WORLD BANK GROUP

WESTERN BALKANS REGULAR ECONOMIC REPORT

No.20 | Fall 2021

Greening the Recovery

Western Balkans
Regular Economic Report No.20

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Fall 2021

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The cutoff date for the data used in this report was September 29, 2021.

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.

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

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

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Greening the Recovery

1. Overview

In 2021, the Western Balkans is seeing an accelerated rebound from the COVID-19-induced recession that all six economies experienced in 2020. The recovery is taking hold at a faster-than-expected pace, with strong growth performances recorded across the region in the second quarter of 2021, in contrast to the subdued performance seen in the first quarter (and as noted in the Spring 2021 *Regular Economic Report*). However, while the recovery is broad-based—as a result of strength in both domestic and external demand—it is also fragile.

The rebound is being supported by a heady combination of domestic reopening, allowing for a recovery in consumption and tourism arrivals, and favorable external conditions for the region's exports. As a result of falling infection rates, countries across the region were able to loosen both domestic and cross-border mobility restrictions during late spring and summer. This saw a sharp rebound in domestic consumption and in travel across Europe, boosting remittances as well as tourism inflows during the peak summer season. A strong recovery in advanced economies, due to rapid vaccination and helped by fiscal stimulus, also provided a welcome boost to demand for the region's exports.

However, early warning signals from the labor market call for close policy attention. The labor force participation rate edged up during the first half of 2021 in several Western Balkan countries, with Montenegro seeing no improvement yet. The unemployment rate increased in the first half of 2021 in most countries, except Kosovo and North Macedonia. While the employment support programs implemented in response to the pandemic helped blunt the impact of COVID-19 on the labor market, a post-crisis jobs recovery will not be easy. Furthermore, job losses from the recession and its aftermath have disproportionately affected women and youth, which may set back efforts to raise the region's perennially low rates of labor force participation. Experience from previous crises suggests that prolonged high youth unemployment could result in long-term labor force scarring.

While the pace of vaccinations has picked up, the Western Balkans still lags more developed European neighbors. Vaccination rates[1] are below 40 percent of the overall population in most countries of the Western Balkans, except for Kosovo and Serbia. This lack of vaccination protection means that the region is less prepared than advanced economies to withstand the ongoing Delta wave or new variants that might emerge, with COVID-19 infectivity and mortality rates already rising sharply across the region. Further, vaccine hesitancy, which appears to be higher across the Western Balkans compared to European Union (EU) averages, suggests that new approaches will be needed to reach the levels of vaccination needed to effectively suppress severe cases of COVID-19.

1 Measured as a total number of people who received at least one vaccine dose divided by the total population of the country.

Fiscal balances have started to improve as a result of a stronger economic performance, but it will take further effort to replenish buffers. The growth recovery is contributing to buoyant revenue collection across the region, particularly in value-added tax collections, as domestic consumption strengthens. Similarly, a leveling off of public spending in 2021 after the countercyclical surge of 2020 is helping on the expenditure side. As a result, all countries except Bosnia and Herzegovina expect to see a narrower fiscal deficit in 2021, with the average deficit reduced by 2.7 percent of GDP year-on-year. However, the deficits across all economies of the Western Balkans are still above pre-pandemic trends, and the legacy of the pandemic is a stock of public debt that has now reached historic highs in all countries except Serbia and Bosnia and Herzegovina. As the recovery from COVID-19 takes hold, greater efforts will be needed to mobilize and diversify sources of revenue and to streamline expenditure programs, which in turn would help address fiscal vulnerabilities that have arisen during the crisis.

In line with global conditions, inflationary pressures in the Western Balkans are on an upward trajectory. Average inflation is projected to reach 2.3 percent in 2021 from 0.9 percent in 2020. On the external side, strengthening demand in advanced economies is driving commodity prices upward and putting pressure on COVID-19-strained logistics networks and global value chains. Similarly, the faster-than-expected recovery in domestic consumption across the region has placed upward pressure on domestic costs, particularly in labor markets during the summer tourism season.

Financial sector conditions are supportive of growth, but risks remain. The financial system continues to maintain resilience due to a combination of COVID-19 support measures and the growth rebound. Public measures have helped to mitigate the impact of the 2020 recession on bank asset quality, keeping nonperforming loan ratios broadly stable. However, the health of the banking system will be tested during the recovery, particularly as remaining borrower relief measures are phased out.

The outlook for Western Balkan countries has improved due to a stronger-than-expected economic performance in 2021. GDP growth is projected to reach 5.9 percent in 2021, after a 3.1 percent contraction in 2020. Thereafter, a steadier pre-crisis growth path is expected to resume, with growth in the region projected at 4.1 percent in 2022 and 3.8 percent in 2023. Pre-crisis levels of output are expected to be surpassed by the end of 2021 for all economies in the Western Balkans, except for Montenegro (by mid-2022). The 2020 recession saw a reversal of previous reductions in the level of poverty in the Western Balkans. With a full year growth recovery in 2021, the poverty rate for the region is projected to resume its historical downward trend and fall by around 1 percentage point to 20.3 percent, close to its 2019 level.

This more positive outlook is still marred by risks clearly tilted to the downside, not least of which is the further impact of domestic or international movement restrictions as a result of new pandemic flare-ups. Depleted fiscal space and high debt levels will continue to weigh on the region. Political uncertainty would also delay a recovery in both domestic and foreign investment, which the region needs to boost potential output.

As the Western Balkans starts to look beyond the pandemic, the policy focus will need to shift back toward addressing the key structural impediments to job creation and economic transformation. Many of these constraints, which among others include weak firm-level productivity, lack of market competition, limited regional economic integration, and weak institutions, have become even more apparent as a result of the stresses that COVID-19 has placed on the region. At a time when fiscal space has narrowed, structural reforms would help boost private investment as well as ease preparation toward EU membership.

Furthermore, the six countries of the Western Balkans now find themselves at a key decision point regarding the impending green transition. The external environment is going through a fundamental structural change. Global strides toward action on climate change, biodiversity loss, air and plastic pollution, and other existential environmental crises are changing the foundations of economic activity, consumer choices, and investor behavior everywhere. Yet, the Western Balkans are currently characterized by a development model tilted toward familiar brown industries, supported by "sticky" brown skills and jobs, and established value chains and market infrastructure.

Leapfrogging to a green growth pathway is far from easy, especially in the short term. However, despite myriad challenges, the green transition also offers opportunities for the Western Balkans, not least through closer integration into Euro-centric global value chains, as well as access to significant EU resources to help fund a green transition. Effectively managing this transition, including the many policy tradeoffs, will need to be a core focus of policy attention for the Western Balkans in the years ahead.

Table 1.1. Western Balkans Outlook, 2019–2023.

	2019	2020	2021e	2022f	2023f
Real GDP growth (percent)					
Albania	2.2	-4.0	7.2	3.8	3.7
Bosnia and Herzegovina	2.8	-3.2	4.0	3.0	3.2
Kosovo	4.8	-5.3	7.1	4.1	4.4
North Macedonia	3.2	-4.5	4.6	3.7	3.4
Montenegro	4.1	-15.3	10.8	5.6	4.8
Serbia	4.3	-0.9	6.0	4.5	4.0
WB6	*3.6*	*-3.1*	*5.9*	*4.1*	*3.8*
Real GDP components growth (percent)					
Consumption	3.4	-1.8	4.0	2.9	2.7
Investment	1.0	-2.4	1.3	0.4	1.5
Net exports	-0.8	-1.9	1.2	0.8	-0.3
Exports	3.0	-10.3	10.9	4.4	3.3
Imports (-)	3.8	-8.5	9.7	3.6	3.6
Consumer price inflation (percent, period average)	1.5	0.9	2.3	2.1	2.1
External sector (percent of GDP)					
Goods exports	28.5	27.6	31.1	31.8	32.4
Trade balance	-13.6	-13.8	-13.3	-12.2	-11.8
Current account balance	-6.2	-5.7	-5.6	-5.1	-4.7
Foreign direct investment	4.9	5.4	4.8	4.9	5.0
External debt	76.5	90.6	93.9	91.5	90.8
Public sector (percent of GDP)					
Public revenues	35.6	35.0	36.6	36.4	36.3
Public expenditures	37.0	42.2	41.2	38.8	37.9
Fiscal balance	-1.3	-7.3	-4.6	-2.4	-1.6
Public and publicly guaranteed debt	50.3	60.9	58.9	57.4	56.0

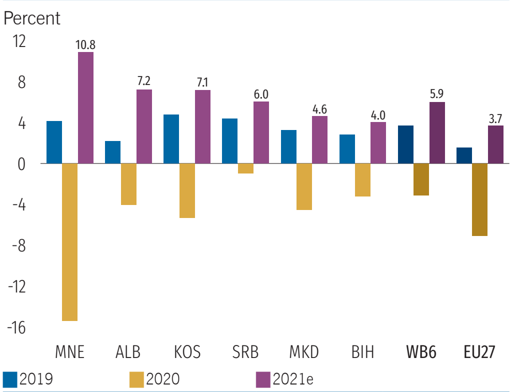
Source: State statistical offices; Ministries of Finance; central banks; World Bank staff estimates.
Note: e = estimate; f = forecast.

2. The Western Balkans is experiencing a strong recovery

The Western Balkan economies are rebounding strongly from the economic crisis caused by the COVID-19 pandemic, in line with global trends. While the human toll of the pandemic continues to accumulate in the region, economies are recovering faster than previously projected as stringent containment measures are being relaxed and external demand picked up. Following a contraction of 3.1 percent in 2020, the Western Balkans are set to grow 5.9 percent in 2021, 1.5 percentage points higher than projected earlier (Figure 2.1). The uptick in the estimates reflects improved external conditions (with European Union growth revised upward by 1 percentage point), higher commodity prices, recovery in tourism exports, and improved business and consumer sentiment. Economic activity in the region is projected to bounce back to 2019 levels by year-end. Yet, with low vaccination rates across the region, and the continued race between the variants and vaccinations globally that may lead to further mobility restrictions, uncertainty around the recovery remains high.

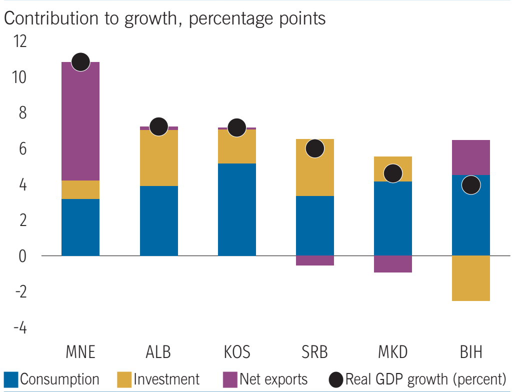
Consumption is driving growth in the region, contributing 4 percentage points to economic growth as social distancing measures eased compared to 2020 (Figure 2.2). Higher wages, credit growth, remittances, a strong tourism season, and pent-up demand are pushing up private consumption despite the slow recovery in labor markets and increasing consumer prices in all Western Balkan countries. Public consumption is supporting growth, except for Montenegro and Kosovo, where spending decelerated. Public consumption growth is driven by higher public sector wages in Albania, Bosnia and Herzegovina, and Serbia; and spending on goods and services also contributes to the rise in Albania, North Macedonia, and Serbia.

Figure 2.1. All Western Balkan countries have experienced a strong economic recovery in 2021.



Source: National statistical offices; World Bank staff estimates.

Figure 2.2. The recovery is driven by a strong rebound in consumption and tourism.

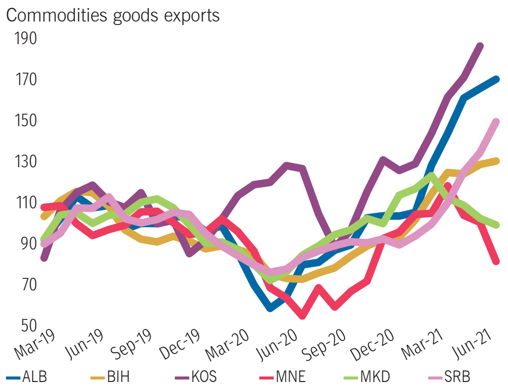


Source: National statistical offices; World Bank staff estimates.

Private investment is recovering after a considerable drop in 2020. Investment is contributing 1.3 percentage points to economic growth in the region driven by private and public investment in most countries. Private investment is firming up in all Western Balkans countries, as business sentiment recovers, and investment lending accelerates. In Albania, North Macedonia, Serbia, and to a lesser extent in Bosnia and Herzegovina, higher public investment is also supporting growth. Public investment is expected to decline by yearend in Kosovo and Montenegro due to delays in implementation. Net foreign direct investment (FDI) inflows to the region remain resilient and have declined much less than in the EU and most other regions in the world since the start of the pandemic. While European investors have long dominated FDI and stronger global value chain participation in the Western Balkans, the region has increasingly attracted new investors from North America and East Asia. There has been discussion that the pandemic may provide significant FDI opportunities for Eastern European countries from nearshoring. While there is little evidence so far for massive FDI nearshoring taking place in the region, the Western Balkan economies could still benefit from a realignment of global production networks in the post-pandemic phase (Box 2.1). To take full advantage of these opportunities, the Western Balkan economies need to embrace proactive policies to strengthen their investment competitiveness.

