remains complex and businesses deal with 35 tax payments a year, more than double the regional average of 14. Efforts to improve tax administration are already underway (e.g. awareness campaigns), but could be strengthened through improving risk-based auditing and increased use of data analytics by tax authorities. Streamlining burdensome inspections can also support efforts to reduce informality. A medium-term revenue mobilization strategy currently being designed can also be used to address informality and tax evasion.

27 Although no specific data is available, it is assumed that the increase may relate to individual farmers. In 2015, the government of Albania issued a new requirement for farmers to register with the tax authorities, in order to be able to sell their products to collectors and agri-processors. As a result of this requirement, during 2015 and 2016 some 30,000 farmers (individual households) were registered for tax purposes.

28 Kosta, Brunilda. "Emerging from the Darkness: Albania's Informal Economy." CSIS. 2018.

29 The Global Competitiveness Report. World Economic Forum. 2019.

The two autonomous entities in Bosnia and Herzegovina (BiH) and the BiH Council of Ministers have adopted a Joint Socio-Economic Program (2019–22) which incorporates measures to address vulnerable workers and begin to formalize the informal sector by, e.g., extending labor subsidies and reforming unemployment insurance to make it more inclusive. The Program also focuses on sustainable and accelerated economic growth as well as greater competitiveness of the private sector and better business environment. BiH Federation has drafted the Development Strategy 2021–27 currently awaiting Parliament approval, within which it also aims to address informality. Republika Srpska in BiH has lowered its labor tax burden to help motivate greater formalization of existing businesses and formal registration of newer ones; in the Federation of BiH the necessary legislation still needs to be completed. Republika Srpska has also taken steps to simplify the registration process for firms, introducing online platforms and one-stop-shops. The government offers support programs to MSMEs, as well as revolving credit scheme. Similar regulatory changes are being prepared by the BiH Federation.

In 2014, the government of Kosovo for the first time adopted a four-year Strategy and Action Plan for the prevention and reduction of informal activity, with particular attention to money laundering. This plan further strengthened Kosovo's existing program of installing fiscal cash registers for tracing payments and transactions, with the objective of broadening the tax base and bringing firms under the legal umbrella. Nevertheless, at 35 percent Kosovo has the highest informal employment in the region.[30] Institutional weaknesses in providing quality governance and weak inspections have consistently been some of the main factors driving informality in Kosovo. The government therefore revised its *Strategy and Action Plan* for 2019–22 to enhance monitoring, simplify legislation, and introduce a regulatory impact assessment system.[31]

Between 2016 and 2018 Montenegro launched a series of programs to support the transition from an informal to a formal economy, supported by the ILO. These are broader economic programs with numerous focus areas, one of which is tackling informality in the country. The informality-specific component of these programs focused on improving the diagnosis and monitoring of the informal economy; enhancing the capacity of labor inspection, public employment, vocational education, and other government institutions; and enhancing social security services. In 2017, the government adopted the Action Plan for Countering the Informal Economy, the activities of which are continuously being implemented. Furthermore, the country adopted the new Labor law, introducing higher labor flexibility and allowing for better control of labor informality; it is implementing a Tax Administration Reform Program to increase efficiency through a new Integrated Revenue Management System and has started implementing the e-fiscalisation of goods and services aimed at increasing tax compliance and reducing informality. Reducing the informal economy is heavily dependent on a holistic and coordinated strategic approach, including through enhancing regulation, and improving the capacities of, and cooperation between, local and state institutions. Other important reforms

30 SELDI. "Hidden economy in the Western Balkans 2020: Trends and Policy Options." Policy Brief No.11. 2020.

31 Informal economy: the devil on Kosovo's shoulder. Prishtina Insight. 2019.

include legislation on public procurement and banking. Efforts need to continue on rationalizing the number and the amounts of fiscal and parafiscal charges imposed by municipalities, strengthening public-private partnership and dialogue, and modernizing procedures for adopting and enforcing laws[32]; since Montenegro's regulations are perceived as unstable and unpredictable, owing to poorly explained laws affecting businesses and employees,[33] and also to its inconsistent and selective implementation.

North Macedonia's business environment is ranked better than that of its peers (ranked 17th out of 190 on ease of doing business) but there is still a significant reform agenda to support formalization. In 2018, the Ministry of Labor and Social Policy issued the Strategy for the Formalization of the Informal Economy (2018–22) to (1) promote measurement, monitoring and detection of informality; (2) improve the business environment; and (3) enhance tax morale for effective reduction of informal employees, unregistered business entities, and informal activities within the formal economy.[34] The Ministry of Finance later issued the Action Plan for Eradication of the Gray Economy 2020–21. In North Macedonia informality mainly manifests itself through tax evasion. For instance, foregone VAT revenues due to noncompliance is estimated at about 20 percent of actual VAT revenues. Other forms of tax evasion are undeclared customs duties on imports or reporting lower income before taxes. To address the issue, the government experimented with an incentive to citizens to buy only from registered traders by reimbursing 10% of VAT on foreign goods and 20% of VAT on domestic good, the myVAT program. [35] In 2021, the new Tax System Reform Strategy 2021–25 further targets reforms to combat tax evasion through strengthening of tax administration, and reviewing legal loopholes in tax laws allowing for tax avoidance. Access to finance has also been cited as a problem for North Macedonia's companies. For over a decade the country has offered €5,000–€10,000 grants to register a company, which has been taken up annually by an average of over 1,000 people.

In 2015, Serbia adopted a three-year reform program (extended to 2019/20), the National Programme for Countering the Grey Economy, to improve the country's business climate and reduce the size of its informal economy.[36] The program's measures were aimed at achieving (1) efficient oversight over grey economy flows; (2) improving the functioning of fiscal systems; (3) reducing administrative and parafiscal burdens; and (4) raising public awareness and encouraging the public to respect the regulations. Recent data estimates that the share of informal employment in total declined between 2016 and 2020 by 5.6 percentage points (based on LFS data), although other factors may also have contributed, like the revised Labor Law (adopted in 2014) as well as outmigration of workers who typically work informally. The plan also included a comprehensive tax reform with detailed guidelines on risk-based audits, trainings, reorganization of taxations

32 Economic Reform Programmes of Albania, Montenegro, North Macedonia, Serbia, Turkey, Bosnia and Herzegovina, and Kosovo. European Commission. Institutional Paper 107. 2019.

33 Economic Reform Programmes of Albania, Montenegro, North Macedonia, Serbia, Turkey, Bosnia and Herzegovina, and Kosovo. European Commission. Institutional Paper 107. 2019.

34 Blazevski, N. M., Policy Brief on Undeclared work in The Former Yugoslav Republic of Macedonia. 2018.

35 APP. "Self-Employment." 2020. http://apprm.gov.mk/News?NewsID=507.

36 IMF. "Republic of Serbia: Request for a 30-Month Policy Coordination Instrument-Press Release." 2018.

departments, and heavier fines and penalties, which has resulted in increased compliance.[37] Serbia has moved to ease access to public services through digitalization, to formalize entrepreneurship and employment. In 2018 it passed the *Law on Simplified Work Engagement on Seasonal Jobs in Selected Areas*, which allows for electronic registration of seasonal workers in agriculture. Serbia has also exempted businesses from income taxes and social security contributions in their first year of operation[38]. The government is also planning to make progress in the implementation of e-government services, including plans to digitalize over 100 administrative procedures.

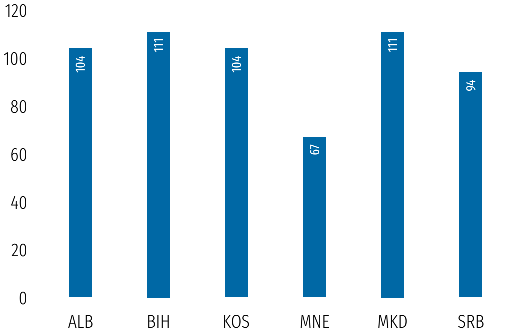
Institutional Credibility and Trust and the Decision to Remain Informal

Government credibility is key to tackle informality. Better taxation or labor market regulation may be necessary for governments to address informality, but credibility in delivering government-to-business public services and maintaining public goods is equally fundamental. In some countries in WB6, where the tax burden may be low and is not seen as a major contributor to informality, informality is instead perpetuated by poor management of business information, low trust in government, and the perception of poor quality public services.

Making government institutions more credible encompasses strengthening the rule of law, reducing corruption, ensuring equitable regulation, and improving transparency and the quality of regulation. Corruption is problematic because it not only undermines tax morale but also deters efficient allocation of resources. Most countries in the region rank low on Transparency International's Corruption Perception Index (CPI) 2020 (Figure 10.4). The prevalence of corruption and politization of civil servants is recognized as a major issue in the Western Balkan countries[39].

Figure 10.4. Global ranking (out of 180 countries) of Western Balkan countries based on the corruption perceptions index

Transparency International 2020, Corruption Perceptions Index – Global Rank



Source: Transparency International's Corruption Perception Index 2020.

Rethinking Informality in Western Balkan Economies

Growth of the informal sector accentuates the need for appropriate policy responses. As the pandemic aggravates the vulnerability of informal businesses and their inability to access government support, response measures become less effective in protecting informal workers and businesses.

To tackle informality, policies should be tailored to target the determinants most pertinent in each country, balancing

37 National Program for Countering Shadow Economy in Serbia. NALED. 2020.

38 NALED. "National Program for Countering Shadow Economy in Serbia." 2020.

39 European Commission, A credible enlargement perspective for and enhanced EU engagement with the Western Balkans, February 2018.

preventive and punitive measures. Informality grows because it is often a source of employment when there are few formal opportunities or as a safety net in economic downturns.[40] Policy should therefore build around a dual objective: help informal firms to become more productive while creating an enabling environment to incentivize formalization for firms who can, including through stricter enforcement. Structural reforms to improve the business environment need to include efforts to strengthen the rule of law and institutional capacity. Sequencing business environment and labor market reforms may reduce short-term costs. This is in line with the evidence that is emerging from recent literature on the need to adopt holistic, multidimensional approaches.

Approaches to target informality will likely differ based on each country's distinct challenges and existing socio-economic landscape. For example, in BiH, there is a need for greater harmonization of policies pertaining to the business environment across the country as a result of the country's fragmented governance structure. While in North Macedonia, where informality is driven by tax evasion, increasing the tax morale by improving government effectiveness, reducing corruption and ensuring better quality of public services might address the problem more effectively. However, there are multiple other factors influencing a business' decision to formalize, including business culture, limited access to finance and to market linkages, and presence of manual (non-digitalized) processes, etc. Interventions and reform strategies should therefore be more holistic targeting distinct factors.

A prominent and impactful example of a region-wide strategy could be digitalization of government-to-business service delivery, which gives informal firms incentives to go formal by reducing the opportunities for arbitrariness, corruption, and unregistered transactions—as well as the broader costs of doing business (Box 10.2)[41]. The use of digital identity, for instance, eases processes such as cash transfers, enforcing propriety rights, and enhancing social protection programs. Low- and middle-income countries often lack robust civil registration systems and therefore by building digital ID systems many are leapfrogging the traditionally physically based systems while supporting the emergence of some e-services. Successful examples are found in Albania, India, Moldova, and Pakistan.

In parallel, new policy avenues could be explored to support formalization. For instance, an intermediate legal or tax status could be used for informal businesses transitioning to full formal status. It could provide a grace period during which the informal business could benefit from formalization without the associated costs. This would help the business understand the potential benefits and give governments more time to influence the cost-benefit calculations that businesses ultimately make when thinking about formalization. Similarly, in recent years, a number of countries have introduced a more flexible legal form, the simplified corporation, among them France, US, Argentina, Colombia, Chile, Mexico, Peru, Ecuador and Paraguay. This reduces operating costs and allows for more flexible management. In Colombia, within five years of the reform 95 percent of companies were

40 Kelmanson, B., Kirabaeva, K., Medina, L. and Mircheva, B. "Explaining the shadow economy in Europe: size, causes and policy options". IMF, 2019.

41 OECD. "G20 Policy Guide: Digitisation and Informality." 2018. http://www.oecd.org/g20/G20-Policy-Guide-Digitisation-and-Informality.pdf.

Box 10.2. Digitalization and informality.

Digitalization can enhance the impact of institutions and policies addressing informality. New technologies can be, and often are, leveraged to make public services more effective, accessible and responsive to people's needs. It is notable that progress in electronically enabled government, measured by the e-government development index (EGDI), has a negative correlation with informality.

Reforms to address many of the factors which drive informality such as burdensome regulations, complex tax filing procedures and administrative processes, tax evasion, and lack of public awareness etc. can be supported by technology driven interventions. Administrative processes change drastically in complexity and time required, depending on whether it is done manually or electronically, virtually or in general with any of the new technologies, including algorithms, big data, or artificial intelligence. Similarly electronic fiscal registers and tax filing systems, one-stop-shop online windows, and online payment platforms are technology induced solutions through which governments can improve public-facing administrative processes, increase tax morale, and considerably improve the capacity of enforcement and oversight.

Digitalization also offers an unprecedented opportunity to address the affordability barriers that push individuals and firms toward informality. Technology-driven solutions are profoundly reshaping government-to-business (G2B) connections by delivering government services like registration, e-licensing, and notarization electronically, facilitating information exchange, reducing transaction costs, and helping to build public trust in institutions. Protocols for G2B transformation require data sharing across government agencies and institutions. Establishing closer cooperation between local and national public bodies can address information gaps and facilitate enforcement of inspection and preventive measures, particularly for fiscal and labor informality. As demand for rapid technological advancement and digital innovation accelerates to reverse the disruption caused by the pandemic, if rightly leveraged this digital transformation can create new avenues for formalization.

registered as a simplified corporation. At least 2.5 million jobs are now in such companies and revenues and social security contributions have increased. Simplified legal or tax statuses are more attainable for microentrepreneurs that would otherwise not consider formalization. They could also make these businesses eligible for targeted technical assistance.

Another avenue for exploration is to target clusters of informal firms rather than individual firms. Their benefits and structure allow clusters to serve as a channel for interventions that support informal businesses by (i) efficiently reaching many businesses through a coordinated manner and central body that works with the cluster, and (ii) promoting growth of informal businesses and facilitating their transition to more formal legal status. Among the positive results of clusters for informal participants are allowing less experienced entrepreneurs to start a business, promoting greater access of informal businesses to customers and traders and accessing scale economies using division of labor. Emerging findings on the positive impact of clustering point to, e.g., higher profits for informal firms, productivity spillovers, and increased market links[42].

Finally, governments should consider complementing regulatory interventions

42 Nielsen, W., Ghossein, T., Marusic, A., & Solf, S. "Re-thinking the Approach to Informal Businesses." World Bank Group, 2020.

with public awareness-raising and sensitization campaigns. That tactic has had good results, for example in Colombia[43]. In conclusion, three consistent inferences from previous policy interventions could be applied in the Western Balkans: (i) there is no one-size-fits-all way to address informality, (ii) reforms need to be addressed to country-specific drivers of informality and gaps in existing national policies and (iii) while incentivizing formalization when possible, policymakers should support subsistence firms that lack capacity to formalize because they provide livelihoods for the poor. Ultimately, economic growth will change the formalization cost-benefit equation. Once there are more market opportunities, compliance will become more affordable. Equally, expansion will become more attractive—which often requires formalization.

43 The "*Colombia Goes Formal*" initiative which included the simplified legal status and an awareness campaign reached 77,615 entrepreneurs in 324 municipalities, of which 32.9% formalized.

Country Notes

Albania

- Albania was hit hard, first by an earthquake in November 2019 and then by COVID-19.
- As tourism and services shrank abruptly, GDP contracted by an estimated 3.3 percent.
- Reconstruction and COVID-19-related stimulus alleviated the shocks, but fiscal space was diminished.
- Reconstruction is likely to be the main driver of the recovery in 2021, supplemented by mild growth in private demand due to continuing restrictions on travel.

Recent Economic Developments

Growth contracted by 3.3 percent in 2020. The COVID-19 pandemic took a heavy toll on an economy already devastated by the earthquake in 2019. However, the shock to economic fundamentals and economic growth was considerably more contained than was initially feared. Key sectors were put in lockdown in the second quarter (Q2) as the economy suffered a severe contraction of -10.6 percent. The pandemic hit the travel and tourism sectors first, and official restrictions and post-COVID behavior change together affected both supply and demand. Given the structure of the economy, the loss in sales, and profits, had a disproportionate effect on small and medium enterprises. In the summer, economic activity returned as social distancing measures were lifted, and domestic tourists partly compensated for the drastic decline in foreign visitors. While in Q3 growth declined by 2.8 percent, post-earthquake reconstruction reduced the effects of the pandemic; in Q4 increased construction led to a growth of 3 percent (y-o-y).

Private consumption and investment decisions were delayed by uncertainty about the end of the crisis as the number of infections rose gradually during the year. Investment contracted by 1.8 percent in 2020, and private consumption declined by 2.4 percent[1]. Fewer garment processing orders led a 6.7 percent drop in goods exports, and tourist visits plunged by 60 percent. Net exports added to growth by 0.5 percentage point (pp), as imports contracted more than exports in response to a slackening of private demand.

Despite structural problems, labor market indicators were corrected relatively quickly after the initial lockdown and the economy started to open up. In the summer, employment bounced back, with tourism and reconstruction partly absorbing losses in manufacturing jobs.

Increased social spending and earthquake reconstruction alleviated the impact of the pandemic on poverty. Albanian authorities introduced wage subsidies, increased social spending, and launched two credit guarantee windows through commercial banks to ease salary payments and release financing for working capital and investment needs. Public spending rose to 33.2 percent of GDP. To help small and medium enterprises, tax deferrals and further VAT exemptions were introduced. Total public revenues slumped to 26.5 percent of GDP, despite grants financing reconstruction. The larger fiscal deficit and the extension of

1 Does not include statistical discrepancy.

post-COVID guarantees for the private sector caused public debt to soar to 77.4 percent of GDP. Because the fiscal rule mandates that the debt-to-GDP ratio decline every year until it reaches 45 percent of GDP, Albania's debt ratio had been declining since 2017, but increased again in 2020 as a result of the pandemic. The fiscal rule includes an emergency escape clause that applied in 2020.

Inflation has stayed below the target band, although following the lockdown it started to reflect higher transport and production costs. Average inflation reached 1.6 percent in 2020, mainly because of supply chain disruptions during the lockdown. Food price increases contributed the most to inflation. These effects began to ease, however, as some containment measures were lifted by May.

With inflation low, monetary policy was accommodative: the Bank of Albania (BoA) lowered the monetary policy rate and injected liquidity into the banking system. In response to the COVID-19 shock to the economy, the BoA again lowered the base policy rate by 50 basis points, to a new historic low of 0.5 percent. In addition, to support banking system liquidity buffers, it abolished the ceiling on short-term central bank loans. It also introduced such macroprudential tools as lowering the capital requirement for government securities in foreign exchange to help banks finance government borrowing in foreign currency; there is ample foreign currency liquidity in the domestic market.

The exchange rate remains flexible, which helps Albania absorb external shocks. By the end of 2020 the domestic currency had appreciated by 1.3 percent against the euro. The banking sector is well-capitalized and liquid and has helped to buffer the crisis. Credit to the economy rose by 6.7 percent by the end of 2020, supported by the COVID-related credit guarantee schemes and low funding costs. In response to the pandemic, the BoA implemented such relief measures as moratoriums, loan restructuring, and favorable loan classifications, some of which will continue into spring 2021. The effects of the crisis on loan portfolio quality are expected to become clearer toward the second half of 2021, with a possible increase in nonperforming loans.

The current account deficit increased to 8.9 percent of GDP in 2020 as the trade deficit in nominal terms expanded. Remittances continued to flow in the country despite the crisis in EU countries where migrants reside. Reduced tourist inflows, declining textile processing orders, and lower oil prices drove a 28.6 percent decline in exports y-o-y. Foreign direct investment (FDI) and substantial government borrowing, including commercial and IFI funding, financed the current account as FDI dropped to 6.9 percent of GDP.

Outlook and Risks

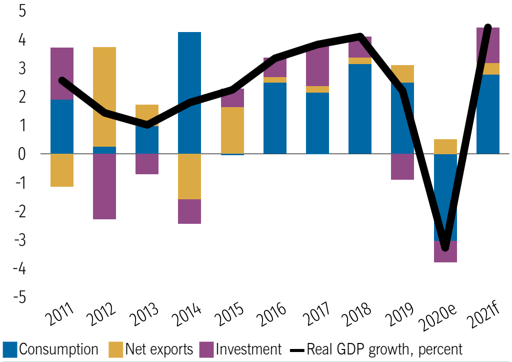
Given that the global vaccination rollout will take several years, growth in tourism and travel are likely to remain limited. In that case, in 2021 GDP would grow by an estimated 4.4 percent as exports, consumption, and investment begin to rebound. The services sector, led by tourism, and construction are expected to drive the recovery, in part thanks to investment in reconstruction, as has occurred after similar natural disasters in developing economies. In the next few years, private consumption will become increasingly important for growth, supporting reconstruction efforts. Private investment will contribute to growth as long as the government continues to reform the business climate and business access to finance opens up. Beyond 2021, limited fiscal space is likely to restrict government spending. The fiscal situation could deteriorate if revenue collection does not expand. In that case, the government might need to reduce capital spending to contain the debt-to-GDP ratio and comply with the fiscal rule.

The current account deficit is expected to narrow to 7.7 percent of GDP in 2021 on its way down to 6.4 percent, in line with pre-crisis trends and driven by projected improvements in the trade balance. Service exports, especially tourism and fast-expanding business-process operations, should narrow the trade deficit over the medium term. Import growth in 2021 will be high at 15.8 percent as infrastructure investment speeds up.

With economic activity picking up, revenues are projected to recover to 27.6 percent of GDP in 2021–22. In 2021 Albania's public debt is projected to decrease only marginally, to 77.3 percent of GDP. The employment outlook is heavily dependent on recovery of the services sectors and on reconstruction, where jobs are mostly low pay and vulnerable to economic uncertainty.

The COVID-19 pandemic and the earthquake hit the economy hard.

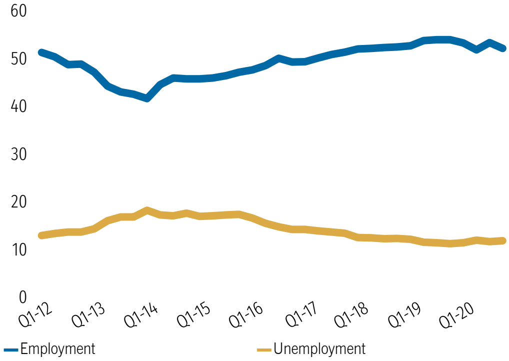
Contributions to growth, percentage points



Source: INSTAT and World Bank staff calculations.

But the effect on the labor market was less severe.

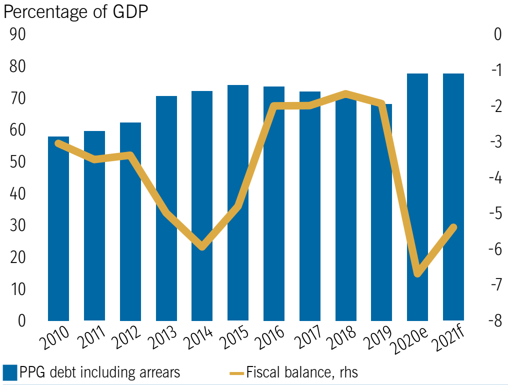
Percent



Source: INSTAT.

Strong fiscal stimulus supported the vulnerable—but at the cost of increasing public debt.

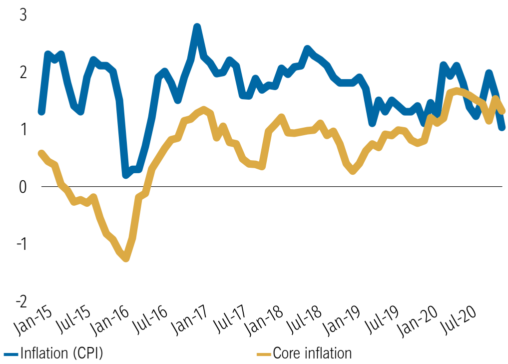
Percentage of GDP



Source: INSTAT, MoFE and World Bank staff calculations.

Inflation fell below the target band of 2–4 percent.

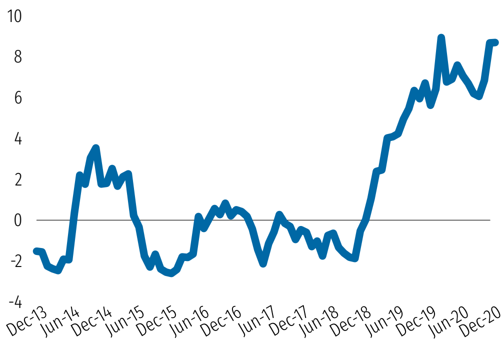
Percent



Source: BoA and World Bank staff calculations.

Guarantee instruments were used to stimulate credit growth.

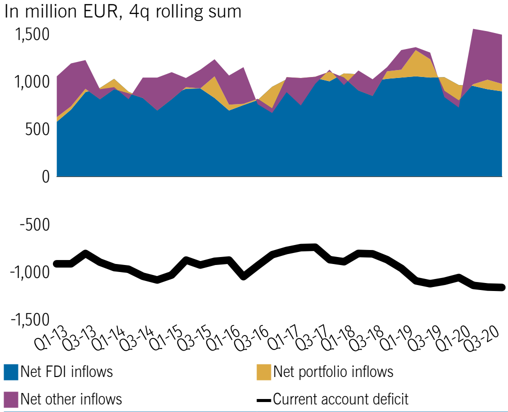
Percent



Source: BoA and World Bank staff calculations.

The expanded current account deficit was financed through government borrowing.

In million EUR, 4q rolling sum



Source: BoA and World Bank staff calculations.

ALBANIA	2017	2018	2019	2020e	2021f	2022f
Real GDP growth (percent)	3.8	4.1	2.2	-3.3	4.4	3.7
Composition (percentage points):						
Consumption	2.1	3.1	2.5	-3.0	2.8	2.5
Investment	1.5	0.7	-0.9	-0.7	1.2	-1.1
Net exports	0.2	0.2	0.6	0.5	0.4	2.2
Exports	4.1	1.4	2.0	-8.9	5.2	4.0
Imports (-)	3.8	1.1	1.4	-9.4	4.8	1.8
Consumer price inflation (percent, period average)	2.0	2.1	1.4	1.6	2.4	2.8
Public revenues (percent of GDP)	27.8	27.5	27.4	26.5	27.8	27.4
Public expenditures (percent of GDP)	29.8	29.2	29.4	33.2	33.3	31.4
Of which:						
Wage bill (percent of GDP)	4.7	4.5	4.6	4.8	4.9	4.7
Social benefits (percent of GDP)	12.0	11.6	11.9	13.7	13.0	12.3
Capital expenditures (percent of GDP)	4.4	4.8	4.5	6.3	6.6	4.6
Fiscal balance (percent of GDP)	-2.0	-1.7	-2.0	-6.7	-5.4	-4.0
Primary fiscal balance (percent of GDP)	0.0	0.5	0.1	-4.7	-2.9	-1.4
Public debt (percent of GDP)	66.9	64.9	63.7	75.1	75.4	74.9
Public and publicly guaranteed debt (percent of GDP)	71.9	69.5	67.9	77.4	77.3	76.6
Of which: External (percent of GDP)	31.6	30.4	29.1	34.1	32.7	30.3
Goods exports (percent of GDP)	6.9	7.7	6.6	6.1	6.2	6.2
Goods imports (percent of GDP)	31.3	30.1	29.7	29.1	29.2	29.1
Net services exports (percent of GDP)	9.4	8.7	9.3	8.1	8.9	11.2
Trade balance (percent of GDP)	-15.1	-13.7	-13.8	-14.8	-14.1	-11.7
Net remittance inflows (percent of GDP)	5.5	5.2	5.2	5.2	4.8	4.8
Current account balance (percent of GDP)	-7.5	-6.8	-8.0	-8.9	-7.7	-6.4
Net foreign direct investment inflows (percent of GDP)	8.6	8.0	7.6	6.9	6.2	7.7
External debt (percent of GDP)	68.8	65.2	60.5	65.0	60.9	55.4
Real private credit growth (percent, period average)	-2.3	-3.0	1.5	5.2	n.a.	n.a.
Nonperforming loans (percent of gross loans, end of period)	13.2	11.1	8.4	8.1	n.a.	n.a.
Unemployment rate (percent, period average)	13.7	12.3	11.5	11.7	n.a.	n.a.
Youth unemployment rate (percent, period average)	25.9	23.1	21.5	20.9	n.a.	n.a.
Labor force participation rate (percent, period average)	58.3	59.4	60.4	59.5	n.a.	n.a.
GDP per capita, PPP (current international $)	11,693	15,101	15,433	n.a.	n.a.	n.a.

Sources: Country authorities, World Bank estimates and projections.

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

Bosnia and Herzegovina

- It is estimated that the economy of Bosnia and Herzegovina (BiH) contracted by 4.3 percent in 2020. As the world recovers from the COVID-19 crisis and with progress on the BiH Economic Reform Program, growth is expected to gradually recover.
- The crisis highlights the country's need for long-delayed structural reforms to speed recovery.
- Addressing persistent unemployment and countering the layoffs during the pandemic is critical to reducing poverty.
- The economic outlook is positive, but with downside risks, both domestic and external. The external risks are related to how slower-than-expected recovery in the EU could affect BiH accession prospects, and to tighter financial conditions in international markets; at home, general elections in 2022 are likely to generate political turmoil. Accelerating structural reforms is necessary to mitigate those risks.