Higher demand and prices for commodities including metals and minerals have driven the surge in goods exports in the Western Balkans since the start of the year. Commodity exports are between 30–80 percent higher than in the year before the pandemic in Albania, Bosnia and Herzegovina, Kosovo, and Serbia. In Kosovo value of goods exports have marked a substantial increase throughout the pandemic, driven by both base metals and minerals exports, but also across the board increases in other products reflecting further diversification in goods exports. Only in Montenegro, commodity exports have recently started to fall back below their 2019 level (Figure 2.3). As international travel restrictions eased and vaccinations hastened in Europe, Kosovo, Montenegro, and Albania further benefitted from a strong recovery in tourism revenues, boosting service exports. Net exports are adding 1.2 percentage points to growth in the Western Balkan region. The net export contribution is highest in Montenegro (6.6 percentage points) driven by a surge in service exports driven by a strong tourism recovery. It is positive in all countries, except for Serbia and North Macedonia where import growth outpaced export growth driven by higher domestic demand or high import component of exports.

Figure 2.3. Higher demand for commodities drove recent goods export growth.



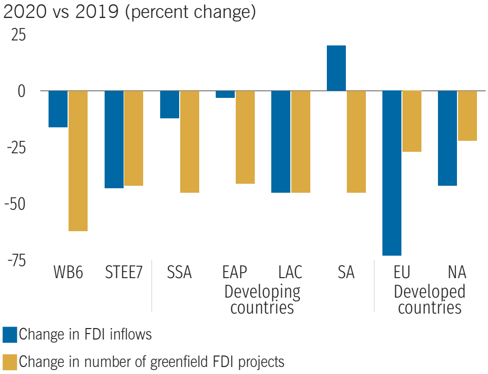
Source: National statistical offices; World Bank staff estimates.
Note: index, 2019=100; 3 months moving average.

Growth in services—the hardest-hit sector in 2020—is spearheading the recovery. The recovery is broad-based across economic activities, except agriculture. The service sector is marking the fastest recovery, particularly in tourism, as foreign tourist overnight stays, and diaspora travel have picked up. The contribution of agriculture to growth remains limited in all countries and is negative in Serbia due to weather-related shocks. In Albania, construction continues to add to growth as infrastructure projects and post-earthquake reconstruction ensue. In Bosnia and Herzegovina, manufacturing is also picking up thanks to higher external demand. In North Macedonia, the fastest recovery is occurring in trade, transport, tourism, manufacturing, and information and communications technology, while construction activity contracted in the second quarter.

Box 2.1. The Western Balkans could benefit from realignment of global production networks in the post-pandemic context.

COVID-19 has presented an unprecedented shock to global FDI flows. Despite challenging circumstances, the Western Balkan economies fared relatively well in attracting foreign investment. FDI inflows shrank by 16 percent in 2020 compared to 2019 in the Western Balkans region, much better than the small transition European economies (STEEs)[2] and EU countries, which suffered from a 43 percent and 73 percent decline in FDI inflows, respectively (Figure 2.4). The Western Balkan region, however, was bearing the brunt of a collapse in new investment announcements. The number of greenfield FDI project announcements plummeted to 65 in 2020, the lowest reading since the data became available in 2003. As a leading indicator, fewer greenfield project announcements may portend a slowdown in actual FDI inflows in the coming months. Proactive government policies might be warranted to restore investor confidence in the region.

Figure 2.4. Despite fewer projects, FDI inflows shrank much less than in other regions in 2020.



Source: National statistical offices; World Bank staff estimates.
Note: Change in FDI inflows by region. EAP = East Asia and Pacific; EU = European Union; LAC = Latin America and the Caribbean; NA = North America; SSA = Sub-Saharan Africa; STEE7 = small transition European economies; WB6 = Western Balkans 6.

Figure 2.5. Manufacturing, financial services, transportation, and construction attract most FDI.

Source: National statistical offices; World Bank staff estimates.
Note: Sectoral composition of FDI.

2 STEE includes Bulgaria, Croatia, Estonia, Latvia, Lithuania, Slovak Republic, and Slovenia.

Box 2.1 continued

Demonstrated FDI resilience in several sectors, global value chain diversification, and potential nearshoring could contribute to the much-needed sustainable and inclusive growth in the region in the post-pandemic era. Manufacturing, financial services, transportation, construction, and real estate were the top FDI receiving sectors in the region before the crisis (Figure 2.5). Manufacturing received the most FDI in Bosnia and Herzegovina, North Macedonia, and Serbia. FDI in Albania flows primarily to utilities, financial services, and mining, while FDI in Kosovo is concentrated in real estate. Official FDI statistics for the entire region show a 28 percent contraction in manufacturing FDI and an 18 percent decline in construction FDI in 2020 compared to the 2015–19 average, while FDI inflows in financial services and transportation grew by 21 percent and 48 percent, respectively. Both the official statistics and greenfield FDI announcement data reveal an uptick in FDI inflows in automotive components in 2020, driven by a huge investment in Serbia. In Serbia, for example, FDI inflows in the sector almost doubled from EUR 173 million in 2019 to EUR 301 million in 2020, with further significant investment announcements in the pipeline.[3] Greenfield FDI in Business Process Outsourcing (BPO) and tourism also grew by 60 percent and 11 percent, respectively. The global shift toward electrical vehicles and digitalization holds potential for the region to integrate into automotive, electronics, and IT-BPO value chains by targeting FDI in these emerging sectors.

European investors have long dominated FDI inflows in the Western Balkans region and continue to expand investment in many global value chain (GVC)-intensive sectors. Meanwhile, the region has increasingly attracted investors from North America and East Asia, attesting to the region's global competitiveness. EU investors consistently accounted for about half of total FDI inflows into the region during 2013–19. Other Europe and Central Asian economies contributed to another 30 percent of FDI inflows. During 2014–19, FDI from the EU nearly quadrupled in North Macedonia, EU investment also more than doubled in Kosovo, and nearly doubled in Albania. FDI from the EU has boomed in a wide range of sectors in recent years, including automotive components, consumer products, electronic components, textiles, software, and IT services. Yet, recently, FDI inflows to the region from North America and East Asia have been growing more rapidly than FDI from the EU and remained resilient during the pandemic. Greenfield FDI data suggest that newly announced investments from the EU more than halved in 2020 relative to 2019, while new investments from East Asia declined only modestly, and FDI from North America recorded strong growth.

Prompted by accelerated technology adoption, economic governance realignment, the push for sustainability and resilience-oriented restructuring, and unprecedented global shipping delays, multinational firms are diversifying their global production networks and creating new opportunities for the Western Balkan region. Investors seek to reduce overdependence on single locations for production and make their global value chains more resistant to external shocks. New technologies have enabled firms to adopt new modes of business operations and embrace more flexible and agile value chains. Delivery delays, congestion, and soaring freight rates during and post-COVID-19 have also prompted firms to rethink their supply chains. All these factors could result in diversification, reshoring, and nearshoring.[4] Given the Western Balkan economies' geographic and cultural proximity to EU member countries; its well-educated, young, and multilingual workforce; and relatively lower wages, the region is well positioned to benefit from potential nearshoring. Sectors such as automotive components, transportation, and BPO have also demonstrated resilience for

3 Japan's Nidec for example plans a 200-billion-yen (1.6 billion euro) investment in Serbia. https://seenews.com/news/japans-nidec-plans-200-bln-yen-16-bln-euro-investment-in-serbia-report-719343
4 UNCTAD. 2021. World Investment Report 2021: Investing in sustainable recovery.

Box 2.1 continued

attracting FDI inflows, signaling strong momentum for value chain regionalization and nearshoring potential.

Massive nearshoring may be unlikely soon, though the Western Balkans region could still benefit from realignment of global production networks, even if it turns out to be on a smaller scale. Various business surveys have painted a mixed picture of the likelihood and scale of nearshoring. While some surveys[5] find significant potential for supply chain diversification, particularly in sectors such as precision mechanics, optics, medical technology, chemicals, pharmaceuticals, plastics, IT, electrical engineering, and automotive industries, some of the more recent studies point to limited evidence of significant changes to GVCs.[6] The intention of firms to nearshore could also fizzle out over time. As the pandemic is still not over and uncertainty remains, many companies may prefer to avoid disruptive and costly relocations at this stage. However, there is a stronger appetite to reduce dependence on single or dominant source countries, and even small-scale nearshoring could have a significant impact on the Western Balkan economies due to their small sizes.

To take full advantage of potential nearshoring opportunities, the region needs to embrace proactive policies to strengthen its investment competitiveness and implement targeted outreach programs to promote itself to potential investors based on the currently successful sectors and those with identified potential. The COVID-19 crisis and emerging megatrends mark a global inflection point for future FDI and GVC trends. They provide a unique opportunity for the Western Balkans region to undertake reforms to ensure it benefits from the shifting global context. Several countries have already undertaken efforts to review and realign their FDI attraction strategies. The region can leverage its proximity to the EU to attract more FDI, but to take full advantage of any potential nearshoring to the EU market, the Western Balkans governments should continue to review and realign their FDI and private sector development policies with post-COVID realities and address key binding constraints for FDI attraction.

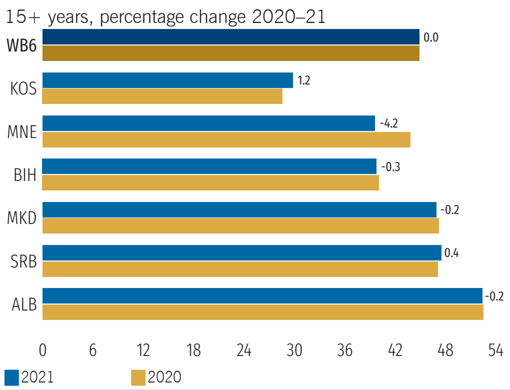
5 AHK World Business Outlook, Spring 2021. Survey by the Network of German Chambers of Commerce Abroad; and WIIW. May 2021. Getting stronger after COVID-19: nearshoring potential in the Western Balkans.

6 EY Attractiveness Survey Europe. June 2021; and Saurav et al. June 2021. The impact of COVID-19 on Foreign Investors: Evidence from the Quarterly Global Multinational Enterprise (MNE) Pulse Survey for the First Quarter of 2021.

3. The labor market is struggling despite a growth recovery

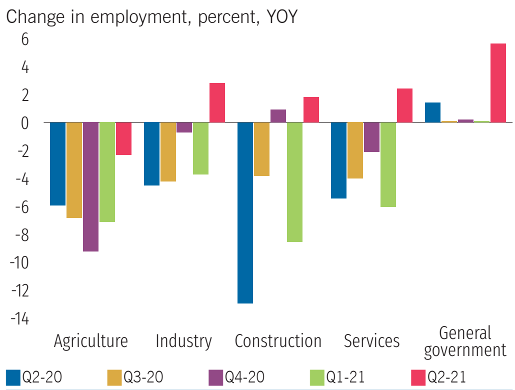
While the labor market started rebounding in late 2020, in line with the growth recovery, it remains fragile given the renewed pandemic waves and the gradual withdrawal of government support measures.[7] Countercyclical and discretionary measures undertaken in response to the crisis helped mitigate the impact of the pandemic on the labor market; however, the duration of the pandemic and the winding down of government job retention programs are impacting the labor market recovery. Some countries (like North Macedonia and Montenegro) kept wage subsidies in place even in 2021, although narrowing the scope and targeting only the most affected sectors. The Western Balkan employment rate (for those age 15 and older) on a four-quarter rolling basis remained largely the same in June 2021 at 45 percent, compared to 2020. The largest decline in the employment rate was seen in Montenegro (4.2 percentage points), where closures and travel bans caused a serious impact on the critical tourism sector. Meanwhile, in Kosovo, the employment rate increased by 1.2 percentage points due to gains in formal employment. According to the Kosovo Pensions Savings Trust, the number of active pension contributors increased by 13.6 percent during the second quarter (Q2) of 2021, indicating an increase of about 40,000 formal jobs compared to the same period of 2020 and 2019. At 52.4 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 is employed (Figure 3.1).

Figure 3.1. The employment rate is decreasing despite a robust rebound.



Source: Data from national statistics offices; World Bank staff estimates.
Note: 2021 is a four-quarter average to June 2021.

Figure 3.2. The public sector is leading the job creation, while agricultural job losses still loom.



Source: Data from national statistics offices; World Bank staff estimates.

7 This analysis was affected by (1) delays in publishing Q4 2020 Labor Force Survey (LFS) data in Kosovo; (2) changes to LFS methodology in Montenegro in 2021, making 2021 data not comparable with previous LFS data; and (3) 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 Q1-Q2 2021 in Kosovo and in Q2 2021 in Montenegro.

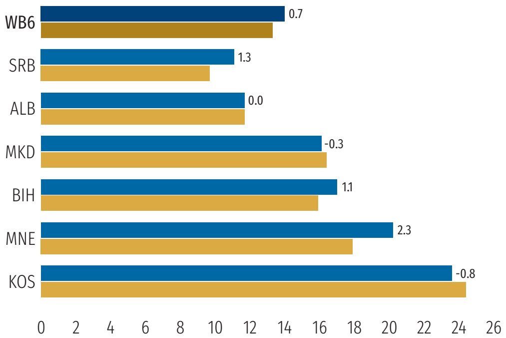
Approximately 84,000 jobs were lost in the first half of 2021 in the Western Balkans, compared to 2020 average, but a major recovery started since April. In Serbia, after a sluggish performance in Q1 2021, the labor market rebounded back in Q2 2021, adding more jobs than in 2020. The recovery has yet to ignite the labor market in Montenegro: since the pandemic outbreak, there has been a persistent decline in employment, with some 40,000 jobs lost since mid-2020. Trade, construction, and tourism have taken the biggest toll, though tourism recovery during the summer is expected to increase employment. In North Macedonia, employment rebounded in late 2020 and continued throughout 2021, with women contributing to the rise as they moved from unemployment to service sector jobs. Employment increased marginally in Q2 2021 in Albania due to employment in construction and manufacturing, while agriculture continued to shrink. Going forward, tourism and post-earthquake reconstruction should absorb earlier losses in manufacturing jobs. While most of the earlier losses were in tourism and construction, the rebound by mid-2021 was led by public sector employment, trade, and tourism (Figure 3.2). Although the public sector became the largest employer across most of the Western Balkans, except in Kosovo, as the recovery takes hold, downsizing will likely be necessary in the medium term driven by fiscal sustainability concerns.