Recent Economic Developments

The pandemic generated a substantial output contraction of 4.3 percent in 2020 due to a slowdown in domestic demand, a weak external environment, and acute political uncertainty. In 2020 growth was positive in the first quarter (Q1) but after lockdown and containment measures were introduced in Q2 the economy braked to a sudden stop as domestic and external demand dropped. By Q4, domestic demand, and economic activity, had gained strength, but annual growth remained negative with overall consumption falling 3.4 percentage points (pp) and investment 4.7 pp. Difficulties in movement of goods and capital affected trade volumes, but the trade balance improved; exports were hard hit by the EU recession but were offset by a severe contraction in merchandise imports, so that ultimately net exports added 4 pp to growth. On the production side, activity declined in most sectors. The main contributors to the contraction were services (-3.1 pp), followed by industry (-0.8 pp) and agriculture (-0.1 pp).

Unemployment has worsened. According to official estimates, in November 2020 the number of people in paid employment was down by about 1 percent year-on-year (y-o-y), and the number of unemployed had risen by about 3 percent. Deeper labor market effects were prevented by wage subsidy programs in both BiH entities and other policy measures targeted to affected economic sectors to prevent more job losses. These labor market changes underscore the need to address structural rigidities to generate private sector jobs and reduce disincentives to participation in the labor market.

With demand depressed and oil prices lower, in 2020 deflation returned. In December the consumer price index was down 1.6 percent y-o-y. The strongest deflationary trends came from two categories that together constitute 30 percent of the CPI basket: transport prices, down by 8.6 percent y-o-y, and prices for clothing and footwear, down 10 percent).

To mitigate the impact of the pandemic, the BiH fiscal stance turned expansionary. A fiscal deficit of 5.4 percent[2] of GDP is expected for 2020, down from a surplus of 1.9 percent

2 BiH Global Fiscal Framework for 2020–22.

in 2019. In 2020 the fall in revenues was driven mainly by the slump in collecting tax revenue, especially for indirect taxes. Spending was up because of higher current spending on crisis-related measures, for both the health sector and support for business. Despite an estimated increase, capital spending is still insufficient, primarily because of long-standing project delays. The deficit has been financed primarily through borrowing domestically and from multilateral lenders. Total public and publicly guaranteed debt in 2020 is estimated to have been 39.6 percent of GDP,[3] up by 5.1 pp from a year earlier, of which 31.1 percent of GDP is external public debt, which is largely concessional and owed to international financial institutions.

Despite the pandemic, the financial sector has been generally stable, but its profitability has been slipping. On average, banks are sufficiently capitalized and liquid. The nonperforming loan (NPL) ratio continued to decline, reaching 6.1 percent by the end of 2020 Q4. Profitability, however, has also been trending downward, with return on equity at 6.0 percent in 2020 (Q4), having gone down from 10.2 percent in 2019 Q4 and 7.0 percent in 2020 Q3. The capital adequacy ratio increased from 18 at the end of 2019 Q4 to 19.2 at the end of 2020 Q4. Capital buffers are within requirements. Safeguarding the banking sector will continue to be especially important because the full impact of the moratoriums has yet to be assessed.

It is estimated that the current account deficit (CAD) widened slightly due to falls in the services balance and in remittances. The CAD is estimated to have grown from 3.2 percent of GDP in 2019 to 3.4 percent in 2020, mainly because both imports and (to a much lesser extent) exports both fell. The fall in exports was caused by lower inflows from transport and travel. At an estimated 7.4 percent of GDP for 2020, remittances are still a significant source of CAB financing, and they are supported by FDI and other investment. Reserve coverage for 2020 continued to be adequate.

Outlook and Risks

The outlook is marked by the continuation of measures to combat the pandemic. Authorities are currently focused on securing vaccines. As the pandemic subsides, attention is expected to return to the Socio-Economic Program,[4] mainly announcement of investments in energy and infrastructure. Consumption will continue to drive growth, especially growth of imports. Remittances will recover in the medium term, and, together with progress on reforms, will underpin a gradual pickup in consumption and finance a major portion of the trade deficit. A strong capital investment push must continue to be a high priority for the government. Once the crisis ends, planned investments in energy, infrastructure, and tourism will also support job creation.

As the pandemic subsides in 2021, economic growth is projected to reach 2.8 percent. The expected gradual economy recovery should improve labor market participation and employment, which are both vital if growth is to reduce poverty.

There are several risks to the outlook. The main one is prolongation of the pandemic,

3 For the latest debt data, see the CBBiH web portal.

4 The BiH medium-term development plan adopted in January 2020 to tackle necessary structural reforms.

which could lower growth in 2021 below projections. In addition, the challenging political environment, lack of agreement on the new Elections Law, and domestic political tensions will affect progress on socioeconomic programs. The main external risks for BiH are again slow growth in the EU and political tensions in the region.

In the medium term it will continue to be important for BiH to keep on a reform path that addresses long-standing issues. If the country is to be more competitive, the reforms must address entrenched structural and institutional problems. To unleash the potential of the private sector, BiH must reduce the very large footprint of the public sector. It also needs to shift its economy from an internal focus on local consumption and imports to making international integration a priority through investments and exports. BiH's unfavorable demographics and difficult politics could also exacerbate lingering effects of the pandemic and cause an even larger decline in GDP than is currently expected.

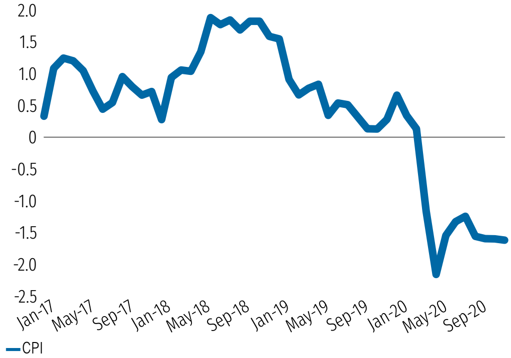
The COVID crisis caused GDP to contract in 2020.

Contributions to growth, percentage points

Source: BiH Agency for Statistics and World Bank staff forecast.
Note: Agri, Ind. Serv. - BHAS production approach; 2021 World Bank staff forecast.

Consumer price inflation turned to deflation in 2020.

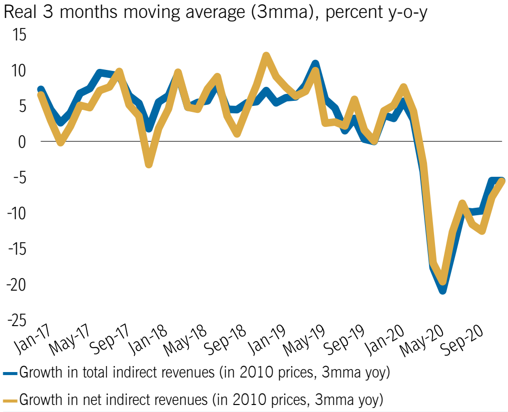
Percent y-o-y



Source: BiH Agency for Statistics and World Bank staff calculations.

The crisis reduced collection of indirect gross tax revenues, but by yearend collections began to improve.

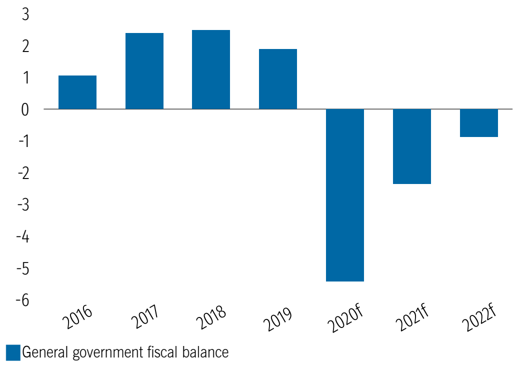
Real 3 months moving average (3mma), percent y-o-y



Source: BiH Indirect Tax Office and World Bank staff calculations.

To mitigate crisis impacts BiH chose an expansionary fiscal stance for 2020.

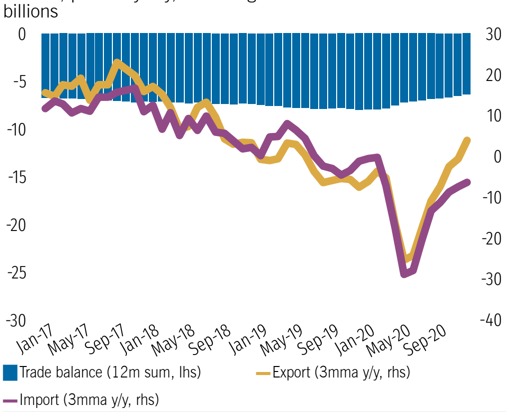
Percent of GDP



Source: Fiscal authoritie and World Bank staff estimates.

The deficit in the goods trade improved due to a fall in overall trade volume.

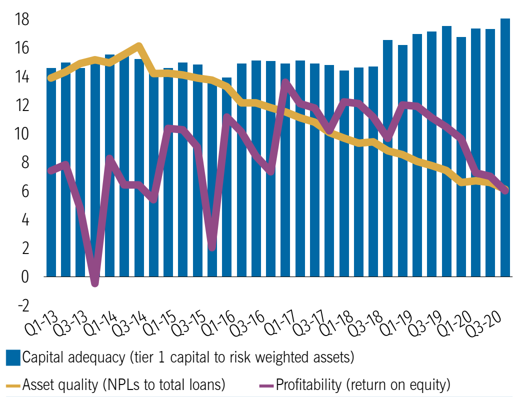
3 mma, percent y-o-y, and the goods trade balance in KM billions



Source: BiH Agency for Statistics and World Bank staff calculations.

Though still high, commercial bank nonperforming loans in commercial bank portfolios are trending down.

Percent



Source: Central Bank of BiH and World Bank staff calculations.

BOSNIA AND HERZEGOVINA	**2017**	**2018**	**2019**	**2020e**	**2021f**	**2022f**
Real GDP growth (percent)	3.2	3.7	2.8	-4.3	2.8	3.5
Composition (percentage points):						
Consumption	n.a.	n.a.	n.a.	-3.4	3.0	3.4
Investment	n.a.	n.a.	n.a.	-4.7	0.5	0.7
Net exports	n.a.	n.a.	n.a.	4.0	-0.7	-0.5
Exports	n.a.	n.a.	n.a.	-3.2	0.7	1.3
Imports (-)	n.a.	n.a.	n.a.	-7.2	1.5	1.8
Consumer price inflation (percent, period average)	0.8	1.4	0.6	-1.1	0.5	0.5
Public revenues (percent of GDP)	43.8	42.7	43.0	42.3	42.3	41.8
Public expenditures (percent of GDP)	41.4	40.2	41.1	47.8	44.6	42.6
Of which:						
Wage bill (percent of GDP)	11.0	10.2	10.9	11.4	11.3	10.9
Social benefits (percent of GDP)	17.8	17.8	18.1	21.6	19.3	18.6
Capital expenditures (percent of GDP)	2.3	2.8	3.1	5.0	4.4	3.8
Fiscal balance (percent of GDP)	2.4	2.5	1.9	-5.4	-2.3	-0.9
Primary fiscal balance (percent of GDP)	3.2	3.2	2.6	-4.6	-1.4	0.1
Public debt (percent of GDP)	36.1	34.2	32.8	37.4	38.2	38.0
Public and publicly guaranteed debt (percent of GDP)	37.7	35.6	34.5	39.6	40.4	40.2
Of which: External (percent of GDP)	30.7	29.9	28.4	31.1	31.5	31.0
Goods exports (percent of GDP)	29.8	31.2	28.8	27.7	26.8	26.5
Goods imports (percent of GDP)	53.4	53.6	51.4	46.3	47.0	47.8
Net services exports (percent of GDP)	7.4	7.8	7.8	4.0	5.1	5.7
Trade balance (percent of GDP)	-16.2	-14.7	-14.7	-14.6	-15.0	-15.6
Net remittance inflows (percent of GDP)	8.4	8.5	8.4	7.4	7.9	7.8
Current account balance (percent of GDP)	-4.8	-3.5	-3.2	-3.4	-4.0	-4.7
Foreign direct investment inflows (percent of GDP)	2.3	3.0	2.0	1.9	2.0	2.1
External debt (percent of GDP)	70.6	66.8	64.1	73.0	76.3	75.9
Real private credit growth (percent, period average)	5.3	5.1	5.2	1.3	n.a.	n.a.
Nonperforming loans (percent of gross loans, end of period)	10.0	8.8	7.4	6.1	n.a.	n.a.
Unemployment rate (percent, period average)	20.5	18.4	15.7	n.a.	n.a.	n.a.
Youth unemployment rate (percent, period average)	45.8	38.8	33.8	n.a.	n.a.	n.a.
Labor force participation rate (percent, period average)	42.6	42.1	42.1	n.a.	n.a.	n.a.
GDP per capita, PPP (current international $)	12,875	13,200	13,775	13,424	14,100	14,700

Sources: Country authorities, World Bank estimates and projections.

Kosovo

- In 2020, economic activity contracted by an estimated 6.9 percent driven by declines in diaspora-related service exports, total investment, and private consumption. Policy support and a surge in remittances and goods exports cushioned the economic impact of the pandemic.
- Economic activity is expected to pick up in 2021, but global and domestic risks are significant, among them delays in vaccine procurement and distribution, international travel restrictions, and reinstatement of strict containment measures.
- Better targeting of policy measures is crucial to increase their impact and preserve fiscal sustainability. Addressing long-standing structural impediments to growth and investing in human capital are vital to foster a resilient recovery and sustainable growth.

Recent Economic Developments

In 2020 Kosovo's economy recorded its first contraction since independence. From 2009 to 2019 growth averaged 3.6 percent. In 2020, economic activity contracted by an estimated 6.9 percent, mainly because of a 51 percent drop in diaspora-related exports of travel services and investment. The rise in government consumption provided a modest positive contribution, but despite the support from higher government transfers and diaspora remittances, private consumption subtracted an estimated 0.2 percentage points (pp) from growth. According to the Kosovo Statistics Agency[5], by the third quarter of 2020 the economy had contracted by 5.6[6] percent. Declared turnover dropped by 9.5 percent for the year, reflecting how heavily the crisis affected the private sector.

Policy support measures, coupled with increases in remittances and goods exports, mitigated the contraction. Goods exports cushioned the downturn; they were up by 21 percent—driven by higher international demand for nickel and improved foreign market access for non-commodity exporters. Service exports also rebounded during the fourth quarter of 2020, halting the already considerable losses. A surge of 15.1 percent in remittances boosted disposable incomes. Meanwhile, public transfers—mainly policy measures to counter the impact of the pandemic—recorded a 38.3 percent increase, supporting disposable incomes by over €240 million.

The labor market reacted primarily by reducing working hours and compensation, according to the results of the World Bank Business Pulse Survey (BPS) conducted in 2020 Q2. Consistent with the BPS findings, tax records show that formal employment weathered the impact of the downturn. Wage-subsidy and other policy measures not only appear to have helped preserve formal jobs, but also encouraged formalization of employment. However, a 4.2 percent drop in personal income tax revenue indicates that the contraction reduced formal employment compensation and working hours. Meanwhile, according to administrative data from employment centers,

5 This publication does not incorporate the provisional estimates of GDP for the fourth quarter of 2020 published on April 02, 2021, given the technical inconsistencies with the annual publication and BoP statistics for the year 2019, as well as the anticipated revision of the national accounts' statistics.

6 All comparisons are year-on-year unless otherwise indicated.

unemployment jumped, probably from job losses in the informal sector. However, the magnitude of this increase is uncertain, given that registered unemployment status was a prerequisite for benefiting from government social protection measures.

The budget deficit more than doubled in 2020, reaching 7.6 percent of GDP in 2020, up from 2.9 percent in 2019 and despite a 28.4 percent drop in public investment. The economic contraction caused public revenue to fall by almost 9 percent, mostly from a shortfall in tax revenue. Current public spending increased by a record 18.6 percent, driven by pandemic-related spending. The government spent an estimated 4.4 percent of GDP in response to the pandemic, with an estimated 0.9 percent for the additional cost of managing the pandemic (wage allowances and goods and services) and 3.5 percent for direct transfers for social protection, employment, and firm and farm support.[7] Kosovo financed the deficit by issuing new domestic debt valued at 2.5 percent of GDP, mobilizing 3.3 percent of GDP in external concessional debt, and drawing on liquidation receipts (1.1 percent of GDP) and government deposits. Public and publicly guaranteed debt increased by 5.2 pp of GDP, reaching 22.8 percent of GDP. The Government also assumed the obligation to compensate from 2023 KPST withdrawals worth 1.5 percent of GDP, a half of the total withdrawals of 3 percent of GDP that occurred between end-December 2020 and January 2021.

Consumer price inflation (CPI) in 2020 was subdued, decelerating significantly from 2019. CPI inflation in 2020 averaged 0.2 percent, down considerably from 2.7 percent in 2019. Inflation pressures were subdued due to slack domestic demand and declining import prices. Inflationary pressures picked up in June 2020 after strict pandemic containment measures eased, but then reversed in July and remained in negative territory until December 2020. Import prices followed a deflationary trend throughout the year; prices dropped most in Q2, but inflation approached positive territory by yearend.

The drop in imports and a rise in secondary income almost compensated for the plunge in exports. As a result, the current account deficit (CAD) deteriorated only marginally, from 5.5 percent of GDP in 2019 to 5.7 percent. The CAD was primarily financed by net foreign direct investment (FDI) and other investment inflows. Despite a 10.7 percent drop in gross FDI inflows, reduction in outward FDI and dividend repatriation led to an increase of 42 percent in FDI. Other investment also increased by 52 percent, reflecting mainly external public loans.

In 2020 Kosovo's financial sector weathered the pandemic well, but the full impact on loan portfolio quality is yet to be assessed. Bank deposits increased by 11.5 percent, with household deposits up by almost 13 percent. Bank credit went up by 7.1 percent, but new loans increased by only 1.8 percent, reflecting significant restructuring throughout the year. Loans from microfinance institutions (MFIs), which accounted for about 6 percent of total loans in December 2020, were down by 6.8 percent for the year. The CBK issued a decision in March to postpone loan payments, which resulted in a 3-month loan payment moratorium that reached more than 50 percent of total bank loans. As this window closed,

7 This estimate excludes the impact of tax deferrals and exemptions, which were discontinued during the second half of 2020.

the CBK in June allowed applications for loan extensions of up to one year and case-by-case restructuring. That is partly why the full impact of the pandemic on loan portfolio quality has yet to be assessed. By end-2020, capital adequacy was above regulatory requirements, and the non-performing loan rate had increased by 0.7 pp by compared to a year earlier.

Outlook and Risks

Growth is expected to rebound in 2021, but risks are significant. Economic recovery will be gradual: in line with the global trend, real activity will reach pre-pandemic levels only in 2022. Recovery will be spearheaded by a rise in exports and consumption. Growth in goods exports should continue to be strong in the medium term because base metal prices are expected to rise. Services exports should also recover, driven by a recovery in diaspora-related tourism, as international travel restrictions and vaccine deployment and administration accelerate in Europe. Private consumption is expected to add to growth, driven by continued fiscal policy support, the impact of the withdrawals from the KPST pension accounts, and a recovery in disposable incomes in 2021. Further capitalization of the Kosovo Credit Guarantee Fund and the increase in the guarantee coverage ceiling should also support recovery.[8] The projected outlook is based on assumptions of relaxed mobility between Europe and Kosovo, no further strict local containment measures, a recovery in Euro Area growth, and an increase in base metal and mineral prices. Economic growth is projected to remain over 4 percent in the medium term, but risks to the outlook are high. In 2021 and beyond, a worsening of the pandemic mandating the reinstitution of strict containment measures, imposition of new international travel restrictions, and lower than projected growth in the EU, could all weigh on growth and the speed of recovery. There is also potential for higher growth, through faster implementation of IFI-financed public investment.

In 2021 the fiscal deficit will continue to be high, driven by recovery support measures and the disruption in the growth trajectory induced by the pandemic. Revenues are expected to recover as economic activity picks up but are likely to remain below the 2019 level. The mitigation and recovery package in support of businesses and individual livelihoods should be fully executed in 2021, at about 3.2 percent of GDP. The overall fiscal deficit is expected to reach 5.1 percent of GDP. Assuming that by 2022 the deficit is aligned with the fiscal rules, public and publicly guaranteed debt would reach 28.2 percent of GDP in 2023, almost doubling from the 2016 level. Considering the uncertainty regarding the pandemic and narrowing fiscal space; it will be important to better target support measures to increase the impact of the fiscal stimulus while maintaining fiscal sustainability.

As in 2020, the current account deficit (CAD) should hover at about 5.7 percent of GDP. Exports are expected to increase because of rising base metal prices, a recovery in diaspora-related tourism, and a rise in external demand. However, the rebound in exports will be partially offset by an increase in import demand as consumption and investment picks up during 2021. While significant inflows of remittances

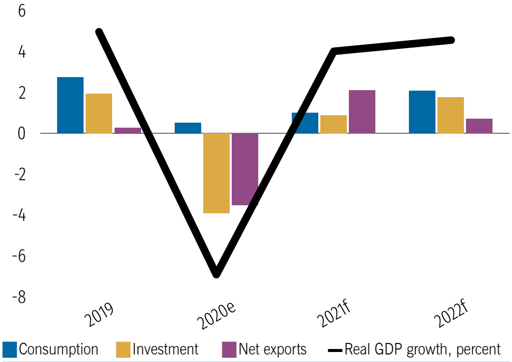
8 The Economic Recovery Law measure to increase loan guarantee coverage to 80 percent and subsidize guarantee fees—implemented by the Kosovo Credit Guarantee Fund and financed by the World Bank—is expected to increase demand for new loans in 2021.

should continue to reduce the CAD, the level of remittance inflows is projected to be lower than the 2020 peak; hence further offsetting the rebound in exports, leading to a CAD of 5.7 percent of GDP, similar to last year.

Progress in structural reforms is vital to reverse the adverse economic and social impact of the pandemic and build resilience to future negative shocks. The epidemic has proved the importance of well-functioning social protection mechanisms that can identify and support groups that are more vulnerable to adverse economic shocks while preserving fiscal buffers. Better targeting of social protection spending to the poorest is crucial both for faster poverty reduction and as an automatic stabilizer to prevent steep declines in consumption. To sustain high and inclusive growth, it is also necessary for Kosovo to boost productivity by improving the business environment. The goal is to reduce the administrative burden on firms, e.g., by better coordinating business inspections, adopting targeted innovation and green competitiveness policies for micro and small enterprises, investing in human capital, and improving the rule of law so that all firms and citizens are treated fairly. Leveraging its investments in digital connectivity in the medium term will give Kosovo an opportunity to broaden access to markets, promote inclusion, and improve public service delivery.

Kosovo's economy contracted for the first time in 2020, but is expected to recover gradually.

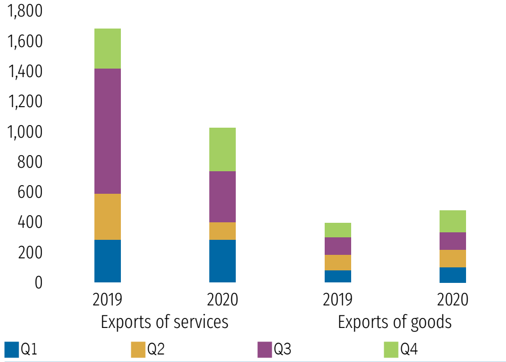
Contributions to growth, percentage points



Source: Kosovo Statistics Agency and World Bank staff calculations and projections.

Exports of services plunged, but merchandise exports rose, though from a lower base.

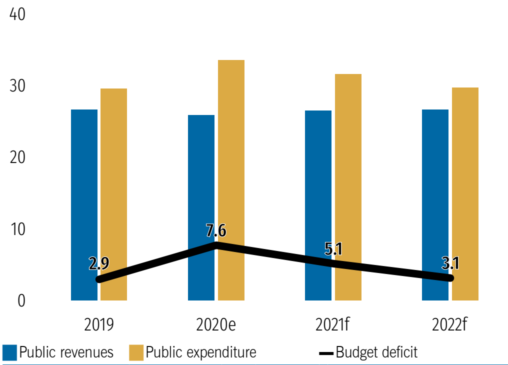
Exports of goods and services, in EUR millions



Source: World Bank staff calculations and projections.

The fiscal deficit surged in 2020, but is projected to narrow in the medium term.

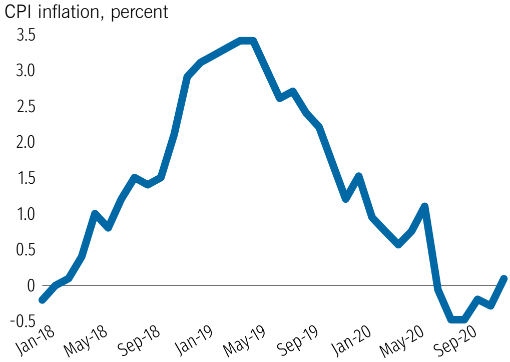
Percent of GDP



Source: Ministry of Finance and World Bank staff calculations and projections.

Consumer price inflation was subdued in 2020.

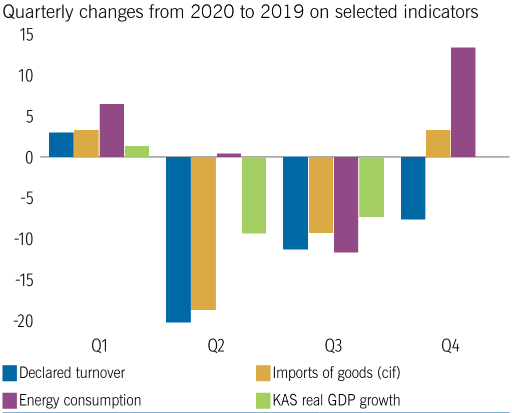
CPI inflation, percent



Source: Kosovo Statistics Agency.

Economic activity was picking up in the fourth quarter of 2020.

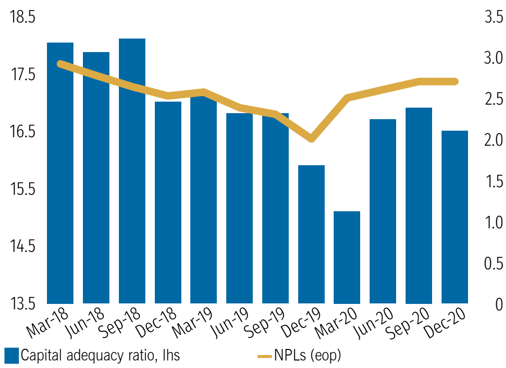
Quarterly changes from 2020 to 2019 on selected indicators



Source: Kosovo Statistics Agency and World Bank staff calculations.

NPLs have worsened slightly, but capital adequacy is above regulatory requirements.

Percent



Source: Central Bank of Kosovo.

KOSOVO	**2017**	**2018**	**2019**	**2020e**	**2021f**	**2022f**
Real GDP growth (percent)	4.2	3.8	4.9	-6.9	4.0	4.5
Composition (percentage points):						
Consumption	1.5	5.4	2.7	0.5	1.0	2.1
Investment	1.5	2.1	1.9	-3.9	0.9	1.8
Net exports	1.2	-3.8	0.2	-3.5	2.1	0.7
Exports	4.0	1.0	2.1	-7.9	5.8	3.7
Imports (-)	2.8	4.8	1.9	-4.4	3.7	3.0
Consumer price inflation (percent, period average)	1.5	1.1	2.7	0.2	0.7	1.0
Public revenues (percent of GDP)	26.4	26.1	26.6	25.8	26.4	26.5
Public expenditures (percent of GDP)	27.6	29.0	29.5	33.4	31.5	29.6
Of which:						
Wage bill (percent of GDP)	8.6	8.8	8.7	9.9	9.3	8.7
Social benefits (percent of GDP)	6.1	6.1	6.2	7.8	6.9	6.3
Capital expenditures (percent of GDP)	7.3	7.9	7.5	5.7	5.8	6.3
Fiscal balance (percent of GDP)	-1.2	-2.9	-2.9	-7.6	-5.1	-3.1
Primary fiscal balance (percent of GDP)	-0.9	-2.7	-2.6	-7.2	-4.6	-2.4
Public debt (percent of GDP)	15.6	16.3	16.9	22.3	24.9	26.5
Public and publicly guaranteed debt (percent of GDP)	16.3	16.9	17.5	22.8	25.2	26.7
Of which: External (percent of GDP)	6.6	6.2	5.8	7.9	8.7	9.1
Goods exports (percent of GDP)	5.9	5.6	5.5	7.1	7.2	6.9
Goods imports (percent of GDP)	44.3	46.3	45.5	45.6	45.9	44.2
Net services exports (percent of GDP)	12.9	12.7	13.1	7.0	10.5	11.1
Trade balance (percent of GDP)	-25.5	-28.0	-26.9	-31.5	-28.2	-26.2
Net remittance inflows (percent of GDP)	11.1	11.3	11.6	14.2	12.8	12.5
Current account balance (percent of GDP)	-5.4	-7.6	-5.5	-5.7	-5.7	-4.9
Net foreign direct investment inflows (percent of GDP)	3.3	3.4	2.7	4.0	3.2	3.2
External debt (percent of GDP)	32.6	30.3	30.3	37.8	39.6	38.5
Real private credit growth (percent, period average)	8.8	10.1	7.8	7.6	n.a.	n.a.
Nonperforming loans (percent of gross loans, end of period)	3.1	2.5	2.0	2.7	n.a.	n.a.
Unemployment rate (percent, period average)	30.5	29.5	25.7	n.a.	n.a.	n.a.
Youth unemployment rate (percent, period average)	52.7	55.4	49.4	n.a.	n.a.	n.a.
Labor force participation rate (percent, period average)	42.8	40.9	40.5	n.a.	n.a.	n.a.
GDP per capita (US$)	3,956	4,424	4,424	4,145	4,317	4,527

Sources: Country authorities, World Bank estimates and projections.

Montenegro

- In 2020, Montenegro's 15 percent recession was one of the deepest in Europe.
- Despite government support measures, employment fell to a 9-year low.
- The debt-to-GDP ratio reached 105 percent at end-2020; this requires credible and sound fiscal policy through the medium term.
- The economy is forecast to rebound in 2021, but the magnitude of the recovery will depend on the evolution of the pandemic.
- The crisis offers the administration an opportunity to strengthen public institutions and put in place structural reforms for sustainable and inclusive post-crisis growth.