Unemployment increased in the first half of 2021 in most countries of the Western Balkans, except in Kosovo and North Macedonia, partly led by improvement in participation rates (Figure 3.3). There were 125,000 more job seekers than in H1 2020, of which two-thirds were from Serbia also supported by the rise in the participation rate to a historical high. As some of the government support programs have been unwound, the unemployment rate in Serbia in H1 2021 increased to 11.9 percent (compared to 9.2 percent in the same period of 2020). As the support gradually declined, some of the foreign-owned large manufacturers decided to close their operations in Serbia, resulting in significant layoffs. The unemployment rates in Montenegro and Bosnia and Herzegovina have also been increasing in H1 2021, by 4.6 and 2.2 percentage points, respectively, compared to a year ago. In Montenegro, the government continued providing wage subsidies that helped avoid even larger layoffs, while the late start of the tourism recovery might further improve the labor market. In Albania, the unemployment rate declined to 11.6 percent in Q2 and has finally been coupled with an increase in the participation rate to above 59 percent—the highest in the region. North Macedonia is the only country in the region that has registered a continued decline in the unemployment rate throughout the crisis—its unemployment rate declined below 16 percent in Q2, the lowest since the measurement was introduced in 2007. However, this is partly due to a falling participation rate and a rise in inactivity (Figure 3.4).

Job losses have disproportionately affected young people and women. While the average unemployment rate in the Western Balkans increased to 17.3 percent, up 1.5 percentage points from June 2020, youth unemployment rose to 37.7 percent, up 5.4 percentage points from June 2020, further worsening youth employment prospects. Montenegro registered the largest increase in youth unemployment, while even North Macedonia has not been spared. Only in Albania did youth unemployment decline—to below

Figure 3.3. Unemployment rates increased except in Kosovo and North Macedonia.

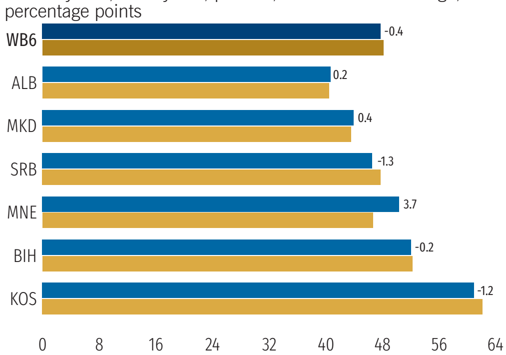
Unemployment rate, 15+ years, percentage change 2020–21



Source: National statistics offices data; World Bank staff calculations.
Note: 2021 is a four-quarter average to June 2021.

Figure 3.4. Inactivity remains a challenge.

Inactivity rate, 15+ years, percent, and 2021–20 change, percentage points



Source: National statistics offices data; World Bank staff calculations.
Note: 2021 is a four-quarter average to June 2021.

20 percent—the lowest level on record. Among those disproportionally affected are also self-employed and workers on non-standard contracts.

The region's labor force participation rate increased slightly compared to June 2020. It increased by 0.4 percentage points to 50.3 percent in June 2021, with the participation rate of women lagging behind that of men. The activity rate in North Macedonia picked up from its low in summer 2020, mostly due to a rise in male labor force participation, while female participation dropped. While the participation rate increased in Albania in Q2, Montenegro has not seen a recovery yet. The largest decline of female participation was in Montenegro, where the service sector was hit hard. Female labor force participation increased in Albania to 51.7 percent in 2021, while it remains the lowest in Kosovo (with a peak of 23.8 percent in 2020).

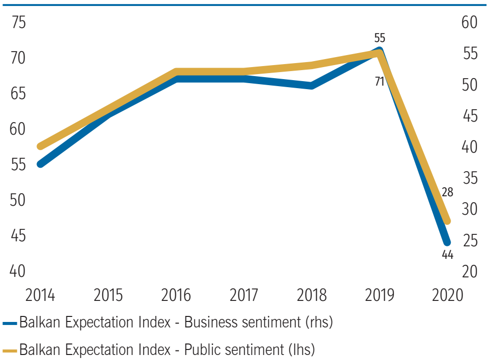
Wage rises may prevent faster recovery in employment. In Serbia, wages increased by 8.6 percent year-on-year in nominal terms in H1 2021, with private sector wages increasing faster than public sector wages. In North Macedonia, wage growth continued in H1, albeit at more subdued pace (6.3 percent year-on-year) compared to the previous year, when the minimum wage increased. The largest increases were observed in sectors that were most affected by pandemic-related restrictions, such as transportation, food and accommodation, entertainment, and other services. Tightening the rules on holiday and Sunday work and increasing the wage rate could add to existing wage pressures. In Montenegro, the Parliament adopted an increase in the net monthly minimum wage of over 12 percent (from €222 to €250), effective October 2021, and Albania negotiated a rise in the minimum wage of around 15 percent, effective September 2021.

As expected, government support packages have prevented a more adverse crisis impact on the labor market, although extended adverse impact is being observed in 2021. While the labor market seems to be rebounding in summer 2021, the speed of the recovery will depend primarily on the epidemiological situation. Further, administrative actions that are expected to increase wage pressures may discourage formal employment, as well as the business expectations on hiring (Box 3.1). Employment support programs have been tightened across the region as fiscal space narrows, while pandemic-weakened corporate balance sheets may prevent a faster recovery of the labor market if risks to the growth outlook materialize.

Box 3.1. Employment expectations of businesses and individuals remain grim.[8]

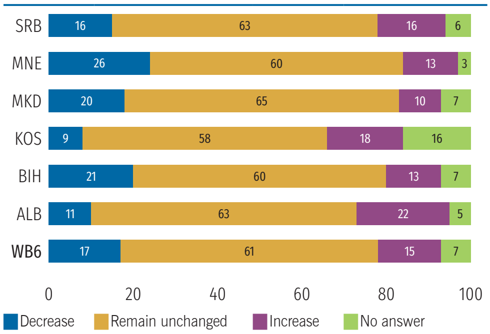
Perceptions of Western Balkan firms and citizens of economic and employment prospects remain grim, as the expectation index declines to the lowest level since first measured in 2014 (Figure 3.5). As governments across the region stepped in to cushion the impact of the pandemic on the labor market, more than half of the firms managed to maintain the number of employees in 2020. Going forward, 61 percent of businesses expect the number of employees to remain unchanged, with an additional 15 percent hoping to increase staffing in the following year (Figure 3.6). Albania has the largest share of firms expecting an increase in employment (22 percent), while only 10 percent of firms in North Macedonia expect their staffing to increase. Montenegrin firms are less optimistic than their regional peers: 26 percent expect their employment to decrease in 2021, while 62 percent of Western Balkan citizens feel confident, they will be able to keep their job in 2021.

Figure 3.5. Employment expectations have reached a record low in late 2020…



Source: Balkan Barometer 2021 Survey.

Figure 3.6. …yet, almost three-fourths of Western Balkan firms will either maintain their current employment levels or even increase it.



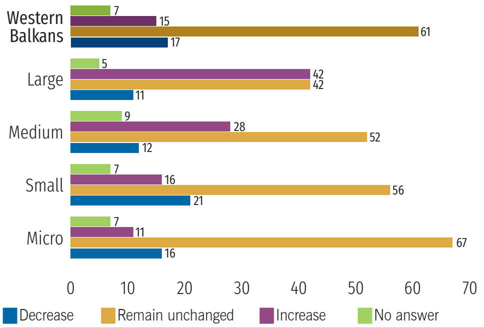
Source: Balkan Barometer 2021 Survey.

Firms' expectations for new hiring in the upcoming months vary by firm size. The large companies are most optimistic about new hiring: 42 percent expect that the number of employees will increase in the next 12 months, and almost the same percent plan to retain their current labor force. Small companies are relatively more pessimistic, with 21 percent believing that their employee count will decline. This is at the same time the largest pool of firms in the Western Balkans. Still, an overwhelming majority of micro and small companies (67 and 56 percent, respectively) are confident that the number of employees will remain unchanged in the next year (Figure 3.7).

8 Based on the 2021 Balkan Barometer surveys (https://www.rcc.int/balkanbarometer/home) that were conducted between December 2020 and February 2021 in the six Western Balkan countries. The Public Opinion survey posed 117 questions to 6000 citizens and the Business Opinion survey presented 110 questions to 1200 business owners, managers or executives.

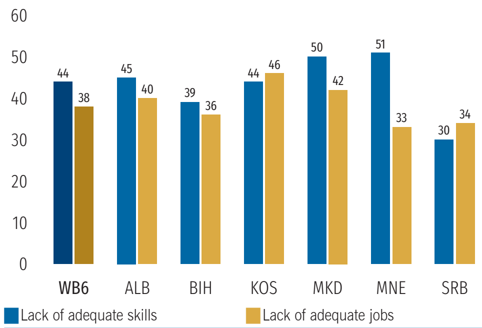
Box 3.1 continued

Figure 3.7. Small and micro firms are more concerned about employment decline.



Source: Balkan Barometer 2021 Survey.

Figure 3.8. Is it lack of adequate skills or lack of jobs that drives unemployment?



Source: Balkan Barometer 2021 Survey.

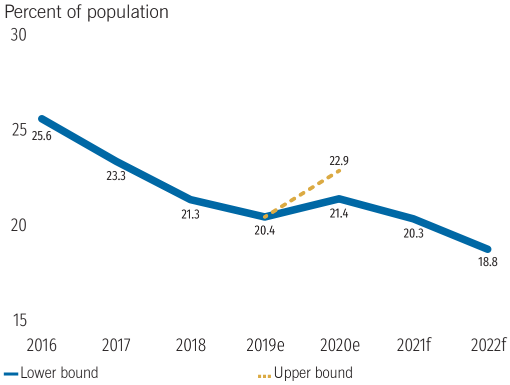
Almost half of Western Balkan citizens continue to see unemployment as one of the most important challenges for the country. This is an increase from 45 percent in 2019, but a decrease from the peak of 68 percent in 2016. More than one-third of citizens across the region think a lack of adequate jobs is one of the main obstacles to finding a job (Figure 3.8). This issue concerns almost half of the respondents in Kosovo (46 percent) and one-third of respondents in Montenegro and Serbia. On the other hand, 44 percent of businesses in the region see lack of adequate skills by applicants as one of the main reasons for unfilled vacancies. For that reason, half the firms in North Macedonia and Montenegro cannot find employees to fill their vacancies. Yet, over the past 12 months, 70 percent of firms have not conducted any employee training that is not legally mandated, and 47 percent of firms in the region do not have or do not plan to have an internship or apprenticeship program. This number, however, has significantly decreased from 63 percent a year ago.

The recovery of the labor market from the COVID-19 crisis, as well as reduced mobility, might have changed attitudes toward retraining and employment migration. Two-thirds of respondents are willing to get an additional qualification in order to get a job. Further, a growing number of respondents (about 38 percent) think that education and hard work are the main preconditions for finding a job, while a still-high 54 percent claim that knowing the right people is key to boosting your prospects in the Western Balkans. Importantly, there is a decline of 6 percentage points in the share of respondents who are seriously considering leaving their economy (now around one-third), while over half claim they have no intention of working abroad in the near future.

4. Poverty reduction is resuming slowly due to an uneven labor market performance

As the Western Balkan economies recover from the 2020 COVID-19 crisis, the region's poverty rate is expected to decline in 2021 to levels similar to 2019. The severe impact of the COVID-19 crisis on the region's economies destroyed many jobs and slashed the incomes of thousands of households. As a result, previous poverty reduction came to a halt, and poverty[9] is estimated to have increased by 1.0 to 2.5 percentage points in 2020 (Figure 4.1). As services and industry rebounded in 2021, growth has returned to the region, and in some countries significantly. In 2021, the poverty rate for the Western Balkans is projected to fall by around 1 percentage point to 20.3 percent, close to its 2019 level. A projected positive growth path beyond 2021 is expected to put poverty back on its historical downward trend.

Figure 4.1. The region's poverty rate is expected to decline in 2021 to about its 2019 level.



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 Bosnia and Herzegovina due to lack of comparable data. Upper bound denotes the more conservative estimates for Albania and North Macedonia.

The projected impacts of the economic rebound on poverty in 2021 vary across countries, reflecting variations in sectoral growth and labor market recovery. GDP growth fell from 3.2 (Bosnia and Herzegovina) to 5.3 percent (Kosovo) in 2020, with two outliers: in Montenegro, the decline in tourism services caused a contraction of 15.3 percent, whereas Serbia suffered a mild recession (-0.9 percent). Economies throughout the region are projected to rebound in 2021 by between 4 percent (Bosnia and Herzegovina) and 10.8 percent (Montenegro) with exports and services being the major driver of the rebound.

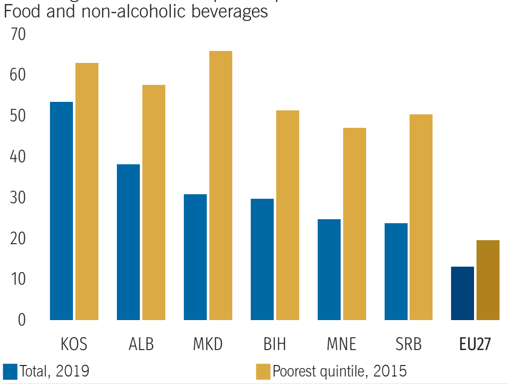
While it is expected that employment will benefit from this rebound, the speed of labor market recovery has so far been uneven. Employment in the first quarter of 2021 did not appear to recover in most of the countries, but many countries saw improvements in second quarter employment indicators. Montenegro still experienced rising unemployment in the first half of 2021. Given the uneven labor market developments at this point, the impact of economic growth on poverty is expected to be positive but weaker than what it could be if its impact on jobs were more significant. Continued uncertainty over the vaccine rollout and renewed restrictions have slowed

9 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 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.

labor market recovery, increasing the risks to sustainable poverty reduction over the medium term. In addition, the rising inflation can also dampen households' purchasing power and hurt the poor, particularly for food and fuel prices, since poor and vulnerable households often spend a larger share of household expenditures on these items (Figure 4.2). In addition to the clusters of poverty before the pandemic (e.g. geographic, ethnic, low education, etc), informal low-skill workers who lost jobs and might not have received much formal-sector government support may still be at risk of poverty. Vulnerable households and individuals who became poor during the pandemic may have difficulty exiting poverty in places where the jobs recovery is still sluggish.

Figure 4.2. Food price inflation could significantly affect the purchasing power of poor households.

Percentage of final consumption expenditure of households: Food and non-alcoholic beverages



Source: EUROSTAT and World Bank staff calculations using HBS.
Note: For Kosovo total and poorest quintile refer to 2015. The expenditure shares are not methodologically comparable to those estimated for the Consumer Price Indices.

Poverty in Albania, the highest in the region, is projected to fall in 2021 below its 2019 level (Table 4.1). Albania has the largest poverty headcount in the Western Balkans; about one-third of its population lives on less than US$5.5 per day (in 2011 PPP). Between 2016 and 2018, income-based poverty declined significantly, from 40 to 32.4 percent of the population. The November 2019 earthquake, followed by the COVID-19 pandemic, reversed this trend. After a modest decline in 2019, poverty is estimated to have increased in 2020, reaching a similar level as in 2018. In 2021, the economy rebounded significantly, but labor force participation and employment have been slower to recover. At the same time, incomes are rising in part due to an increase in the minimum wage, which has already pushed formal real wages up by 4.3 percent. Poverty is projected to fall in 2021 by 1 percentage point relative to the 2019 estimated value, and by 1.5 percentage points in 2022, leaving income-based poverty at below 30 percent.

Table 4.1. Poverty reduction is projected to resume at a different pace across countries, reflecting the uneven labor market recovery.

Year	Poverty projections (percent)				
	ALB	KOS	MKD	MNE	SRB
2016	40.0	23.6	21.6	16.0	22.2
2017	35.8	24.4	19.5	16.0	19.8
2018	32.4	23.2	17.9	15.2	17.9
2019	31.8	20.9	16.9	14.5	17.3
2020	32.6	23.4	18.0	20.0	17.4
2021	30.8	20.9	16.9	17.7	17.1
2022	29.3	18.9	15.8	16.3	15.4

Source: Calculations based on ECAPOV harmonization using SILC-C data for ALB, MKD, MNE, and SRB, and HBS data for KOS.
Note: Black=Actual. Orange=Nowcasted/projected. Income measures in the SILC and consumption measures in the HBS are not strictly comparable. Poverty is defined as living on less than $5.5/day per person in revised 2011 PPPs. Bosnia and Herzegovina is excluded due to lack of comparable data.

As the economy recovers in Bosnia and Herzegovina, improvements in labor market participation and employment will remain crucial if growth is to translate into poverty reduction. Economic growth has not translated into more and better jobs in the past. As such, the poverty rate does not seem to have improved. The latest available data using the national poverty line of KM 205 per capita per 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 substantial damage to the labor market, which did not appear to recover in the first quarter of 2021. The slowdown in the economy and the consequent loss of jobs and earnings have likely eroded household welfare. The policy measures the government introduced to protect firms and households prevented a worse impact on the labor market.

Due to a rebound of the economy in 2021, the poverty rate in Kosovo is projected to fall back to its 2019 level. 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 percent in 2019. In 2020, the crisis reversed this positive trend and GDP per capita is estimated to have shrunk by 6.2 percent. Poverty in 2020 is estimated to have increased by 2.5–5.2 percentage points mainly because of steep output losses in services (diaspora travel) and industry, despite the fiscal stimulus and a net increase in remittances. Together with a strong projected rebound in per capita GDP of 6.5 percent in 2021, poverty is projected to fall back to its 2019 level; however, this is only a partial result as no data are yet available regarding overall employment recovery. The government, along with several other countries in the Western Balkans, is undertaking a major reform of its social assistance system to expand the coverage in response to future shocks (Box 4.1).

Poverty is projected to decline slowly in Montenegro in 2021 as tourism rebounds but remains higher than its 2019 level. The COVID-19 pandemic caused a severe contraction of economic activity, reversing six years of gains in poverty reduction. COVID-19 containment measures and the collapse of tourism and related services depressed employment and earnings, especially for poorer and low-skilled 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 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. Montenegro's economy is recovering in 2021, thanks to revived tourism, but unemployment remained high in the first half of the year, limiting the pace of resumed poverty reduction.

In North Macedonia, poverty in 2021 is projected to decline back to pre-crisis levels. The country has reduced poverty considerably since the 2008 global financial crisis. The poverty rate was halved to 18 percent in 2018 compared to 2009, driven primarily by greater employment opportunities and increased labor earnings. The adverse effects of the COVID-19 crisis have reversed earlier poverty reduction gains: a simulation analysis predicts that poverty has likely increased between 1 to 4 percentage points in 2020. The government provided support measures, such as subsidies and social security contributions to private sector firms and cash benefits and vouchers for vulnerable people, which to some extent relieved the negative poverty impacts of the COVID-19 crisis. In the short term, a slow rollout of the COVID-19 vaccine, coupled with continuous containment measures and unresolved structural bottlenecks, represent challenges for a faster poverty reduction.

Poverty reduction is expected to resume with a lag in Serbia, depending on the pace of labor market improvements as fiscal stimulus programs expire. The COVID-19 pandemic pushed the Serbian economy into a mild recession in 2020, and interrupted poverty reduction. The government's massive fiscal package of about 13 percent of GDP, including broad-based wage subsidies for all sectors and a universal cash transfer, helped cushion the immediate impacts on the population and the economy. The labor market held up, 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. While economic growth is projected to pick up in 2021, the labor market recovery has been sluggish. Employment and unemployment rates deteriorated early in the year, when some of the fiscal stimulus programs expired, and only started recovering in the second quarter.

Box 4.1. The COVID-19 crisis has initiated a series of social assistance systems reforms.

The pandemic has stimulated a variety of reforms to the design and delivery of social protection. Similar to other developing economies, social protection systems in the Western Balkans did not respond adequately to the poverty impacts of the pandemic. As a result, governments in some countries are considering structural reforms to make their systems more adaptable, while others are advancing innovations in delivery systems. The features of these reforms vary, informed by the initial conditions of the country and the experience of the social assistance response to COVID-19.

North Macedonia has modified the eligibility criteria for its Guaranteed Minimum Income (GMI) program that allowed it to expand to people who lost their jobs and income because of the pandemic. The GMI law was amended to reflect this, and with the declaration of an emergency, the modified eligibility criteria can be rapidly rolled out. While these changes to the GMI program legal framework are an important step forward in terms of building the resilience of the social assistance system, the government is also considering operational changes that will help ensure this support reaches people in need quickly. This includes reviewing the legal requirement that people who apply to the GMI program must do so in person in a Center for Social Work and establishing new procedures that would allow applications to also be submitted online.

In Kosovo, the Government is embarking on a broader reform of its Social Assistance Scheme (SAS) to eliminate strict categorical selection requirements, thereby focusing the SAS on the poorest. As part of this reform, the Government aims to set out the legal basis to enable the SAS to expand coverage in response to shocks, thereby eliminating the need to establish new emergency programs as was done during the initial months of the COVID-19 pandemic. Complementing such legal changes with investments in the systems and procedures to support such a response, through online applications, enrollment, recertification, and greater use of e-payments, for example, would help ensure that these legal changes lead to effective and timely support to the poorest in Kosovo.

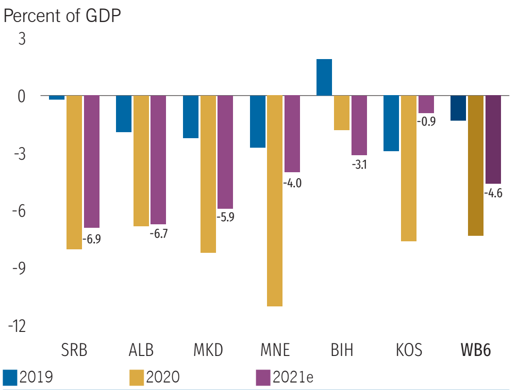
In other countries, such as Serbia, recent innovations will help improve the responsiveness of the social protection system to shocks. Serbia's Social Card Registry, once fully operational, will enable the better identification of vulnerable groups. It will thus provide timely and reliable data for rapid identification of groups and individuals in need, as well as effective management of the social protection system response to a crisis.

5. Fiscal policy needs to strike a balance between maintaining stability and boosting growth

A strong rebound in growth is narrowing fiscal deficits in most of the Western Balkans in 2021. The regional average[10] deficit is expected to drop by more than 2.7 percentage points of GDP compared to 2020 (Figure 5.1). The sharpest declines are expected in Montenegro and Kosovo, followed by North Macedonia. Albania is expected to see only a slight improvement in its fiscal balance. The exception is Bosnia and Herzegovina, which is expected to widen the fiscal deficit in 2021 compared to the previous year, despite some higher revenue collection. Yet, excluding Kosovo, all Western Balkan countries are expected to run significantly higher deficits in 2021 compared to pre-pandemic levels.

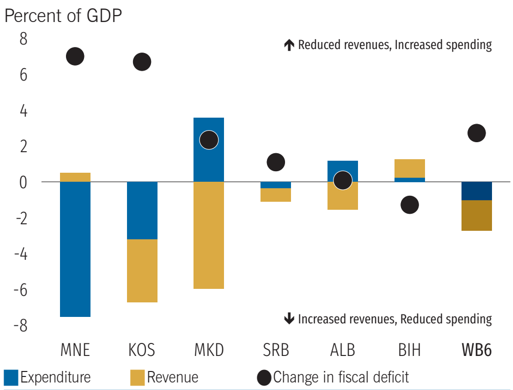
Buoyant revenue collection is reducing deficits. With growth gaining momentum, most Western Balkan countries are experiencing a strong rebound in revenue collection. In Albania, Kosovo, and Serbia, public revenues increased nominally by more than 20 percent[11] for the first seven months of 2021. By year-end, North Macedonia is expected to experience the most buoyant revenue collection performance in the region, with revenue increasing by 5.9 percentage points of GDP. The value-added tax (VAT) is the greatest contributor to revenue growth for most countries. Higher international commodity prices and consumer prices have also temporarily boosted VAT collection. Revenue buoyancy is the key driver of fiscal consolidation in North Macedonia and Albania, given the continued increase in expenditures. Montenegro is experiencing strong revenue growth, but at a slower pace than GDP growth, thus contribution to fiscal deficit reduction comes mainly from the expenditure side. (Figure 5.2). In Kosovo,

Figure 5.1. Fiscal deficits have narrowed in most Western Balkan countries…



Source: National statistical offices; Ministries of Finance; World Bank staff estimates.
Note: pp = percentage points.

Figure 5.2. …owing to robust revenue growth and lower expenditure



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

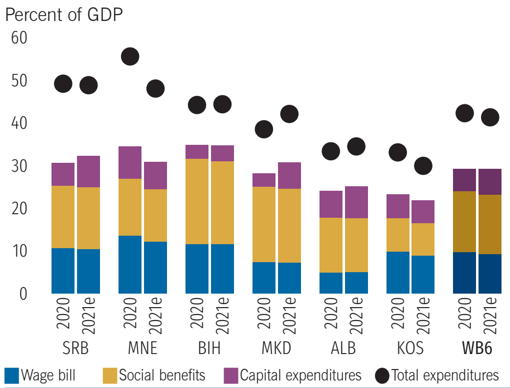
10 Unweighted average of fiscal deficit levels in Western Balkan countries.
11 From here on, comparisons are year-on-year unless otherwise indicated.

part of the expenditure consolidation is due to the sluggish public investment execution. In Bosnia and Herzegovina, revenue growth is expected to be modest compared to the region, and pent-up current spending commitments from 2020 together with an expected increase in capital spending should drive up expenditure in 2021 and lead to a higher fiscal deficit.