Recent Economic Developments

Loss of Montenegro's tourism season in 2020 led to one of the deepest recessions in Europe. The economy contracted by an estimated 15.2 percent in 2020 as foreign tourist overnight stays and receipts sank down by almost 90 percent. As a result, exports of goods and services plunged, reducing growth by 25 percentage points (pp), and outpacing the positive contribution of the decline of imports by 18 pp. As a result, net exports took almost 7 pp from growth—almost half the drop in growth. The collapse in tourism and pandemic social distancing restrictions together slashed private consumption, taking 4.7 pp from growth. Despite increased fiscal support to households and businesses, government consumption took away another 0.1 pp. Final consumption has thus subtracted a total of 4.8 pp from growth. Despite recovering in Q3, investment also reduced growth, by 3.7 pp.

High frequency indicators suggest a slight recovery, but it is not clear whether this is temporary or the first sign of a permanent turnaround. The halt in tourism caused transport services to contract by 40 percent and had repercussions on retail trade, which fell by almost 17 percent. Industrial production was more resilient, recovering from a dip in Q2, as mining and quarrying strengthened; energy production remained below its 2019 level. Although construction fell by 5.6 percent in 2020, it grew strongly in Q4, indicating a near-term recovery of investment.

Previous employment and poverty gains have largely been wiped out. Almost eight in ten jobs in Montenegro are in services, which were heavily impacted by the crisis. Administrative data show that employment fell to a 9-year low, with tourism, construction, and trade hit hardest. Registered unemployed rose from 37,616 in December 2019 to 47,509 in December 2020. The government wage subsidies and one-off cash transfers helped to prevent even larger layoffs and increases in poverty, although vulnerable workers in the informal sector may not have received enough support.[9]

Because of the demand shock and falling oil prices, deflation prevailed for most of 2020. Inflation averaged -0.3 percent as prices fell for transport, garments, and utilities, thosugh prices were up for food, beverages, and health

9 See World Bank (2020), "The impact of COVID-19 on Formal Firms: Evidence from Montenegro", MTI practice note, and World Bank (2021) SCD Update, forthcoming.

care. With deflation and a slight increase in nominal wages (which suggests that mainly low-wage workers lost jobs), real wages were up 0.5 percent, though still below 2010 levels.

The financial sector has so far been resilient. Among other support measures, the Central Bank introduced moratoria on loan repayments; reduced reserve requirements; and allowed restructuring of loans for borrowers who had lost at least 10 percent of their income. Despite a decline in new lending by 26 percent, the stock of loans including those in moratoria increased by 3 percent as repayments of loans were delayed. As a result, the lending-to-deposit ratio increased to 94 percent, its highest point since 2015, and bank profits declined by more than 50 percent. Nonperforming loans had increased only slightly, to 6 percent of total loans by December 2020 and the capital adequacy ratio was a healthy 18.5 percent. The full impact of the crisis on bank asset quality will only be clear once the loan moratorium expires and if corporate bankruptcies rise after government crisis response programs are phased out. International reserves of €1.7 billion covered a healthy 10 months of goods imports.

External imbalances widened because declines in imports were not sufficient to compensate for plummeting exports. The chronically high trade deficit[10] further widened to 35 percent of GDP, the highest since 2008. With net tourism receipts down by 90 percent, the net service account was at only 17 percent of its 2019 level. Part of the deficit was covered by the primary income surplus, which almost quadrupled due to lower dividend payments. A further contribution came from net remittances, up by 13 percent. Yet it is estimated that the current account deficit (CAD) swelled to 26 percent of GDP. Almost 45 percent of the CAD was financed by net foreign direct investment (FDI). Net FDI increased by 50 percent despite a 15 percent drop in FDI inflows because outflows fell more sharply by 58 percent from a high base in 2019 when the buyback of EPCG shares from the Italian company was completed. The remainder of the CAD was financed by drawing down reserves and issuing new debt.

Struck by a strong revenue shortfall and crisis response expenditures, the fiscal deficit widened to 11 percent of GDP. In 2020, general government revenues declined by 13 percent, driven by declines in VAT (-24 percent) and non-tax revenues (-35 percent), though corporate income tax revenues were up 8 percent. General government spending went up by 4.6 percent, partly for support to the private sector and households, while delays in highway construction reduced capital spending by 25 percent. In January 2021, the government adopted a fourth package of support, worth 3.5 percent of GDP, which softened eligibility criteria for wage subsidies, provided additional one-off support for the most vulnerable, and extended support for the tourism and agriculture sectors.

Gross public debt peaked at 105 percent of GDP in 2020. When the crisis began, Montenegro already had one of the highest levels of public debt in the region—it had reached 76.5 percent of GDP in 2019. As the fiscal deficit worsened with the crisis, the government drew down deposits and increased borrowing. In December, Montenegro placed a 7-year €750 million Eurobond with a favorable interest rate of 2.875 percent which is estimated to fully cover the 2021 financing

10 Averaging 22 percent of GDP 2010–19.

needs. In March, part of the receipts were used to repay the remaining €228 million of a more expensive Eurobond that had a 5.75 percent interest rate and a 5-year maturity, and accounted for a large part of the debt obligations in 2021. This reduced gross public debt to 99 percent of 2020 GDP by end-March 2021. The remaining funds should be used to refinance debt and finance priority programs and growth-enhancing investments.

Outlook and Risks

The uncertainty about pandemic developments and vaccine rollouts and thus the pace of economic recovery is high. Montenegro ranks third in the world in the number of COVID-19 infections per million inhabitants. Rollout of the vaccine has been slowly picking up since immunizations began in late February. The government has been expanding restrictions in order to curb the pandemic. The tourism season will largely depend not only on when the pandemic is contained but also on the pace of immunization. It is, however, encouraging that some of Montenegro's major sources of tourists, like Serbia, are progressing rapidly with immunization.

GDP is expected to rebound in 2021. Subject to tourism recovering to 55 percent of its 2019 levels, and due to its low base, Montenegro's GDP is expected to rebound to 7.1 percent in 2021. It is projected, however, that the total output loss will not be fully recovered until 2023, when the economy is expected to grow 3.5 percent. The pace of recovery might be stronger if the immunization accelerates. The employment outlook is also highly uncertain and depends on the recovery of labor-intensive sectors, which also depends on the scope and duration of government support. The extent to which the recovery will lead to the creation of new low-skilled jobs will determine how fast poor and vulnerable households can return to pre-crisis income levels. Addressing long-standing job challenges is thus critical for robust improvements in welfare.

Sound and credible fiscal policies are imperative to keep debt sustainable. If further government support to the private sector becomes necessary, it must be targeted, fiscally prudent, and designed to be grasdually scaled back as recovery takes hold. It is estimated that the fiscal deficit will gradually decline from 5 percent of GDP in 2021 to 1.3 percent in 2022 which implies a primary fiscal surplus of 1.1 percent. After peaking in 2020, gross public debt is projected to decline to 90 percent of GDP in 2021. It is forecast to return to pre-crisis levels by 2023. However, the actual medium-term trajectory of the fiscal deficit and debt reduction may be steeper or flatter, depending on the government's budgetary plans.[11] The crisis impact and high public debt levels mandate prudent fiscal policy, targeting a primary fiscal surplus once the economy has fully recovered.

External imbalances are expected to narrow but stay high. Finalization of the import-dependent motorway section and stronger exports led by tourism recovery are projected to reduce the CAD to 13 percent of GDP in 2022 and 10 percent in 2023.

A new government took office in December 2020, which delayed adoption of the 2021 budget. It is currently issuing temporary

11 This report was finalized before the 2021 budget details were released.

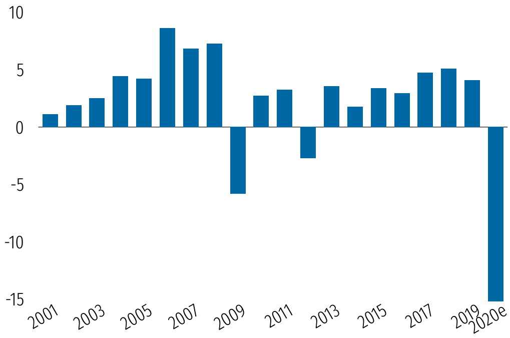
decisions on financing until the new budget is adopted. The new government committed to accelerating reforms, strengthening the rule of law, and fighting corruption, all of which is fundamental for stronger, more sustainable, and inclusive growth.

The outlook is surrounded by downside and but also significant upside risks. External risks may arise from a protracted pandemic, the slow pace of immunization, and a possibility that travel restrictions will be extended into the summer. Proceeding with the second section of the highway could threaten the sustainability of public debt unless back up by the findings of the ongoing technical feasibility study and adequate and transparent financing modalities. Given the country's dependence on tourism, a weaker than expected recovery in Europe is another downside risk. However, there are significant upside risks, such as an accelerated pace of immunization in Montenegro and in the region and speedier containment of the pandemic, which would reflect in a stronger recovery. More robust recoveries than expected in regional and EU economies would also support growth in Montenegro. Domestic risks, including political polarization remain elevated.

The crisis should be used to implement key structural reforms. This would lead to more resilient post-crisis growth for all and avoid reversals of previous reforms. To accelerate recovery and sustain growth and poverty reduction, Montenegro must maintain macroeconomic stability, boost human capital, reduce barriers to private sector productivity, ensure inclusive and efficient provision of public services, and carefully manage its natural resources. The successful implementation of these reforms requires strong and independent public institutions, including a public administration based on merit.

Montenegro's economy suffered a deep recession…

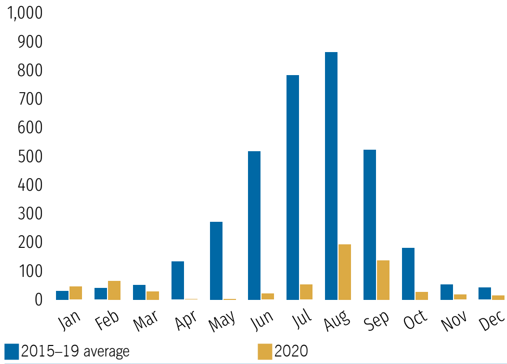
Real GDP growth, percent



Source: MONSTAT and World Bank staff calculations.

…as tourism halted.

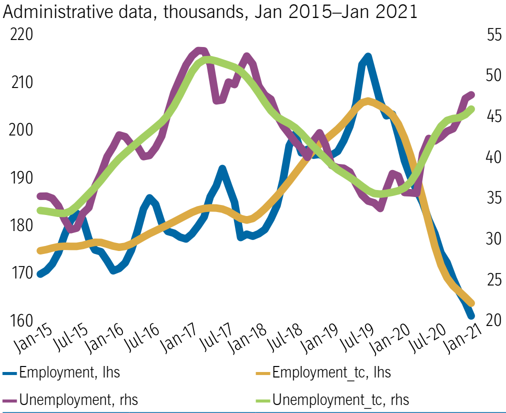
International tourists overnight stays, in thousands



Source: MONSTAT and World Bank staff calculations.

Employment fell to a 9-year low…

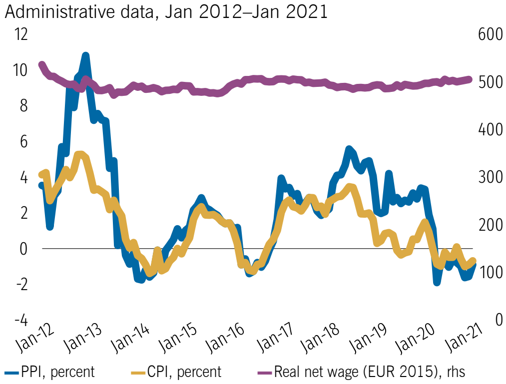
Administrative data, thousands, Jan 2015–Jan 2021



Source: MONSTAT and World Bank staff calculations. tc=trend cycle.

…while inflation stayed in negative.

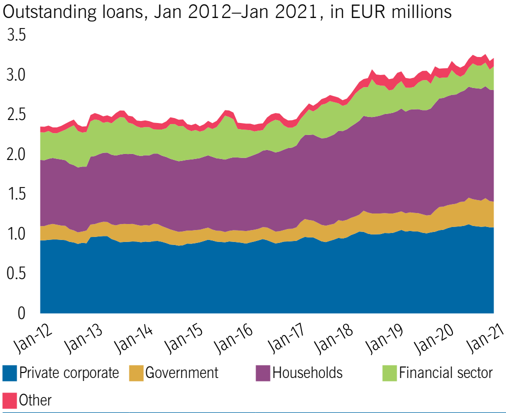
Administrative data, Jan 2012–Jan 2021



Source: MONSTAT data and World Bank staff calculations.

Outstanding loans have remained stable…

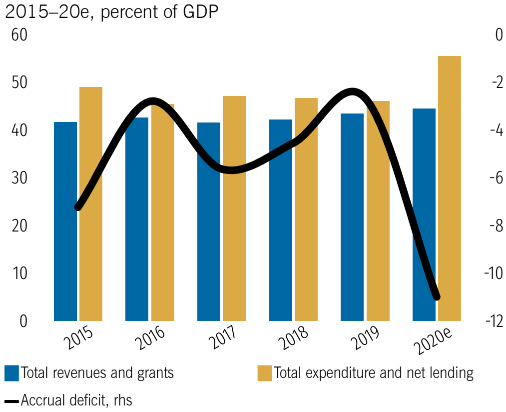
Outstanding loans, Jan 2012–Jan 2021, in EUR millions



Source: Central Bank and World Bank staff calculations.

…but the fiscal position has deteriorated.

2015–20e, percent of GDP



Source: MoF and World Bank staff calculations.