After a significant jump in 2020, public expenditure in the Western Balkans is leveling off in 2021, as rescue measures are scaled back and become more targeted. While public expenditure is expected to increase in all Western Balkan countries during 2021, a faster-than-expected recovery in economic activity is expected to outpace expenditure growth in Montenegro, Serbia, and Kosovo. In Bosnia and Herzegovina, Albania, and North Macedonia, the expenditure-to-GDP ratio is set to further increase; in North Macedonia due to the government Growth Acceleration Plan, which aims to boost public and private investments. The relaxation in pandemic-related restrictions on economic activity and mobility in 2021 have enabled the adoption of more targeted counter-pandemic policy support measures, such as the micro and small and medium-sized enterprise loan subsidy scheme in Montenegro, or even the withdrawal of some measures, such as Serbia. The high cost of fiscal policy measures in the previous year, and the uncertainty over the persistency of the pandemic, have also limited the scope for public expenditure growth in 2021 for more financially constrained Western Balkan countries. Against this backdrop, the average level of public expenditure for the region is expected to decline by 1.1 percentage points of GDP, with the steepest drop expected for Montenegro and Kosovo, and a slight drop expected for Serbia (Figure 5.3).

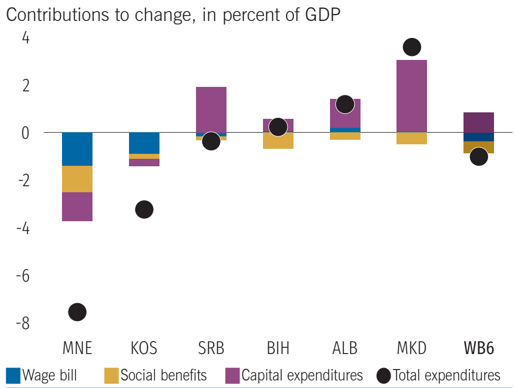
Spending on wage bill and social benefits, is decelerating in relative terms in most Western Balkan countries from the high levels in 2020. At the regional level, spending on social benefits is expected to decrease by an average of 0.6 percentage points of GDP. Kosovo and Montenegro are expected to see a decline in social spending and wage bill spending relative to GDP, but also in capital expenditure as Montenegro approaches the last phase of its highway construction

Figure 5.3. Expenditure is marginally contracting from its very high levels in 2020.



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

Figure 5.4. Capital expenditure has underperformed in Kosovo and Montenegro.



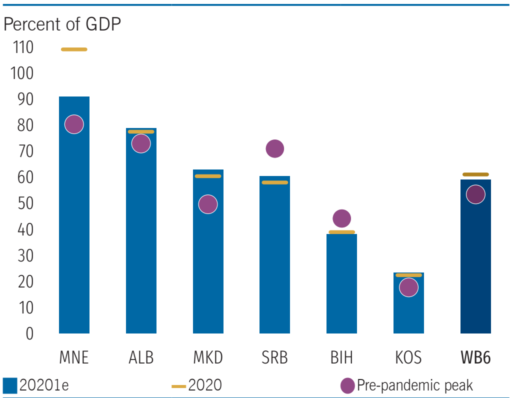
Source: National statistical offices; Ministries of Finance; World Bank estimates.

project, while Kosovo has yet to progress on externally financed capital projects. Serbia, North Macedonia, Albania, and to a lesser extent, Bosnia and Herzegovina, are expected to experience a significant increase in capital expenditure. North Macedonia experienced a 45 percent growth in public investment during the first half of 2021, and Albania and Bosnia and Herzegovina are expected to see an increase in wage bill spending by 0.2 and 0.1 percentage points of GDP, respectively (Figure 5.4).

After a historically high increase in 2020, public and publicly guaranteed (PPG) debt remains elevated. New borrowing to finance the widening fiscal deficits in 2020 has pushed PPG debt to historical highs in all countries, except for Serbia and Bosnia and Herzegovina (Figure 5.5). Owing more to the denominator effect as nominal GDP rebounds faster than expected in all economies, the average PPG debt to GDP of the Western Balkan countries is estimated to decline from 61 percent of GDP in 2020 to 59 percent in 2021. The two countries driving this decrease are Bosnia and Herzegovina and Montenegro, where PPG debt-to-GDP ratio will decline by 1 percentage point and 18 percentage points, respectively, while other countries will see an increase. However, in nominal terms, a decline in PPG debt is expected only in Montenegro, as the country repays debt worth 10 percent of GDP in 2021 from the 2020 Eurobond receipts. In Albania, PPG debt is expected to rise further, as the fiscal rule was temporarily suspended in July 2021, to allow for additional infrastructure projects to start in 2021. Fiscal rules, where exist, have, in effect, been suspended in all countries, but will need to be reinstated as the recovery takes hold.

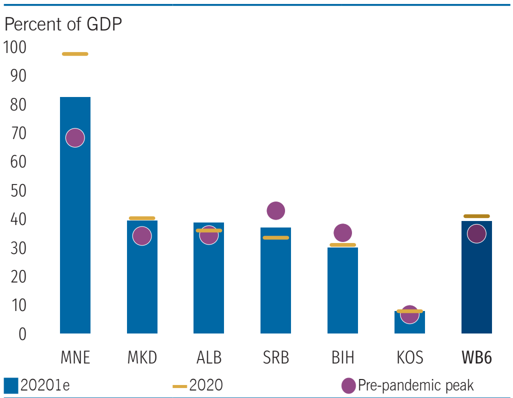
Eurobond issuances as well as borrowing from international financial institutions pushed external public debt up in all countries. During 2020–21, Western Balkan countries placed Eurobonds worth over EUR 7 billion, with proceeds used to finance swelling deficits and debt repayment. Consequently, the Western Balkan external PPG debt-to-GDP ratio reached its historic high of 41 percent in 2020 but is estimated to decline to 39 percent in 2021 (Figure 5.6). In the first half of 2021, Montenegro and North Macedonia repaid large Eurobonds, which has helped reduce external debt. In these two countries and in Bosnia and Herzegovina, external PPG to GDP is expected

Figure 5.5. Public and publicly guaranteed debt (PPG) remains elevated…



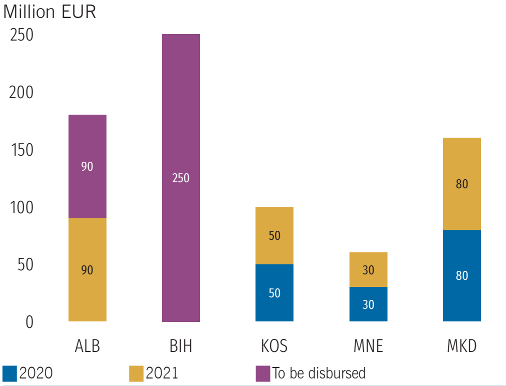
Source: National statistics offices; World Bank staff estimates.

Figure 5.6. …due to the rise in external debt.



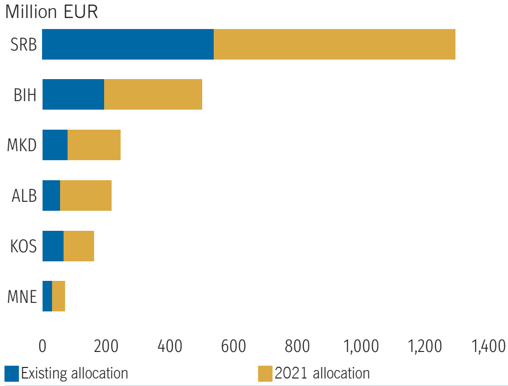
Source: National statistics offices; World Bank staff estimates.

Figure 5.7. The EU provided Macro-Financial Assistance to almost all countries...



Source: National statistics offices; World Bank staff estimates.

Figure 5.8. ...while the IMF increased SDR allocations worth EUR 1.5 billion for the Western Balkans.

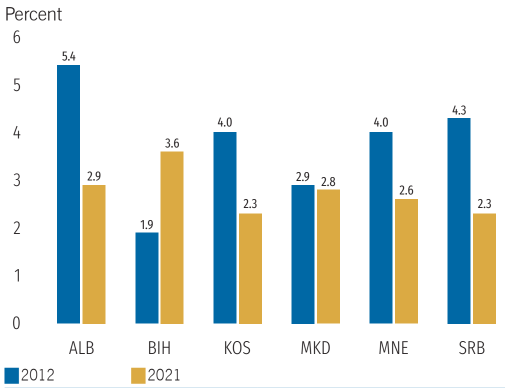


Source: National statistics offices; World Bank staff estimates.

to decline, while other countries will see an increase, most notably Serbia and Albania. All Western Balkan countries except Serbia requested Macro-Financial Assistance (MFA) from the European Union after having received IMF support through the Rapid Finance Instrument. Kosovo, North Macedonia, Bosnia and Herzegovina, and Albania also received significant support from World Bank fast-disbursing emergency COVID-19 operations in response to the pandemic (Figure 5.7). In August, the IMF approved the largest Special Drawing Rights (SDRs) allocation in history, with the Western Balkans being credited about EUR 1.5 billion (Figure 5.8). The increase provides additional liquidity, supplements countries' international reserves, and reduces not only balance-of-payment risks, but also fiscal financing risks for the euroized Western Balkan economies.

Financing conditions have been benign for years, but tightening is expected going forward. Since 2012, most Western Balkan countries have turned to international markets, which has helped extend maturities and reduce interest rates (Figure 5.9) driven by lower global financing costs on the back of highly accommodative monetary policies. However, given a quick buildup in inflationary pressures in the advanced economies during the summer, there are now indications of a possible tightening of monetary policies by the U.S. Federal Reserve and the European Central Bank. This would increase the cost of borrowing and impact capital inflows into emerging markets, which in turn would adversely affect the Western Balkan countries, especially those with high debt burdens and limited fiscal space.

Figure 5.9. Average nominal interest rate on public debt in 2012 and 2021.



Source: National authorities and World Bank staff calculations.
Note: Average nominal interest rate is derived as nominal interest expenditure divided by previous period debt stock.

Thus, the Western Balkan countries should strengthen their own fiscal management to mitigate the potential risks from the increased cost of financing.

Stronger revenue performance and availability of financing should be used to gradually consolidate fiscal balances. While government support was critical in preventing the adverse impact of the crisis, as the recovery takes hold, governments should start phasing out their support and creating buffers. Some countries have already discontinued wage subsidies (Montenegro), while others strengthened targeting to most affected sectors (North Macedonia), which has brought down the fiscal costs of support measures. Montenegro has additionally reduced spending on goods and services in an attempt to reduce fiscal imbalances. On the other hand, most countries have incorporated in their medium-term fiscal strategies measures to boost the recovery, such as Kosovo's Economic Revival Plan and North Macedonia's Growth Acceleration Plan, which may push fiscal expenditures up going forward. As part of the recovery plan, most Western Balkan countries plan to increase their capital spending in the medium term.

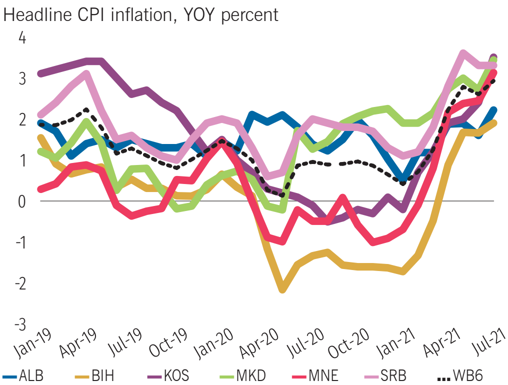
To create sufficient fiscal space to weather any future crises and support growth in a sustainable manner, governments of the Western Balkan countries should consider widening the tax base and improving tax compliance. Environmental taxes are low in the Western Balkans and could be an important revenue source going forward. Gradually shifting tax burden from income to fossil fuels can raise domestic revenue in a way that makes growth environmentally sustainable while reducing economic distortions, improving equity and easing tax administrations (as discussed in the Chapter 10. *Spotlight*). Further, all countries need to significantly strengthen public financial management and debt management. Managing fiscal risks, including those arising from state-owned enterprises, is important to ensure fiscal sustainability. Addressing public investment management challenges will be critical to ensure stronger growth effects of capital spending, bearing in mind the need for environmentally sustainable investment. Greening public investments could also be a catalyst for attracting private investment, while focusing on education and health sector efficiency would help ensure more inclusive and sustainable growth.

6. Stronger demand and higher global prices are creating inflationary pressures

Global inflation has accelerated in 2021 with pandemic induced pressures linked to supply constraints adding to the global demand acceleration. While most central banks remained patient through the recent increase in prices, in emerging market economies, interest rates are likely to increase, in order to preserve policy credibility and keep expectation anchored. Global food prices rose during 2020, as pandemic-related disruptions in distribution chains, supply bottlenecks, and increased transportation costs affected food prices. Even as temporary supply and demand dislocations eased, the acceleration in food prices persisted as a result of the recovery in demand picking in H1 2021. Across the world, as in the Western Balkans, the rise in food prices is occurring simultaneously with a pick-up in core inflation, thus increasing the likelihood of intensifying inflationary pressures in 2021 (Figure 6.1).

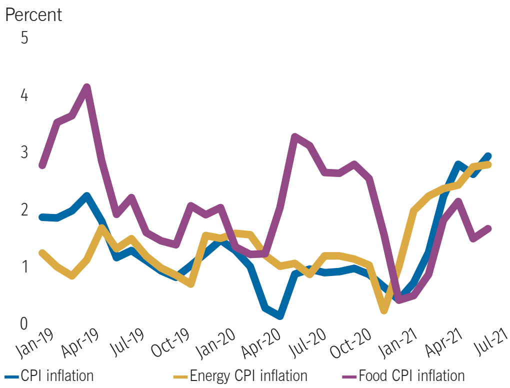
With the recovery in aggregate demand, inflationary pressures in the Western Balkans are building up. Supply-side shocks, increased inflation in trading partners, and demand expansion drove an increase of average inflation to 2.6 percent in June 2021, up by 1.7 percent from 0.9 percent in June 2020. Food prices accounted for most of this growth, as did commodity prices as transmitted from international markets, as reflected in higher fuel prices. Electricity and transport prices also increased. The increase in prices intensified in the summer months and was most notable in Kosovo (4.7 percent YOY in August 2021), Serbia (4.3 percent YOY), and North Macedonia (3.6 percent YOY). In Albania, exchange rate appreciation during the summer mitigated some of the impact of imported inflation, which reached 2.2 percent in July. In Bosnia and Herzegovina, inflation jumped to 2.3 percent YOY in August, with food prices picking up pace since January (Figure 6.2).

Figure 6.1. Inflation is picking up in the Western Balkans.



Source: Central Banks; World Bank staff calculations.
Note: WB6=Western Balkans 6.

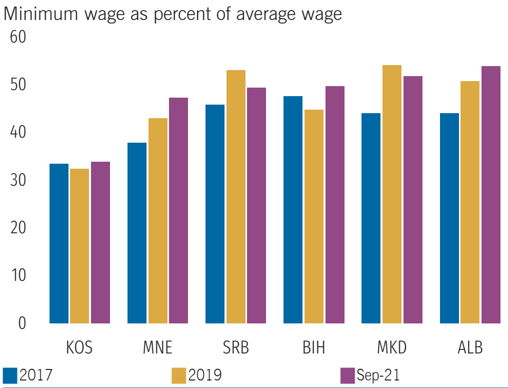
Figure 6.2. Food and energy prices drove most of the increase in inflation.



Source: Central Banks; World Bank staff calculations.
Note: CPI=Consumer Price Index.

Wage pressures also increased as the recovery took hold and inflation picked up (Figure 6.3). In North Macedonia wage pressures were notable, with wages increasing by 6.3 percent YOY in the first half of 2021, partly due to the minimum wage increase, and formalization of envelope wages also incentivized by the government support measures. In Montenegro, the pressure from producer prices was limited, but a recovery of tourism boosted consumption, which was then reflected in rising prices during the summer. Albania and Montenegro negotiated a rise in the minimum wage in September and October 2021, respectively, that will create potential cost pressures toward year-end.

Figure 6.3. Minimum wages have gone up in most COVID-19-affected countries.

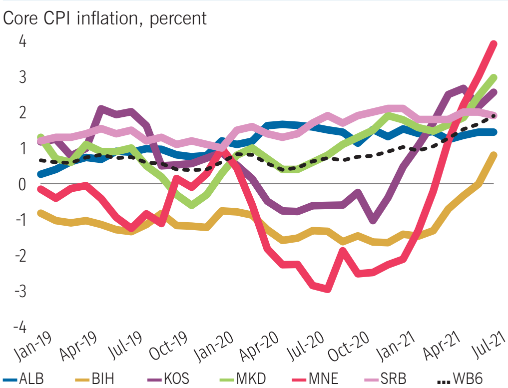


Source: Statistical offices, authorities, World Bank staff calculations.

Despite the recent increase in headline inflation, core inflation has not increased in all countries. Core inflation increased (Figure 6.4), reaching record-high in Montenegro of 3.9 percent in July and 3 percent in North Macedonia. In Albania and Serbia, core inflation was more stable, thus allowing monetary policy to continue to provide a stimulus to demand through keeping the policy rates low. In North Macedonia, the central bank left the policy rate low—at 1.25 percent, given a still fragile recovery path (Figure 6.5).

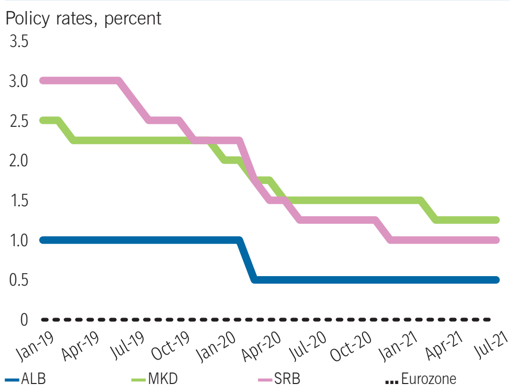
The policy stimulus also translated into increased money supply, and credit growth in the first half of the year. In Albania, low liquidity risk premia in the domestic financial market facilitated the transmission mechanism to lower lending rates, leading to an expansion of credit to the private sector by 7.7 percent YOY by June 2021. In Serbia, the money supply increased by 13.5 percent YOY in July 2021.

Figure 6.4. The impact of demand pressures on core inflation shows a mixed picture.



Source: Central Banks; World Bank staff calculations.

Figure 6.5. In countries with a flexible exchange rate, anchored expectations have enabled monetary stimulus to continue.



Source: Central Banks; World Bank staff calculations.

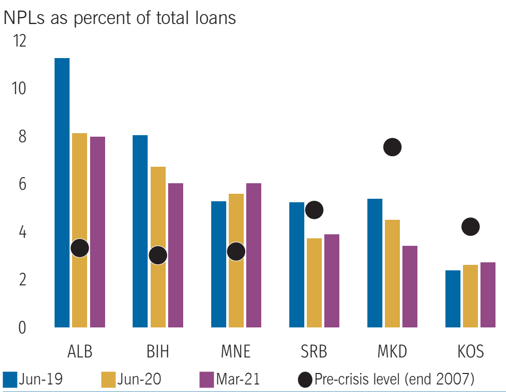
After a long period of low and stable inflation, the balance of risks for inflation has tilted upward. Imported inflation through commodity, oil, and food prices is likely to continue putting pressure on producer prices and in turn wages, while domestic policies on wage increase can intensify along. Food price increases are likely to erode the purchasing power of poorer households, given the large share of food in their consumption basket, and be a drag on overall consumption. Central banks need to be ready to tighten policy rates in case inflationary risks materialize.

7. Preserving financial stability is key in the post-COVID-19 recovery

The financial system remained resilient so far backed by continued COVID-19 support measures, and by the growth recovery across the Western Balkans. Public measures implemented in most jurisdictions mitigated, at least temporarily, the negative effects of the pandemic on bank asset quality. Most of these temporary measures, including the borrower relief and prudential measures, are gradually expiring in 2021, while the few remaining ones are expected to be phased out by yearend. Although the worst-case scenario—a major deterioration of asset quality—has been avoided so far, the ultimate impact of the crisis on bank asset quality remains uncertain. According to the results of the Central, Eastern and South-Eastern Europe (CESEE) Bank Lending Survey,[12] banks in the region expect an increase in nonperforming loan (NPL) ratios in the remaining part of the year (Figure 7.1). Going forward, financial sector regulators need to continue to closely monitor bank lending portfolios and potential vulnerabilities that may arise after borrower relief measures expire. Maintaining the health and financial stability of the banking system becomes ever more important during the recovery phase, as the provision of credit by the banking system will play a central role in helping the economies boost growth over the medium term (Figure 7.2).

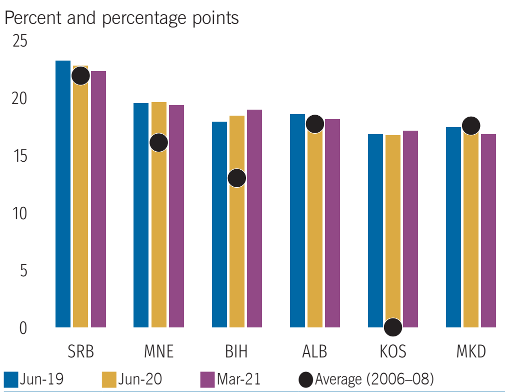
As of June 2021, the credit growth has been positive in all Western Balkan countries (Figure 7.3), with household loans growing faster than corporate loans. However, the first six months of 2021 registered a slower average loan growth compared to the second half of 2020, with loan growth decelerating in Serbia, Montenegro, and North Macedonia while accelerating in Kosovo, Bosnia and Herzegovina, and Albania. Kosovo saw the

Figure 7.1. NPL ratios increased slightly in Q1 2021 and are expected to increase further as borrower relief measures expire.



Source: IMF Financial Soundness Indicators; central banks.

Figure 7.2. Banks preserved capital buffers



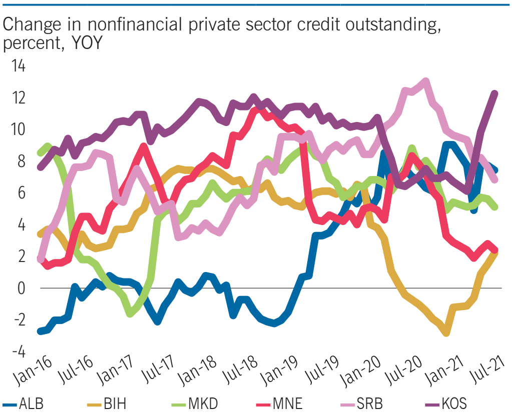
Source: IMF Financial Soundness Indicators; central banks.

12 The CESEE Bank Lending Survey – Spring 2021. Banks in the region expect NPLs to rise in four of the five countries covered in the Western Balkans.

strongest private sector credit growth, at 12.2 percent year-on-year (YOY) in July 2021, backed by a positive economic outlook leading to more favorable loan demand and supply conditions. Loan growth in Albania was at around 7.4 percent YOY, while Bosnia and Herzegovina maintained low (1 to 2 percent) but steady growth in the second quarter of 2021 after exiting from negative growth territory. In both countries, this credit growth was supported by a fast recovery in loan demand and eased bank funding conditions. A deceleration of loan growth in Serbia, North Macedonia, and Montenegro was driven by milder market outlooks, expiration or tightening of support programs, and tighter loan supply conditions. As of June 2021, annual household loan growth in all countries except Montenegro was higher than corporate loan growth. Specifically, household loans grew on average by 8.2 percent, more than double that of corporate loan growth at 3.9 percent, a trend that has continued since July 2020, indicating a return to pre-COVID-19 trends. As of June 2021, Western Balkans lending to households increased by 2.3 percentage points, and lending to corporates declined slightly by 0.2 percentage points compared to end-2020 (Figure 7.4). The largest decline in corporate lending was in Serbia due to tightened supply conditions, especially for small and medium-sized enterprises (SMEs) and corporate segments.

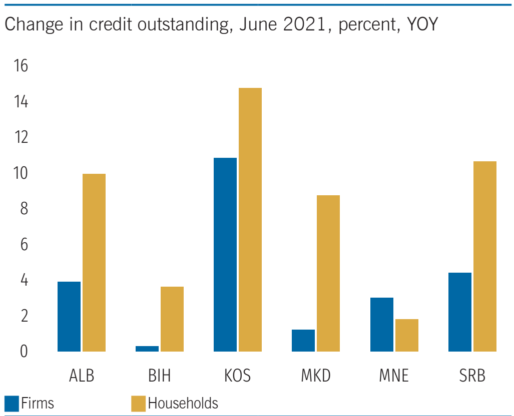
The NPL ratios deteriorated slightly in early 2021, albeit less than anticipated. A negative trend is expected to continue throughout 2021. As of March 2021, the regional NPL average was 5 percent of total loans, 0.1 percentage points higher than in the previous quarter. However, the March 2021 NPL ratio was still 0.2 percentage points lower than a year ago when the pandemic hit the region. Kosovo's NPLs remain the lowest in the region, while NPLs in Albania, Bosnia and Herzegovina, and Montenegro remain high, at around 6 to 8 percent. Most of the borrower relief measures including moratoriums, relaxation of loan classification standards for NPLs, and favorable loan restructuring schemes have expired in the first quarter of 2021 after several rounds of extensions. Remaining borrower relief

Figure 7.3. Credit growth has been positive in all countries but with a slower pace in H1 2021.



Source: IMF International Financial Statistics; central banks.

Figure 7.4. Lending to households surged in 2021.



Source: central banks.

measures—a loan moratorium in Montenegro and a restructuring scheme in Albania—are expected to expire by yearend. Therefore, the 2021 first quarter NPLs may not fully capture the complete picture on asset quality. The CESEE Bank Lending Survey indicates a deterioration of asset quality in the second half of 2021, both in corporate and retail segments of most of the financial markets in the region.

Capital buffers and bank liquidity in the Western Balkan countries stayed broadly stable. As of March 2021, bank capital adequacy averaged 18.8 percent, far above the regulatory minimum, and slightly higher compared to December 2020, at 18.6 percent. The ratio of liquid to total assets averaged 28.9 percent, slightly lower than in December 2020 (29.2 percent), and loan-to-deposit ratios were well below 100 across the board.

Bank profitability started to recover in the first quarter of 2021. Bank profitability is showing signs of recovery after remaining depressed for four quarters following the outbreak of the pandemic. Profitability as measured by return on assets has increased to 1.4 percent in March 2021 from 1.1 percent in March 2020, mainly due to expiring borrower relief measures, removal of additional provisioning, and declining impairment costs. However, if asset quality deteriorates toward the end of 2021, this would put additional pressures on profitability, with increasing impairment costs.

As the recovery takes hold, maintaining financial stability will be of the utmost importance to preserve the ability of the financial sector to play its key role in providing funding to support economic recovery. Going forward, continued vigilance, with particular attention to restructured loans, will be key to the early detection of any buildup of vulnerabilities. Authorities should continue strengthening the NPL resolution capacity by focusing on (i) robust banking regulation and supervision to ensure the proper identification and classification of NPLs and provisioning for credit losses; (ii) strengthening of banks' operational readiness to work out rising volumes of problem assets; and (iii) a legal environment (that is, insolvency and creditors' rights) that enables banks to work out bad loans and thus avoids steering distressed but viable borrowers toward liquidation. In addition, authorities should also refocus on a medium- to long-term reform agenda to align financial systems in the region with international standards (that is, Basel Core Principles, European Union Banking Directives) that might have been interrupted due to other priorities related to the COVID-19 response.