MONTENEGRO	2017	2018	2019	2020e	2021f	2022f
Real GDP growth (percent)	4.7	5.1	4.1	-15.2	7.1	4.5
Composition (percentage points):						
Consumption	3.2	5.2	2.9	-4.8	2.1	2.0
Investment	8.0	4.9	0.8	-3.7	1.7	-2.2
Net exports	-6.5	-5.0	0.4	-6.7	3.4	4.7
Exports	0.9	3.4	2.7	-24.8	13.8	9.0
Imports (-)	7.4	8.4	2.3	-18.1	10.4	4.3
Consumer price inflation (percent, period average)	2.4	2.6	0.4	-0.3	1.5	1.5
Public revenues (percent of GDP)	41.4	42.0	43.3	44.4	43.2	42.0
Public expenditures (percent of GDP)	47.0	46.6	46.0	55.4	48.2	43.3
Of which:						
Wage bill (percent of GDP)	11.8	11.2	11.0	13.5	12.1	11.5
Social benefits (percent of GDP)	12.5	11.7	11.2	13.4	12.8	12.2
Capital expenditures (percent of GDP)	7.8	8.5	8.7	7.4	6.4	4.3
Fiscal balance (percent of GDP)	-5.7	-4.6	-2.7	-11.0	-5.1	-1.3
Primary fiscal balance (percent of GDP)	-3.3	-2.4	-0.5	-8.3	-2.3	1.1
Public debt (percent of GDP)	64.2	70.1	76.5	105.1	90.1	82.3
Public and publicly guaranteed debt (percent of GDP)	69.1	74.1	80.0	109.2	93.8	85.8
Of which: External (percent of GDP)	57.9	64.6	68.1	96.9	83.8	77.0
Goods exports (percent of GDP)	8.9	9.4	9.4	9.7	9.3	9.2
Goods imports (percent of GDP)	52.2	53.3	51.1	48.9	48.7	47.7
Net services exports (percent of GDP)	19.8	20.1	20.6	4.3	12.0	17.7
Trade and services balance (percent of GDP)	-23.5	-23.9	-21.1	-34.8	-27.5	-20.8
Net remittance inflows (percent of GDP)	3.9	4.0	4.0	5.3	4.5	4.2
Current account balance (percent of GDP)	-16.1	-17.0	-15.0	-26.0	-19.4	-13.1
Net foreign direct investment inflows (percent of GDP)	11.3	6.9	7.0	11.2	8.2	7.9
External debt (percent of GDP)	159.9	162.6	167.2	n.a.	n.a.	n.a.
Real private credit growth (percent, period average)	4.4	6.8	5.5	6.5	n.a.	n.a.
Nonperforming loans (percent of gross loans, end of period)	8.4	7.4	5.1	5.9	n.a.	n.a.
Unemployment rate (percent, period average)	16.1	15.2	15.1	17.9	n.a.	n.a.
Youth unemployment rate (percent, period average)	31.7	29.4	25.2	36.0	n.a.	n.a.
Labor force participation rate (percent, period average)	54.7	56.0	57.4	53.3	n.a.	n.a.
GDP per capita, PPP (current international $)	19,745	22,227	24,036	19,555	21,306	22,690

Sources: Country authorities, World Bank estimates and projections.

North Macedonia

- The economy is recovering from the deepest recession since independence, which affected almost all sectors of the economy.
- Government support partially mitigated the impact of the crisis on workers and firms, but fiscal space narrowed rapidly as public debt reached 60 percent of GDP.
- The near-term outlook for 2021 is positive but downside risks have intensified; the containment phase has not yet finished, and vaccine rollout is proving to be challenging.
- Government attention should be gradually shifted to policies for a sustainable, inclusive, and green recovery; these would also complement EU accession ambitions.

Recent Economic Developments

GDP declined by 4.5 percent in 2020—the deepest recession since independence. The recession was milder than earlier projected as the recession sharply eased in the fourth quarter (Q4). Private consumption, previously the main driver of growth, declined markedly, by 5.6 percent y-o-y because of containment measures and low consumer confidence. Investments also declined by more than 10 percent, even though they rebounded in Q3 based on public investments in infrastructure. The increase in government consumption of more than 10 percent partly alleviated the decline as the fiscal stimulus ramped up to protect jobs and firms. Meanwhile, external demand plummeted, as evidenced by a 10.9 percent y-o-y decline of exports. The accompanying decline in imports alleviated the pressure on the current account balance. On the production side, two sectors that had previously been drivers of growth were the sectors with the steepest declines, 10.6 percent for manufacturing, and 7.9 percent for trade, transportation, and tourism. Construction also went down but began to turn around in Q3. In 2020 the only sectors that grew were agriculture, information and communication, and real estate.

High-frequency data at end-2020 and early 2021 suggest the recession continued, though with signs of bottoming out. Industrial production turned positive in December as manufacturing and mining activities improved but in January 2021 dropped again, by double digits. Construction surged in September, due to public investments in transport infrastructure, but in December it too dropped by double digits. In Q4 wholesale and retail trade were deeply subdued but in January 2021 sales rebounded. Tourism numbers are half down from early 2020. Agricultural production also slackened in Q4.

External imbalances widened as exports and transfers tumbled. In 2020, a steep fall in exports was followed by a similar fall in imports, and the trade deficit narrowed to 16.8 percent of GDP. Further, due to travel restrictions there were fewer exports of services and fewer remittances received in diaspora visits to the country. This shortfall was partly compensated by increased private transfers through formal banking and cash transfer channels. In sum, in 2020 private transfers declined by 24 percent. The current account deficit widened slightly, to 3.5 percent of GDP for 2020, and net FDI was almost halved by delays as previously announced foreign investments got delayed.

As a result of the sizable public borrowing to finance emergency support for the economy and refinance maturing debt, external debt had risen to 79.9 percent of GDP, a 7.2 pp increase over 2019.

Government financial support helped cushion the impact of the crisis on the labor market but both employment and participation gains from 2019 were wiped out. At the peak of the crisis in Q2 unemployment rate had initially increased to 16.7 percent, but government job retention subsidies and support for employment benefits managed to contain the fallout so that unemployment rate declined to 16.4 percent in 2020 (0.9 pp below 2019). However, the improvement was not due to a rise in employment rate which was in fact 0.2 pp lower in 2020, but by a rise in inactivity as people retired, returned abroad as seasonal workers, or simply became discouraged. By yearend there were 13,000 fewer people in the labor force (a drop of 1.4 percent y-o-y), all of whom had moved into inactivity, resulting in the highest number of inactive people since 2005. As a result, the activity rate dropped by 0.8 pp to 56.4 percent, the lowest level since 2008, with women being more affected. The largest employment losses were in transport and storage, agriculture, energy, real estate, tourism, and construction. In ICT, health, education, trade, professional services, mining, and manufacturing, employment in fact rose.

Consumer prices increased in the second half of the year. Consumer prices increased by 1.2 percent in 2020, with food and electricity prices contributing the most to the rise. In August regulated electricity prices were raised 7.4 percent y-o-y. On the other hand, prices for fuels, utilities, and transport dropped further. Despite the severe recession, by yearend real wages had increased by 3.1 percent y-o-y, with the largest rises in the ICT, health, mining, and financial sectors. Transport, tourism, and professional services were the only sectors to see a real drop as a result of persisting effects of the COVID-19 crisis. The rise in public sector wages and in the minimum wage from 2019 helped to raise wages in 2020 across most sectors.

So far the banking sector has withstood the crisis well. The liquidity ratio, over 23 percent in Q4, remained adequate, also helped by central bank anti-crisis measures. Lending continued to grow, though slowing to 4.7 percent by yearend, with credit available to both households and firms, supported by strong deposit growth and crisis-support programs. Given the moratoriums on loan reclassification, effective through December 2020, and repayment, effective through June 2021, nonperforming loans declined to 3.3 percent. However, an upward correction is expected in 2021 as the moratoriums end. In Q4 2020 the capital adequacy ratio was 16.7 percent, doubling the mandatory level, which provides a solid buffer if the recession is prolonged. To support a recovery, in March 2021, the central bank reduced the key monetary policy rate by 25 bps to a new historic low of 1.25 percent. It also introduced a preventive measure to temporary limit the distribution and payment of dividends to banks and savings houses' shareholders with an aim to further strengthen the resilience of the banking system in the context of the prolonged crisis.

The general government deficit tripled in 2020, reaching 8.2 percent of GDP (8.9 percent if accounting for the Public Enterprise for State Roads (PESR) deficit as well). Revenues were affected by lower private consumption as a result of restrictive measures and imports, leading to a drop of 1.3 pp (to 31.3 percent of GDP with revenues from PESR), the lowest level since 2014. The drop in VAT and excise revenues amounting to 1.1 percent of GDP was cushioned somewhat by an increase in social contributions, largely supported by the government wage and social contributions subsidies. In addition, non-tax revenues declined by 1 percent of GDP. However, spending increased by 4.6 percent of GDP as health and social assistance expenditures and subsidies to retain jobs surged. Spending on wages and pensions also increased as a result of pre-crisis policy changes. Capital spending jumped in Q4 but was still largely under-executed, resulting in a decline from 2019.

Public and publicly guaranteed (PPG) debt increased to 60 percent of GDP. The government ramped up borrowing to finance the soaring deficit and repay maturing obligations. The government was able to refinance payments due and secure financing to mitigate the rising deficit. Net borrowing amounted to more than 11 percent of GDP.

Outlook and Risks

Growth is expected to rebound to 3.6 percent in 2021, but downside risks are high. The scenario assumes accelerated vaccination by mid-2021, no further lockdowns in 2021, and a recovery in external demand. In this scenario, after continued recession in Q1 2021, growth is then expected to resume as restored consumer and investor confidence push up personal consumption, private investment, and exports.

The extension of government support to firms and households in the first half of 2021 should cushion the recession. However, the countercyclical fiscal policies adopted to mitigate the impact of COVID-19 depleted fiscal buffers and raised sustainability concerns. As the recovery firms up, a gradual withdrawal of state support will be necessary.

The 2021 budget foresees a reduction in the deficit led by revenue recovery as growth returns. A targeted deficit of 4.9 percent of GDP is envisaged under the optimistic scenario of 4.1 percent growth. Yet, the 4th and 5th packages of support measures further increased tax expenditures. Low tax compliance and tax administration inefficiency often add to a weak revenue performance. On the other hand, the 5th support package increased the spending for businesses and households by 1.4 percent of GDP, a large part of which was not planned in the original budget. Even though the government foresees tight control on goods and services spending, a budget revision is likely to be required in 2021. As announced by the government, some budget savings should come from the limits to the highest wages in the public sector, digitalization of some services, introduction of criteria for use of public sector business premises, and limits on vehicle and furniture purchase. A new model proposed for allocating capital spending to better-performing projects and thus improving chronic under-execution of the capital budget, should help boost recovery.

The fiscal deficit will likely rise above the planned deficit target unless further savings are found to compensate for the 5th package of support, pushing public debt toward 65 percent of GDP. With financing needs in 2021 amounting to about 12 percent of GDP, proactive debt management and tapping into the Eurobond market is necessary. In February

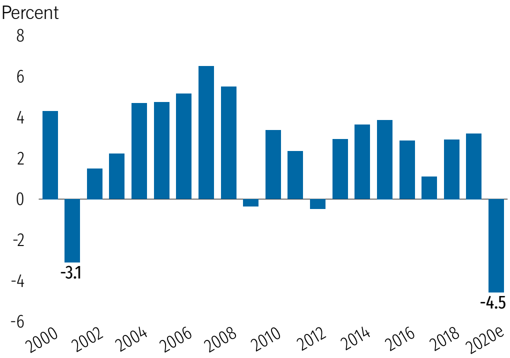
2021, Standard and Poor's confirmed North Macedonia's BB- credit rating with a stable outlook. In early March, a €700 million Eurobond was issued with a maturity period of seven years and an interest rate of just 1.625 percent. The Eurobond will be used to finance the budget deficit and repay debt obligations falling due in 2021, of which the largest is a 2014 issue worth €500 million.

In the medium term, setting public finances back on a sustainable path will be necessary to avoid further accumulation of public debt. Fiscal prudence and achievement of the primary balance would be needed to stem further growth in public debt and to avoid crowding out productive spending, especially if international financing costs rise. Boosting revenues by cutting back on exemptions and strengthening compliance are priorities, as is gradual withdrawal of the state from the corporate sector. The new peak for public debt will require North Macedonia to reprioritize spending, including streamlining state aid, addressing long-term liabilities in the pension system that erode its sustainability, improving management of state-owned companies, and enhancing management of public investment to maximize its efficiency and its impact on growth.

Bringing people back to the labor market and reforming education and governance could help boost potential growth. Strengthening human capital should remain a high priority if future growth is to be sustainable and long-lasting. Opportunities for Macedonians to build human capital are limited as a result of the weak education system and minimal workforce skills acquisition, which, together with low and declining productivity, has been constraining growth. That has only been exacerbated by the learnings loss caused by COVID-19. Moreover, labor resources are underutilized: less than 48 percent of working-age Macedonians are employed, and low birth rates and emigration are shrinking the workforce further. Finally, there is a need to align the curriculum with the evolving needs of the labor market.

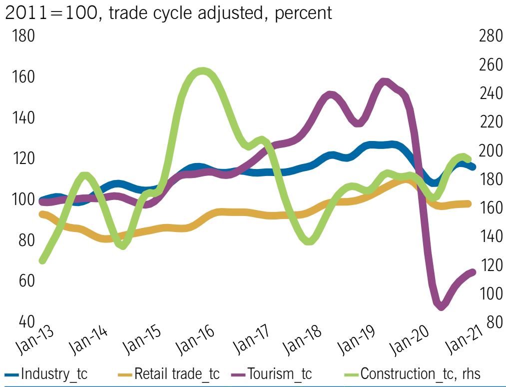
Further delay in opening EU accession negotiations may jeopardize political stability and reduce structural reform efforts. The transition to a more dynamic economic model and, with it, the creation of job opportunities for youth is linked to the carrying out of the most needed social, economic, and governance reforms in a context of political stability, increased transparency, accountability, voice, and participation. The current economic model, based on generous public support through subsidies and broad tax exemptions, might need to be shifted toward less state involvement in the economy in favor of stronger regulatory role.

The economy in 2020 saw its worst recession since independence...



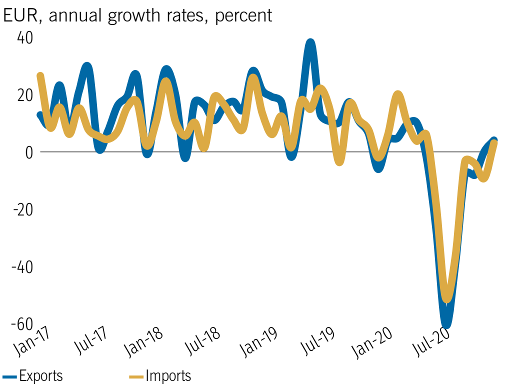
Source: State Statistics Office.

...although a bottoming out has started.



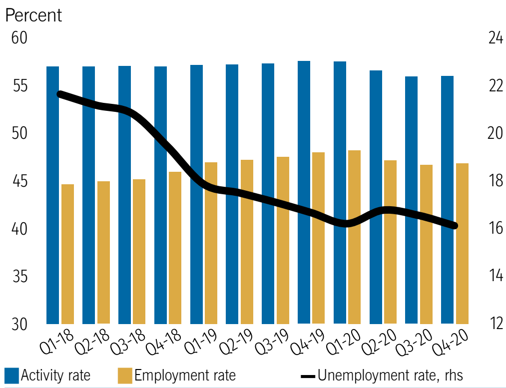
Source: State Statistics Office and World Bank staff calculations.

Exports are still 10 percent below the pre-crisis level.



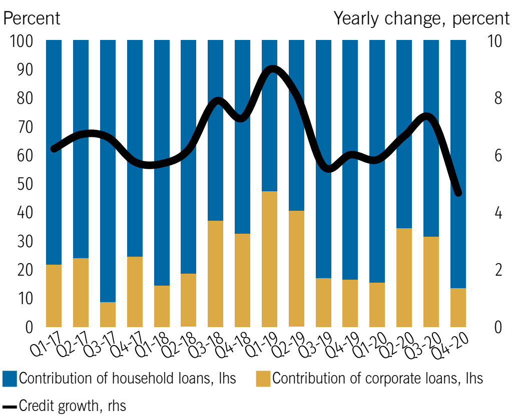
Source: State Statistics Office and World Bank staff calculations.