While many countries introduced financial support instruments to alleviate the liquidity shock faced by firms during the COVID-19 crisis, including Public Credit Guarantee Schemes (PCGSs) with exceptional design features, there is now a need to adapt the instruments to a recovery phase. Countries in the Western Balkan region either scaled up already existing schemes (Kosovo), introduced new PCGSs (North Macedonia, Serbia, Bosnia and Herzegovina), or are still considering introducing one (Montenegro). The economic distress caused by the pandemic and the need to act swiftly to preserve economic stability have implied in many cases a departure from the principles, especially on the legal and institutional framework, risk sharing, and pricing PCGSs. The primary objective of these interventions has been to protect firms and jobs. As economies are now entering a recovery phase, PCGSs can still play an important role in enabling the flow of credit to the productive sector and supporting resource reallocation. However, compared to the exceptional operational design features implemented during the outbreak phase, PCGSs should go back to "normal" to minimize moral hazard. This implies restoring international best practices,[13] including (i) revising eligibility criteria for target groups, (ii) lowering coverage rates to more traditional levels, and (iii) adopting risk-based pricing (Box 7.1).

Box 7.1. Well-designed Public Credit Guarantee Schemes are a useful instrument to support the economic recovery.

Public Credit Guarantee Schemes (PCGSs) have become a prominent policy response around the world to support the financing needs of firms in the context of the COVID-19 crisis. PCGSs are particularly relevant and effective when there is enough liquidity in the financial system, yet this liquidity does not flow to some sectors or segments because of higher credit risk. PCGSs can help mitigate the credit risk and therefore facilitate the flow of bank finance. The nature of the COVID-19 crisis is aligned with this situation, characterized by substantial liquidity due to support measures, and large uncertainty on the length and depth of the crisis, leading to a very high credit risk that is constraining credit activity. PCGSs are also preferred to other interventions because they are (i) among the most market-friendly interventions with minimal distortions; (ii) crowding in private capital as banks typically share some of the risk; and (iii) requiring much lower initial cash flow needs and, as such, represent a cost-effective government intervention to incentivize lenders to provide financing to firms.

However, PCGSs may add limited value and prove costly when their design and implementation are flawed. As economies are entering into a recovery phase, restoring international best practices of PCGSs by revising exceptional operational design features implemented during the outbreak phase is critical to ensure PCGS's role in enabling the flow of credit to the productive sector and supporting resource reallocation. The Principles for the Design, Implementation and Evaluation of Public Credit Guarantee Schemes for SMEs, a set of international best practices developed by the World Bank in 2015, identified important aspects for the success of public PCGSs. Among the most important ones are:

- ***Legal and Regulatory Framework:*** **A PCGS should be established as an independent legal entity, with a clearly defined legal and regulatory framework** that should encourage the private sector's participation in the scheme, clarify the ownership policy of the government, and separate government control from day-to-day operations, ensuring the PCGS's independence and accountability. The legal framework should specify the sources of funding of the PCGS. The PCGS should also be supervised by a financial sector supervisory authority, according to the risk posed by its products.

- ***Corporate Governance and Risk Management:*** **The PCGS should have a clearly defined mandate, strong internal controls, and a solid risk management framework.** The mandate should be set in legislation and include the target market and any other services in addition

13 World Bank (2015). Principles for public credit guarantee schemes for SMEs. Washington, D.C.: World Bank Group. http://documents.worldbank.org/curated/en/576961468197998372/Principles-for-public-credit-guarantee-schemes-for-SMEs.

Box 7.1 continued

to the guarantees (such as technical assistance). Based on the mandate, the PCGS should develop strategies for different segments. The PCGS should have a sound corporate governance structure, set in legislation, with an independent board of directors appointed in accordance with defined criteria. Effective PCGSs have in place strong internal controls, and internal audit and compliance functions. An adequate risk management framework is also essential, with accurate information and timely reporting systems to enable adequate monitoring and management of risks, including credit, liquidity, market, and operational risks. A comprehensive management information system for loan tracking and a guarantee issuance system facilitates risk identification, monitoring, and remedial action in a timely manner.

- ***Operational Framework:*** **Eligibility criteria should be designed to target financially constrained SMEs, while providing for some flexibility.** The coverage ratio refers to the percentage of the loan exposure by the PCGS and should be on a risk sharing basis to provide sufficient protection against the risk of default and moral hazard, while preserving incentives for effective loan origination and monitoring. A risk-based pricing policy should be adopted, with fees high enough to discourage banks from using guarantees for good borrowers, but not excessive to avoid adverse selection. The claim payout should be quick and predictable in order to build the credibility of the guarantee scheme, while encouraging loan collection. Guarantee schemes should be allowed to require collateral up to reasonable limits.

- ***Monitoring and Evaluation:*** **PCGSs should also have rigorous financial reporting requirements, have the financial statements externally audited, and undertake reviews to assess additionality, outreach, and financial sustainability.** Periodic reviews are important to provide the checks and balances to evaluate operations and refine procedures with regard to operational efficiency, claim payout, design features, performance, client satisfaction, additionality, sustainability, outreach, new products, and others.

8. External imbalances are set to moderate in most Western Balkan economies

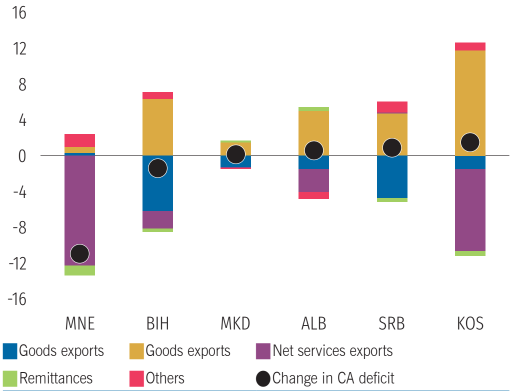
In 2020, the Western Balkans saw a bifurcation in external imbalances, with the current account deficits of Albania, Kosovo, and Montenegro widening, and those in other countries improving or maintaining broadly unchanged. Travel restrictions and labor market shocks in source countries led to a sharp drop in tourism receipts and remittances in many countries in the Western Balkans. This caused a widening of the current account deficit in some countries, despite the sizable contraction in oil prices, and merchandise import volume compressions exceeding declines in export volumes. In Montenegro, which was hit hardest by the COVID-19 shock, the current account deficit ballooned 12 percentage points to 26 percent of GDP, whereas in Albania, the external shortfall widened to close to 9 percent of GDP. In Kosovo, despite the rise in merchandise exports to 6.9 percent of GDP in 2020 compared to 5.6 percent the previous year, the current account deficit widened by 1.4 percentage points to 7 percent of GDP. Meanwhile, Bosnia and Herzegovina and North Macedonia recorded a broadly unchanged current account deficit of 3.3 and 3.5 percent of GDP, respectively. With a current account deficit that shrank in 2020 by 2.7 percentage points to 4.2 percent of GDP, Serbia stood out in the region. The contraction in the external shortfall is, on the one hand, a consequence of the improvement in the merchandise deficit as imports were compressed more than exports, and on the other hand, a significant improvement in the primary income surplus due to a fall in direct investment income outflows.

The rapid growth recovery in the United States and China strengthened Europe's external demand, with positive spillover effects on Western Balkan countries. The rebound in economic growth resulted in higher commodity prices, with the price of Brent Crude oil rising from US$18 per barrel recorded in April 2020 to US$71.60 per barrel in early September 2021. The latter has increased pressures on the structural merchandise deficits in the Western Balkans, which ranged from close to 12 percent of GDP in Serbia to 46 percent of GDP in Montenegro in 2020.

Higher tourism receipts and remittances compared to the halt seen in 2020 will offset the higher oil import bill in 2021 and help either narrow current account deficits or leave them broadly unchanged across most of the Western Balkans (Figure 8.1.). In the first half of 2021, exports of goods and services rebounded, but so did merchandise imports. Nevertheless, the strong recovery in remittances resulted in a broad-based improvement in external shortfalls. Specifically, in Bosnia and Herzegovina, Montenegro, and North Macedonia, external shortfalls are expected to continue shrinking or remain at the same level as a year ago, in GDP terms. In Bosnia and Herzegovina, the improvement in the external imbalance is driven by a surge in manufacturing and consumer durable goods exports rather than remittances, which reflects strong external demand in predominantly Central European Free Trade Agreement (CEFTA) countries. Meanwhile, Serbia and Albania are expected to widen their current account deficit, with the increase in import exceeding the rise in export

Figure 8.1. Current account deficits will narrow or remain unchanged across most of the Western Balkans.

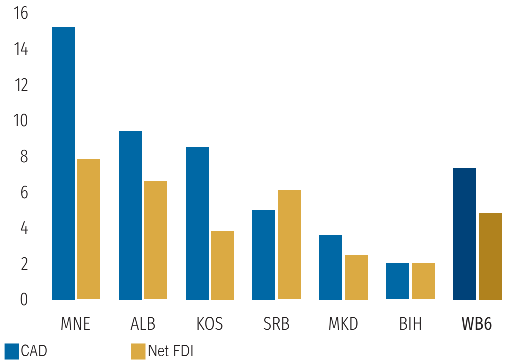
Contributions, 2021 projections, percent of GDP



Source: Central banks; World Bank staff estimates.

Figure 8.2. Net FDI remained an important financing source of the current account deficit.

2021 projections, percent of GDP



Source: Central banks; World Bank staff estimates.

volumes. Remittances will remain an important source of secondary income surpluses, which in part offset the merchandise trade deficits and are likely to benefit further from the rebound in the European Union (EU) in the second half of 2021. The net inflow of remittances is especially significant for Albania, Bosnia and Herzegovina, and Kosovo, where the primary source countries are Austria, Germany, Greece, Italy, and Switzerland.

While foreign direct investment (FDI) flows declined globally, equity inflows in the Western Balkans remained robust in 2020 and in the first half of 2021, reducing external borrowing requirements (Figure 8.2). That said, direct equity investment and reinvested earnings fell 50 percent in Serbia and close to 80 percent in North Macedonia but were largely offset by soaring intercompany loans. Similarly, in Montenegro, FDI remained robust and was complemented by an acceleration in intercompany loans that almost tripled compared to 2019, as parent companies kept subsidiaries afloat through liquidity injections. The external borrowing requirement totaled 21.5 percent of GDP in Montenegro in 2020. In Serbia, the sharp increase in intercompany loans and portfolio investment had to offset weakened equity inflows, but also a substantial outflow of other investment resulting from an increase in bank deposits abroad and net government debt repayments. In the first half of 2021, an uptick in direct investment equity inflows took place across all Western Balkan countries compared to the same period last year, while intercompany loans slowed.

External debt increased by over 14 percentage points in the Western Balkans in 2020, raising sustainability concerns (Box 8.1). The largest increase is seen in Montenegro, estimated at above 220 percent of GDP in 2020, as it issued a Eurobond in late 2020 to refinance debt in early 2021. The rise in debt is largely attributable to the government external debt increase (by 8.5 percentage points to 40.9 percent of GDP in 2020), but private sector did not deleverage either. Meanwhile, North Macedonia and Serbia issued new Eurobonds in 2021 at historically low rates, reflecting an international landscape of low interest rates but also investor confidence. Serbia issued the inaugural green bonds in September 2021 as well. The increased external borrowing led to rise in foreign exchange reserves across all Western Balkan economies in 2020 and 2021.

Box 8.1. Macro-financial indicators point to external vulnerabilities in the Western Balkans.

Most Western Balkan countries seem to have weathered the impact of the COVID-19 crisis well when it comes to current account deficits. On average, the current account deficits did not deteriorate significantly in 2020 and 2021 compared to the pre-crisis years as import compression outpaced declines in exports. Foreign exchange reserves have risen across the board due to capital inflows exceeding external borrowing requirements. However, although net equity inflows remained robust, external borrowing accelerated, especially by the public sector, as fiscal revenues collapsed (Figure 8.3). Private external borrowing, in the meantime, rose marginally in some countries, supported by intercompany loans. As a result, from 2019 to 2021, total external debt is set to rise by about 17 percentage points of GDP, to an average for the Western Balkans of 94 percent of GDP. Thus, even though external buffers in the form of foreign exchange reserves rose since 2019, foreign liabilities increased at a higher pace.

Figure 8.3. Total external debt and foreign exchange reserves rose sharply.

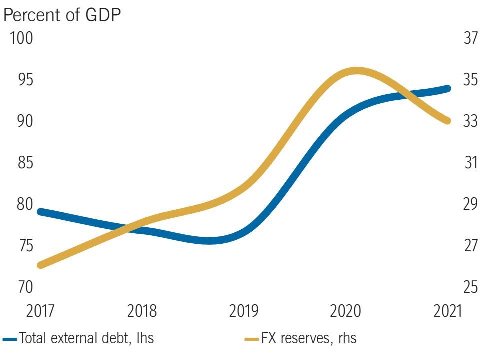
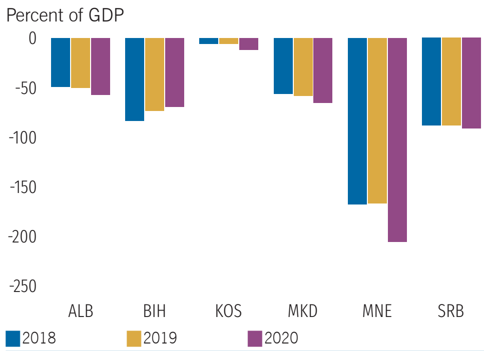


Figure 8.4. Net international investment positions worsened.