Unemployment rate declined again, but due to a rise in inactivity.



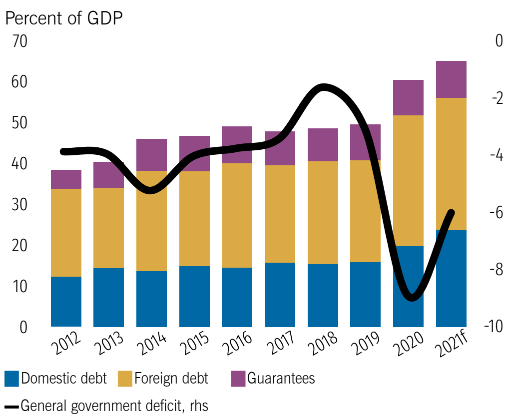
Source: State Statistics Office.

Corporate lending slowed in late 2020, despite accommodative monetary policy.



Source: National Bank and World Bank staff calculations.

Public debt is expected to grow further as support measures continue.



Source: Ministry of Finance and World Bank staff estimates.

NORTH MACEDONIA	**2017**	**2018**	**2019**	**2020e**	**2021f**	**2022f**
Real GDP growth (percent)	1.1	2.9	3.2	-4.5	3.6	3.5
Composition (percentage points):						
Consumption	1.3	3.5	4.0	-4.3	3.9	3.0
Investment	-0.8	-2.6	5.1	-2.4	1.3	1.5
Net exports	0.6	2.0	-5.9	2.2	-1.6	-1.1
Exports	4.6	9.2	3.1	-7.3	3.9	4.7
Imports (-)	4.0	7.3	9.0	-9.6	5.5	5.7
Consumer price inflation (percent, period average)	1.4	1.5	0.8	1.2	1.6	2.0
Public revenues (percent of GDP)	32.0	31.4	32.6	31.3	31.8	32.5
Public expenditures (percent of GDP)	35.4	33.1	35.7	40.3	37.8	36.7
Of which:						
Wage bill (percent of GDP)	6.7	6.3	6.4	7.4	6.9	6.5
Social benefits (percent of GDP)	15.9	15.8	16.3	18.5	17.6	17.2
Capital expenditures (percent of GDP)	5.4	3.8	5.1	4.6	4.6	4.6
Fiscal balance (percent of GDP)	-2.8	-1.1	-2.2	-8.2	-5.3	-3.9
Overall Fiscal Balance with the Public Enterprise for State Roads*	-3.4	-1.7	-3.1	-8.9	-6.0	-4.2
Primary fiscal balance (percent of GDP)	-1.5	0.1	-1.0	-6.9	-3.9	-2.5
Public debt (percent of GDP)	39.4	40.4	40.7	51.4	56.5	57.5
Public and publicly guaranteed debt (percent of GDP)	47.7	48.4	49.4	60.0	64.7	65.7
Of which: External (percent of GDP)	31.7	32.9	32.7	40.2	41.4	40.4
Goods exports (percent of GDP)	40.6	45.4	47.5	44.7	45.6	46.9
Goods imports (percent of GDP)	58.4	61.6	65.1	61.5	62.6	63.1
Net services exports (percent of GDP)	3.7	3.5	3.1	4.0	4.2	4.4
Trade balance (percent of GDP)	-14.1	-12.7	-14.5	-12.8	-12.8	-11.8
Net remittance inflows (percent of GDP)	1.9	1.9	1.7	2.6	2.5	2.4
Current account balance (percent of GDP)	-0.9	-0.1	-3.3	-3.5	-3.4	-2.6
Net foreign direct investment inflows (percent of GDP)	1.8	5.6	3.2	1.9	2.6	2.7
External debt (percent of GDP)	73.4	73.0	72.7	79.9	82.6	81.2
Real private credit growth (percent, period average)	1.1	5.0	6.5	5.7	n.a.	n.a.
Nonperforming loans (percent of gross loans, end of period)	6.1	5.0	4.6	3.3	n.a.	n.a.
Unemployment rate (percent, period average)	22.4	20.7	17.3	16.4	n.a.	n.a.
Youth unemployment rate (percent, period average)	46.7	45.4	35.6	35.7	n.a.	n.a.
Labor force participation rate (percent, period average)	56.8	56.9	57.2	56.4	n.a.	n.a.
GDP per capita, PPP (current international $)	15,529	16,518	17,815	17,007	17,620	18,236

Sources: Country authorities, World Bank estimates and projections.
Note: Youth unemployment rate is for labor force aged 15–29.

Serbia

- In 2020 Serbia went through a relatively modest COVID-19-related recession of 1 percent.
- Despite the economic slowdown, employment was not affected, mainly because of the government fiscal stimulus program.
- However, keeping the economy afloat during the pandemic had a high cost: the stimulus measures accounted for nearly 13 percent of GDP, of which fiscal revenue and spending measures cost 8 percent of GDP; the estimated 2020 fiscal deficit is therefore a record-high 8.1 percent.
- The current account deficit lessened in 2020, to about 4.3 percent of GDP, primarily thanks to lower outflows of foreign company net income and to some extent a lower trade deficit.
- Full recovery is expected to start in 2021 with projected growth of 5 percent and a return to the previous growth path over the medium term.

Recent Economic Developments

After two years of above 4 percent growth, the Serbian economy in 2020 entered a pandemic-caused recession. The year began well—GDP in the first quarter (Q1) was up by 5.2 percent, year-on-year (y/y)—but growth turned negative in the remainder of the year as lockdowns introduced to control the spread of the COVID-19 pandemic took a toll on the economy. Preliminary estimates suggest that in 2020 GDP fell by 1 percent in real terms. The recession could have been deeper if not for the timely and sizeable government stimulus package of nearly 13 percent of GDP (of which 4.8 percent of GDP were in the form of loan guarantees and 8 percent of GDP were different revenue and expenditure measures).

Looking at the expenditure side of GDP, consumption and net exports had a negative contribution to growth while investment had a positive contribution. Consumption is estimated to have declined by an estimated 1 percent in real terms in 2020 because of the significant reduction of private consumption (down by 2.5 percent in real terms); meanwhile, government consumption increased by 5.6 percent. Although the net balance in goods and services decreased, it made a negative contribution to growth in 2020 of 1 percentage point (pp). Total investment is estimated to have increased by 3.3 percent in real terms, thanks to an 8 percent increase in public investment and inventories that were higher in real terms by 47.7 percent. Private investment decreased in real terms by 5.7 percent compared to 2019, thus negatively contributing to growth by 1 pp.

The labor market was resilient to the shock caused by the pandemic. According to Labor Force Survey (LFS) data, in 2019 unemployment fell to an estimated 10.4 percent and employment hit a record high of 49 percent. This improvement continued throughout 2020, despite the impact of the pandemic, mainly because jobs in formal sectors remained unchanged due to the fiscal stimulus program (since one of the requirements for receiving the government support was to ensure that total employment remains unchanged or decreased by a maximum 10 percent). In 2020 the unemployment rate averaged 9 percent (based on the LFS), and the employment rate was 49.1 percent. Pandemic-related shocks to the economy mainly affected informal employees;

the number of informally employed people declined by 55,500. Youth unemployment continued to rise throughout 2020, reaching 32.4 percent in Q4—the highest level since 2018 Q1. Wages continued to go up (9.4 percent in nominal terms), with public sector wages increasing faster than in the private sector (up by 10.6 percent in nominal terms) while wages in the private sector increased by 9.1 percent. On average, in 2020 wages in the public sector were about 20 percent higher than in the private sector.

Serbia's fiscal consolidation efforts in recent years meant that it entered the COVID-19 crisis in a strong fiscal position that allowed it to implement a large support program. The large stimulus package introduced early on helped to limit the negative impact of the crisis on growth. However, it led to a record high 2020 fiscal deficit of 8.1 percent of GDP. Fiscal revenues fell by 1 percent in nominal terms, and spending in 2020 was higher than in 2019 by 17.8 percent. On the revenue side, non-tax revenues, VAT from import, excises on petroleum products, and corporate income tax fell most compared to 2019. At the same time revenue from the VAT on domestic consumption increased significantly in 2020 (up by 30.4 percent in nominal terms). Budgetary expenditures increased across the board with one noticeable exception: spending on social assistance was down by 5.6 percent in nominal terms.[12] Higher spending on subsidies accounted for one-third of the total increase in budget spending, equivalent to 4.6 percent of GDP in 2020. The wage bill went up by 12.1 percent and accounted for 10.6 percent of GDP. On the positive side, capital expenditures increased by 10.1 percent and reached 5.4 percent of GDP. The widening deficit led to a rise in the gross financing requirement which was met through issuance of Eurobonds and solid activity in the domestic debt market, as well as a number of international loans. Public debt, which had fallen since 2015 to an eight-year low of 52.9 percent in 2019, at yearend 2020 stood at 58.2 percent of GDP.

Although the current account deficit (CAD) had narrowed significantly, in 2020 external debt started to gradually rise. The CAD is estimated at 4.3 percent of GDP for 2020, down from 6.9 percent in 2019. The CAD narrowed mainly because of the decrease in transfers of net income by foreign companies from Serbia (down by 44 percent in euro terms in 2020 compared to 2019). Deficit in trade in goods was lower by 7 percent in 2020 (in euro terms) while surplus in trade in services increased by 6 percent. Export performance in 2020 was much better than expected given the start of operations of predominantly export oriented companies and improvements in terms of trade. Small and medium sized exporters increased exports (between 3 and 7.3 percent in euro terms). Only the group of largest exports (with annual exports of over 200 million euros) lowered exports in 2020 (down by 8.8 percent in euro terms). Terms of trade improved in 2020—exports prices went up by 0.8 percent, while import prices went down by 3.7 percent (mainly because of lower raw materials and oil prices). Net transfers reached 7.6 percent of GDP despite a significant drop in remittances (down 16 percent in euro terms). The CAD is again fully financed by FDI. Net FDI accounted for 6.2 percent of GDP, despite being down in 2020 by about 18 percent. Inflow of foreign equity was slashed by 48 percent; as a result,

12 The Serbian government provided a one-off payment of €100 to all adult citizens in direct support of living standards, at a cost to the budget of 1.3 percent of GDP. However, this is classified as "Other current expenditures".

external debt started to increase gradually, reaching an estimated 67.1 percent of GDP at yearend, compared to 61.8 percent a year earlier.

Low inflation and the high official reserves of the National Bank of Serbia (NBS) provided a solid foundation for monetary policy responses to the pandemic. Inflation in 2020, as in 2019, was low and stable, with prices having increased by just 1.3 percent by yearend. In early 2021 inflation was down even further, reaching 1.1 percent in January. The NBS remains committed to inflation targeting (3 percent +/-1.5 percent). To stimulate the economy, the NBS continued to lower the key policy rate—in March 2020 by 50 bps to 1.75 percent, in April to 1.5 percent, in June to 1.25 percent, and in December to 1 percent. The money supply increase was also notable: in December 2020 M1 was 35 percent higher than a year before. After a small appreciation in 2019, the dinar held steady in 2020, primarily because of central bank interventions in the foreign exchange market; through December it had sold foreign currencies equaling €1.5 billion. At that point, NBS had official foreign currency reserves of €13.5 billion, up €113 million over 2019.

Banking sector performance continued to be robust despite two rounds of debt moratoriums introduced in 2020 as part of the COVID-19 response. Based on preliminary data banks remained profitable in 2020 although both return on assets (ROA) and return on equity (ROE) went down (ROA down from 1.7 percent in 2019 to 1.1 percent; and ROE down from 9.8 to 6.5 percent). Nonperforming loans hit a historic annual low of 3.7 percent in December primarily because of the resolution strategy introduced in 2015 and the recent crisis mitigation measures. The total value of new consumer loans in 2020 was down 16 percent from 2019, and new company loans for investment projects were down 22.2 percent. However, new loans to finance companies' current assets went up by 7.7 percent.

Outlook and Risks

Growth is expected to recover from the COVID-19–related recession, reaching about 4 percent over the medium term. Based on the latest data, the GDP is expected to rebound in 2021 (up by 5 percent). Growth in 2021 is being pushed up by the stimulus package of about 5 percent of GDP announced in February and all components of GDP are expected to increase. Over the medium term the economy is expected to grow steadily at 3.5–4 percent annually, similar to levels before the pandemic, as the economies of main trading and investment partners recover fully from the pandemic. The main driver of GDP growth over the medium term will be consumption, while net exports will make a negative contribution to growth.

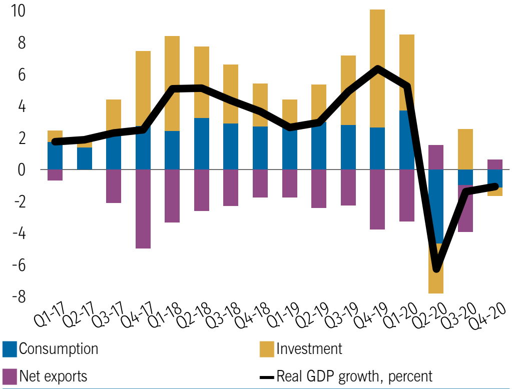
Going forward, the focus of policy makers should be not only on accelerating growth but also on greening it. Green—clean and resilient—growth could be supported by, e.g., promoting efficiency gains; expanding green industries and technologies; emphasizing less polluting and more energy-efficient industries; and proactively building up resilience to climate and disaster risks.

Macroeconomic stability will be maintained over the medium term. This year the new stimulus program will again increase the budget deficit (to 5 percent of GDP, up from the previously projected 3 percent), but since the program is based on one-off measures, over the medium term the deficit is expected to be lowered to about 0.5 percent of GDP over the medium term. Consequently, public debt will start falling as a share of GDP, reaching 54 percent by 2024. Inflation will remain low and within the NBS target. External debt will be kept sustainable; the CAD is expected to increase only marginally over the medium term and will primarily be covered by FDI inflows.

This relatively positive outlook could be affected by numerous risks. The main ones relate to external developments—recovery of the European and global economy—since that will impact the evolution of exports and FDI, which are both critical for the growth of the Serbian economy. There are, however, also internal risks to the baseline scenario. Contingent liabilities could affect public finances, particularly those related to the deterioration in performance of state-owned enterprises, as demonstrated recently by Telekom Srbija and Air Serbia, in addition to other SOEs that have long been financially troubled. Political developments could distract the government from undertaking necessary reforms, most important from the growth perspective being those related to improving the business environment, education, and environmental management.

In 2020 the COVID-19 pandemic caused GDP to contract.

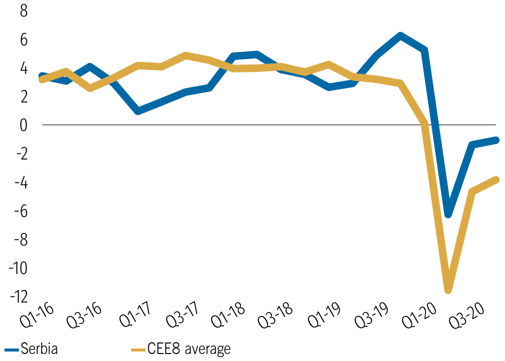
Contribution to growth, percentage points



Source: Statistics Office of Republic of Serbia.

However, it was significantly less than recessions across CEE countries.

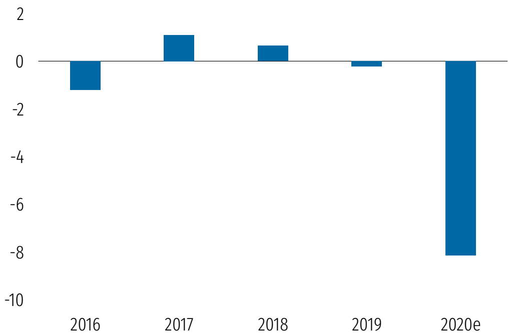
Real GDP change, y/y



Source: Statistics Office of Republic of Serbia and Eurostat.

Support to the economy came at the price of a record-high fiscal deficit.

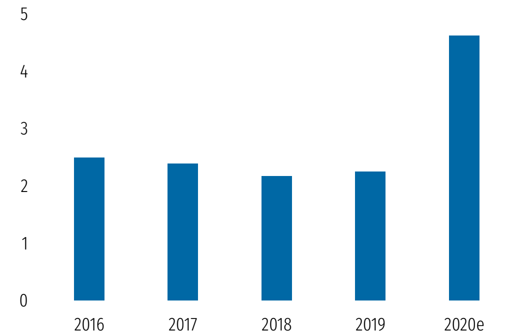
Share in GDP



Source: Ministry of Finance.

Spending on subsidies led the growth in total budgetary spending in 2020.

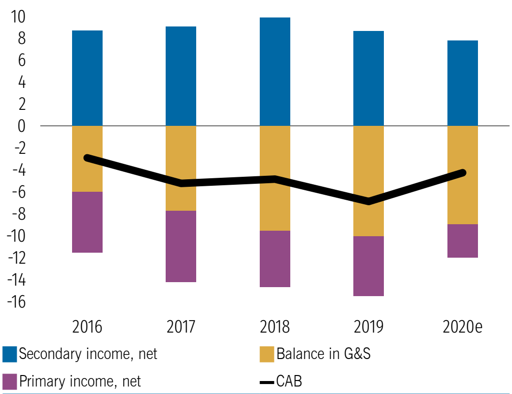
Share in GDP



Source: Ministry of Finance.

A lower primary income deficit and a lower trade deficit narrowed the CAD.

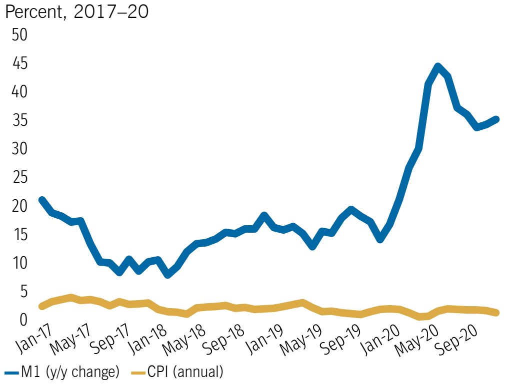
Percent of GDP. 2016–20e



Source: National Bank of Serbia and World Bank staff calculations.

Inflation is low, although the money supply has grown.

Percent, 2017–20



Source: National Bank of Serbia and World Bank staff calculations.

SERBIA	**2017**	**2018**	**2019**	**2020e**	**2021f**	**2022f**
Real GDP growth (percent)	2.0	4.4	4.2	-1.0	5.0	3.7
Composition (percentage points):						
Consumption	1.9	2.8	2.7	-0.9	4.3	3.3
Investment	2.2	4.2	3.0	0.8	1.4	1.1
Net exports	-2.1	-2.6	-1.5	-1.0	-0.6	-0.6
Exports	4.0	4.3	4.6	-3.3	4.1	4.6
Imports (-)	6.1	6.9	6.0	-2.3	4.7	5.3
Consumer price inflation (percent, period average)	3.2	2.0	1.9	1.6	2.5	2.1
Public revenues (percent of GDP)	41.5	41.5	42.1	41.3	41.2	41.7
Public expenditures (percent of GDP)	40.4	40.9	42.3	49.4	46.2	43.9
Of which:						
Wage bill (percent of GDP)	9.0	9.2	9.5	10.6	10.3	10.2
Social benefits (percent of GDP)	15.1	14.7	14.5	14.8	14.5	14.3
Capital expenditures (percent of GDP)	2.8	3.9	4.9	5.4	5.8	5.6
Fiscal balance (percent of GDP)	1.1	0.6	-0.2	-8.1	-5.0	-2.1
Primary fiscal balance (percent of GDP)	3.6	2.8	1.8	-6.1	-3.0	-0.3
Public debt (percent of GDP)	55.6	50.8	49.7	53.7	54.0	52.7
Public and publicly guaranteed debt (percent of GDP)	58.7	54.4	52.9	58.2	58.0	56.2
Of which: External (percent of GDP)	35.5	31.4	30.3	33.7	37.0	38.0
Goods exports (percent of GDP)	35.9	35.2	35.7	34.5	34.6	35.8
Goods imports (percent of GDP)	46.0	47.1	48.0	45.7	46.0	45.5
Net services exports (percent of GDP)	2.4	2.3	2.3	2.3	3.6	1.9
Trade balance (percent of GDP)	-7.8	-9.5	-9.9	-8.9	-7.8	-7.8
Net remittance inflows (percent of GDP)	5.2	6.1	5.6	4.6	5.0	4.9
Current account balance (percent of GDP)	-5.2	-4.8	-6.9	-4.3	-5.2	-5.9
Net foreign direct investment inflows (percent of GDP)	6.2	7.4	7.8	6.2	5.8	5.6
External debt (percent of GDP)	68.9	61.3	61.8	67.1	64.4	61.7
Real private credit growth (percent, period average)	1.9	3.7	6.9	9.2	n.a.	n.a.
Nonperforming loans (percent of gross loans, end of period)	9.8	5.7	4.1	3.7	n.a.	n.a.
Unemployment rate (percent, period average)	13.5	12.7	10.4	9.0	n.a.	n.a.
Youth unemployment rate (percent, period average)	31.9	29.7	27.5	26.3	n.a.	n.a.
Labor force participation rate (percent, period average)	54.0	54.5	54.6	54.0	n.a.	n.a.
GDP per capita, PPP (current international $)	16,599	17,842	18,972	18,840	20,393	n.a.

Sources: Country authorities, World Bank estimates and projections.

Key Economic Indicators

Key Economic Indicators	**2016**	**2017**	**2018**	**2019**	**2020e**	**2021f**	**2022f**
Real GDP growth (percent)							
Albania	3.3	3.8	4.1	2.2	-3.3	4.4	3.7
Bosnia and Herzegovina	3.1	3.2	3.7	2.8	-4.3	2.8	3.5
Kosovo	4.1	4.2	3.8	4.9	-6.9	4.0	4.5
North Macedonia	2.8	1.1	2.9	3.2	-4.5	3.6	3.5
Montenegro	2.9	4.7	5.1	4.1	-15.2	7.1	4.5
Serbia	3.3	2.0	4.4	4.2	-1.0	5.0	3.7
WB6	*3.3*	*2.7*	*4.0*	*3.6*	*-3.4*	*4.4*	*3.7*
Consumer price inflation (percent, period average)							
Albania	1.3	2.0	2.1	1.4	1.6	2.4	2.8
Bosnia and Herzegovina	-1.6	0.8	1.4	0.6	-1.1	0.5	0.5
Kosovo	0.3	1.5	1.1	2.7	0.2	0.7	1.0
North Macedonia	-0.2	1.4	1.5	0.8	1.2	1.6	2.0
Montenegro	-0.3	2.4	2.6	0.4	-0.3	1.5	1.5
Serbia	1.1	3.2	2.0	1.9	1.6	2.5	2.1
WB6	*0.4*	*2.2*	*1.8*	*1.4*	*0.9*	*1.8*	*1.8*
Public expenditures (percent of GDP)							
Albania	29.6	29.8	29.2	29.4	33.2	33.3	31.4
Bosnia and Herzegovina	41.5	41.4	40.2	41.1	47.8	44.6	42.6
Kosovo	27.7	27.6	29.0	29.5	33.4	31.5	29.6
North Macedonia	35.3	35.4	33.1	35.7	40.3	37.8	36.7
Montenegro	45.3	47.0	46.6	46.0	55.4	48.2	43.3
Serbia	41.9	40.4	40.9	42.3	49.4	46.2	43.9
WB6	*36.9*	*36.9*	*36.5*	*37.3*	*43.2*	*40.3*	*37.9*
Public revenues (percent of GDP)							
Albania	27.6	27.8	27.5	27.4	26.5	27.8	27.4
Bosnia and Herzegovina	42.7	43.8	42.7	43.0	42.3	42.3	41.8
Kosovo	26.3	26.4	26.1	26.6	25.8	26.4	26.5
North Macedonia	31.5	32.0	31.4	32.6	31.3	31.8	32.5
Montenegro	42.5	41.4	42.0	43.3	44.4	43.2	42.0
Serbia	40.8	41.5	41.5	42.1	41.3	41.2	41.7
WB6	*35.2*	*35.5*	*35.2*	*35.8*	*35.3*	*35.4*	*35.3*

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

	2016	2017	2018	2019	2020e	2021f	2022f
Fiscal balance (percent of GDP)							
Albania	-1.8	-2.0	-1.7	-2.0	-6.7	-5.4	-4.0
Bosnia and Herzegovina	1.2	2.4	2.5	1.9	-5.4	-2.3	-0.9
Kosovo	-1.4	-1.2	-2.9	-2.9	-7.6	-5.1	-3.1
North Macedonia	-2.7	-2.8	-1.1	-2.2	-8.2	-5.3	-3.9
Montenegro	-2.8	-5.7	-4.6	-2.7	-11.0	-5.1	-1.3
Serbia	-1.2	1.1	0.6	-0.2	-8.1	-5.0	-2.1
WB6	*-1.4*	*-1.4*	*-1.2*	*-1.3*	*-7.8*	*-4.7*	*-2.5*
Public debt (percent of GDP)							
Albania	68.7	66.9	64.9	63.7	75.1	75.4	74.9
Bosnia and Herzegovina	42.4	36.1	34.2	32.8	37.4	38.2	38.0
Kosovo	14.1	15.6	16.3	16.9	22.3	24.9	26.5
North Macedonia	39.9	39.4	40.4	40.7	51.4	56.5	57.5
Montenegro	64.4	64.2	70.1	76.5	105.1	90.1	82.3
Serbia	62.8	55.6	50.8	49.7	53.7	54.0	52.7
WB6	*48.7*	*46.3*	*46.1*	*46.7*	*57.5*	*56.5*	*55.3*
Public and publicly guaranteed debt (percent of GDP)							
Albania	72.3	71.9	69.5	67.9	77.4	77.3	76.6
Bosnia and Herzegovina	43.8	37.7	35.6	34.5	39.6	40.4	40.2
Kosovo	14.4	16.3	16.9	17.5	22.8	25.2	26.7
North Macedonia	48.8	47.7	48.4	49.4	60.0	64.7	65.7
Montenegro	70.4	69.1	74.1	80.0	109.2	93.8	85.8
Serbia	68.6	58.7	54.4	52.9	58.2	58.0	56.2
WB6	*53.0*	*50.2*	*49.8*	*50.4*	*61.2*	*59.9*	*58.5*
Goods exports (percent of GDP)							
Albania	6.7	6.9	7.7	6.6	6.1	6.2	6.2
Bosnia and Herzegovina	25.7	29.8	31.2	28.8	27.7	26.8	26.5
Kosovo	5.1	5.9	5.6	5.5	7.1	7.2	6.9
North Macedonia	36.5	40.6	45.4	47.5	44.7	45.6	46.9
Montenegro	8.9	8.9	9.4	9.4	9.7	9.3	9.2
Serbia	34.9	35.9	35.2	35.7	34.5	34.6	35.8
WB6	*26.3*	*27.9*	*28.5*	*28.5*	*27.5*	*27.4*	*28.1*

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

	2016	2017	2018	2019	2020e	2021f	2022f
Trade balance (percent of GDP)							
Albania	-16.8	-15.1	-13.7	-13.8	-14.8	-14.1	-11.7
Bosnia and Herzegovina	-16.6	-16.2	-14.7	-14.7	-14.6	-15.0	-15.6
Kosovo	-27.2	-25.5	-28.0	-26.9	-31.5	-28.2	-26.2
North Macedonia	-15.2	-14.1	-12.7	-14.5	-12.8	-12.8	-11.8
Montenegro	-22.5	-23.5	-23.9	-21.1	-34.8	-27.5	-20.8
Serbia	-6.0	-7.8	-9.5	-9.9	-8.9	-7.8	-7.8
WB6	*-12.8*	*-13.1*	*-13.4*	*-13.6*	*-14.1*	*-13.0*	*-12.1*
Current account balance (percent of GDP)							
Albania	-7.6	-7.5	-6.8	-8.0	-8.9	-7.7	-6.4
Bosnia and Herzegovina	-4.8	-4.8	-3.5	-3.2	-3.4	-4.0	-4.7
Kosovo	-7.9	-5.4	-7.6	-5.5	-5.7	-5.7	-4.9
North Macedonia	-2.6	-0.9	-0.1	-3.3	-3.5	-3.4	-2.6
Montenegro	-16.2	-16.1	-17.0	-15.0	-26.0	-19.4	-13.1
Serbia	-2.9	-5.2	-4.8	-6.9	-4.3	-5.2	-5.9
WB6	*-4.8*	*-5.5*	*-5.1*	*-6.2*	*-5.8*	*-5.8*	*-5.6*
External debt (percent of GDP)							
Albania	73.5	68.8	65.2	60.5	65.0	60.9	55.4
Bosnia and Herzegovina	79.1	70.6	66.8	64.1	73.0	76.3	75.9
Kosovo	33.2	32.6	30.3	30.3	37.8	39.6	38.5
North Macedonia	74.7	73.4	73.0	72.7	79.9	82.6	81.2
Montenegro	161.8	159.9	162.6	167.2	n.a.	n.a.	n.a.
Serbia	72.1	68.9	61.3	61.8	67.1	64.4	61.7
WB6	*82.4*	*79.0*	*76.5*	*76.1*	*64.5*	*64.8*	*62.5*
Unemployment rate (period average, percent)							
Albania	15.2	13.7	12.3	11.5	11.7	n.a.	n.a.
Bosnia and Herzegovina	25.4	20.5	18.4	15.7	n.a.	n.a.	n.a.
Kosovo	27.5	30.5	29.5	25.7	n.a.	n.a.	n.a.
North Macedonia	23.8	22.4	20.7	17.3	16.4	n.a.	n.a.
Montenegro	17.7	16.1	15.2	15.1	18.1	n.a.	n.a.
Serbia	15.3	13.5	12.7	10.4	9.0	n.a.	n.a.
WB6	*20.8*	*19.5*	*18.1*	*15.9*	*n.a.*	*n.a.*	*n.a.*

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

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