Source: Central banks; World Bank staff calculations.

Total external debt, and more broadly net foreign liabilities to GDP, is a significant crisis predictor for emerging markets and high-income countries. Catão and Milesi-Ferretti (2014)[14] estimate the probability of an external crisis using the Net International Investment Position (NIIP), which reflects the aggregate net financial assets of all agents in an economy and uses equity as well as debt as significant explanatory variables for crisis prediction. The NIIP threshold of -50 percent of GDP is derived from a large sample of countries and provides a common point of reference, which disregards country-specific characteristics. Turrini and Zeugner (2019)[15] estimate such country-specific prudential benchmarks that aim at gauging the NIIP level beyond which there is higher risk

14 Catão, L.A.V., and G.M. Milesi-Ferretti (2014), "External liabilities and crises", *Journal of International Economics*, 94, 18-32.
15 Turrini, A., and S. Zeugner (2019), "Benchmarks for Net International Investment Positions", European Commission Discussion Paper No. 97, May.

Box 8.1 continued

of a balance-of-payments crisis. Such interaction of NIIP values with structural variables affecting the riskiness of a given NIIP stock allows for deriving country-specific thresholds.

All Western Balkan countries except Kosovo deviate significantly from prudential NIIP levels (Figure 8.4). Turrini and Zeugner (2019) estimate prudential benchmarks for countries used here as proxies for assessing the external risks stemming from the stock of assets and liabilities in each country. As expected, Montenegro is an outlier with an NIIP level roughly nine times the prudential benchmark,[16] whereas Serbia, North Macedonia, and Bosnia and Herzegovina exhibit NIIPs about two to three times the prudential level. With such elevated levels likely to persist over the medium term, external vulnerabilities appear more pronounced in the Western Balkans from the perspective of NIIPs than when assessed based on current account deficit outcomes alone.

16 While external public debt is projected to decline to 82 percent of GDP in 2021 from 97 percent the year before, total external debt is expected to decline to 196 percent of GDP in 2021 from 224 percent in 2020. Turrini and Zeugner (2019) list benchmarks, among others, for North Macedonia (22.8 percent of GDP) and Croatia (37.4 percent of GDP). We use the simple average of the two countries (i.e. 30 percent of GDP) as a proxy for the threshold of other Western Balkan countries.

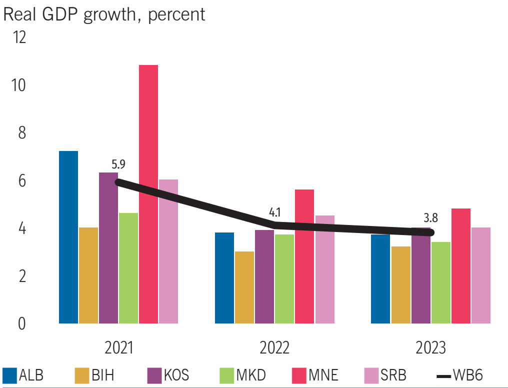
Over the medium term, external imbalances are set to moderate across most Western Balkan economies, but external debt will remain elevated. Assuming that new COVID-19 variants do not cause widespread containment measures in the EU, the recovery of exports in goods and services seen in the first half of 2021 is expected to continue over the medium term. Bringing COVID-19 infections under control through accelerated vaccinations and managing cluster outbreaks is paramount to reducing external imbalances in Western Balkans economies that are tourism dependent. Many Western Balkan countries are struggling to secure sufficient vaccine supplies and fight vaccination hesitancy and are thus unlikely to achieve widespread inoculation before 2022. The major tourism season has been successful in Albania, Montenegro, and to some extent in Bosnia and Herzegovina, which helped keep external financing needs manageable. Tourism and travel inflows are, nevertheless, likely to reach pre-crisis levels only in 2022, as inoculations become more widespread and labor markets in Europe fully recover from the COVID-19 shock.

The rebound in exports will in part be offset by an acceleration in merchandise imports driven by a recovery in private consumption and public investment in the Western Balkans. Remittances, meanwhile, are likely to recover sooner than tourism incomes, helping to some extent soften the re-emergence of widening structural merchandise deficits. Overall, a broad moderation in current account deficits is expected over the medium term largely financed by direct investment in equity and reinvested earnings. Intercompany loans could decelerate, while external financing of gradually adjusting fiscal deficits is likely to ensure a further buildup in foreign exchange reserves.

9. Setting the course for a stronger and greener economic recovery

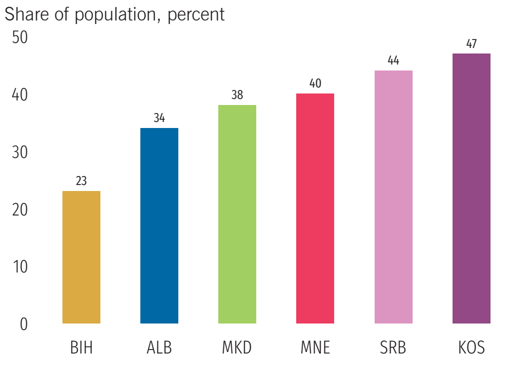
The outlook for Western Balkan countries has overall improved due to an overall stronger-than-expected economic performance in 2021, but early indicators point to moderating momentum in the second half of 2021. The pre-crisis growth path is expected to resume, with growth in the Western Balkans expected to be 4.1 percent in 2022 and 3.8 percent in 2023. Three main factors are behind the stronger-than-expected recovery: (i) the recovery of key sectors, like tourism and trade, as countries adjusted to the "new normal" and have reduced stringency measures; (ii) strong domestic demand, fueled primarily by government support, remittances, household credit, and, investments especially in Serbia and North Macedonia; (iii) the stronger-than-expected recovery in the EU and key trading partners, which gave a boost to manufacturing industries linked to the value chain. In 2022 and 2023, growth in the region is expected to stabilize closer to the pre-crisis potential output (Figure 9.1). Yet, economies in the Western Balkans have been among those most impacted by the spread of the Delta variant in the third quarter of 2021, with the number of new COVID-19 cases approaching or surpassing previous peaks. Vaccination rates lag the world average of 47 percent (Box 9.1), with the exception of Kosovo (Figure 9.2), and clearly lag the EU average of 68 percent. In addition, global disruptions in trade due to delays in shipments, low capacity of ports, and disruptions in value chains, will likely contribute to a deceleration in trade. While the growth in the first half of the year have been driven by external forces, going forward, domestic factors, in particular consumption and investment, are expected to sustain the recovery.

Figure 9.1. Growth is settling at pre-crisis levels from 2022.



Source: World Bank staff calculations.

Figure 9.2. Vaccination rates are lower than in the EU.



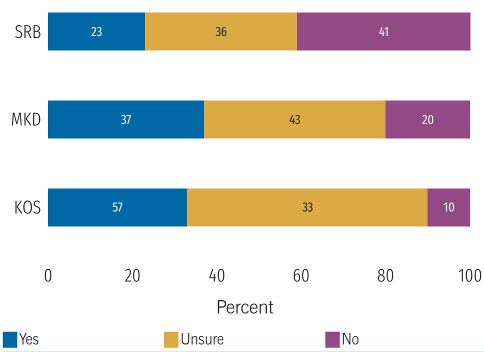
Source: Our World in Data, accessed on October 15, 2021.
Note: Total number of people who received at least one vaccine dose divided by the total population of the country.

Box 9.1. Understanding COVID-19 vaccine hesitancy in the Western Balkans.

As the COVID-19 vaccine rollout gains momentum globally, many countries struggle to effectively communicate the importance of vaccines in preventing the spread of the virus, saving lives, and reviving economic activity. Social, economic, and behavioral barriers to vaccine take-up can slow the progress toward herd immunity. A detailed understanding of perceptions of the COVID-19 vaccines can help governments take effective steps to increase vaccine take-up. To that end, the World Bank has collected data on vaccine perceptions among Facebook users in 15 countries.[17] In each country, 5,000 to 10,000 Facebook users whose age, gender, region, and education levels aim to align with the national population, are surveyed about their attitudes toward vaccines and sources of information. Teachers and health workers are identified in the survey due to their importance as trusted messengers on COVID-19-related information. Results from these surveys have shed light on the drivers of vaccine hesitancy, such as safety concerns, low trust in institutions, and lack of understanding of the need for vaccines. The survey tests the impact of different messages on people's intention to get vaccinated by randomly varying the framing of questions. Experimental test from several countries[18] highlights the power of framing: messages that incorporate relevant information to specific subgroups by differentiated messengers can increase the intention to get the COVID-19 vaccine by about 20 to 40 percent.

While vaccination has recently accelerated in the Western Balkans, fully vaccinated rates range from only 23 percent in Bosnia and Herzegovina to 47 percent in Kosovo.[19] To support the vaccination progress in the region, the World Bank conducted a survey during July–August 2021 in Kosovo (6,078 responses), North Macedonia (4,554 responses across four regions, Polog, Skopje, Vardar, and Pelagonia) and Serbia (13,992 responses). Preliminary results show that, among the unvaccinated, an important proportion of respondents are unsure about getting the COVID-19 vaccine, underscoring a need for behaviorally informed messaging to encourage uptake among this group (Figure 9.3). People are more likely to be hesitant if they do not believe it is important to vaccinate to protect others, do not believe friends and family will get vaccinated, and do not think the government response has been effective. People who are hesitant because of low trust in institutions are more likely to be male, while those hesitant because of concerns about the safety or efficacy of the COVID vaccine are more likely to be female.

Figure 9.3. Percentage of the unvaccinated population that will take the COVID-19 vaccine when available.



Source: World Bank survey.
Note: Because the survey only reaches Facebook users, certain demographic groups (men, young adults, and more educated individual) are overrepresented. Due to advertising targeting, only four regions (Polog, Skopje, Vardar, and Pelagonia) were included in the North Macedonia sample. Thus, the surveys are not nationally representative.

17 As of September 2021. World Bank, Behavioral Science Support to COVID19 Vaccine Distribution.
18 Earlier experiments were carried out in Lebanon, Iraq, West Bank, Gaza, Tunisia, Libya, and Honduras.
19 Data as of October 15, 2021. Mathieu, E., Ritchie, H., Ortiz-Ospina, E. et al. A global database of COVID-19 vaccinations. Nat Hum Behav (2021). https://ourworldindata.org/explorers/coronavirus-data-explorer

Box 9.1 continued

The most common concern among the vaccine-hesitant—27 percent of respondents in North Macedonia and Serbia, 38 percent in Kosovo—is long-term side effects. The most trusted source of information for health advice is family members: trusted by 51 percent of those who do not intend to get vaccinated in North Macedonia, 44 percent in Serbia, and 41 percent in Kosovo; and by 45 percent of the uncertain in North Macedonia, 37 percent in Serbia, and 29 percent in Kosovo. Scientists and epidemiologists are the second most trusted source. Hesitancy among health and education workers mirrors the general population, with similar proportions indicating they do not intend to get vaccinated in North Macedonia and Kosovo, and slightly lower but still important proportions in Serbia. Messaging that highlights the fact that studies from around the world confirm that COVID-19 vaccines are effective in protecting individuals, families, and friends increases the intention to get vaccinated by 39 percent in North Macedonia and 10.5 percent in Kosovo. In Serbia, messaging that highlights that other people are getting vaccinated against COVID-19, including how many have done so in the past two weeks, increases the intention to vaccinate by 20 percent. These findings provide useful insights about the drivers of hesitancy and how communications can be customized to appeal to specific concerns related to the COVID-19 vaccines.

Inflationary pressures are expected to moderate as the economies settle closer to their potential growth, but to remain elevated due to inevitable energy price hikes. As the economies have recovered faster, inflationary pressures have started to build up. Supply-side shocks, increased inflation in trading partners, and strong demand have led to an increase of the average inflation in the region to a projected 2.3 percent in 2021, from 0.9 percent in 2020. However, inflationary expectations are still anchored, and wage growth is kept moderate, which will keep core inflation subdued over the medium term. The necessary energy price adjustments as countries align excises and reform their energy sectors may keep the consumer prices elevated.

Fiscal deficits are expected to decline gradually, but public debt will not return to the pre-crisis level over the medium term. Improved revenue collection and the reduction in relative spending led to a reduction of the average fiscal deficit by 2.7 percentage points of GDP in 2021. Yet, beyond 2021, expenditure rationalization will have to lead a fiscal consolidation effort in order to bring the elevated debt levels down. Public and publicly guaranteed debt is expected to decline from its peak in 2020 of 61 percent of GDP to below 56 percent of GDP in 2023. This is well above the pre-crisis debt levels, suggesting further efforts will be needed to restructure spending and improve tax compliance across most of the region. Bosnia and Herzegovina and Serbia are the only exceptions, where consolidation efforts in the pre-COVID-19 period managed to bring public debt down considerably, thus creating fiscal space to respond to such shocks.

With resumed trade activity, external deficits are also expected to narrow, assuming inflows from remittances and tourism remain stable in the medium term. Inflows from remittances and a surplus in services compensated the higher demand for imported goods coming from increased investment and consumption. With exports and remittances bouncing back, the current account deficit is expected to gradually narrow in the Western Balkans, leading to a slow reduction in historically high external debt.

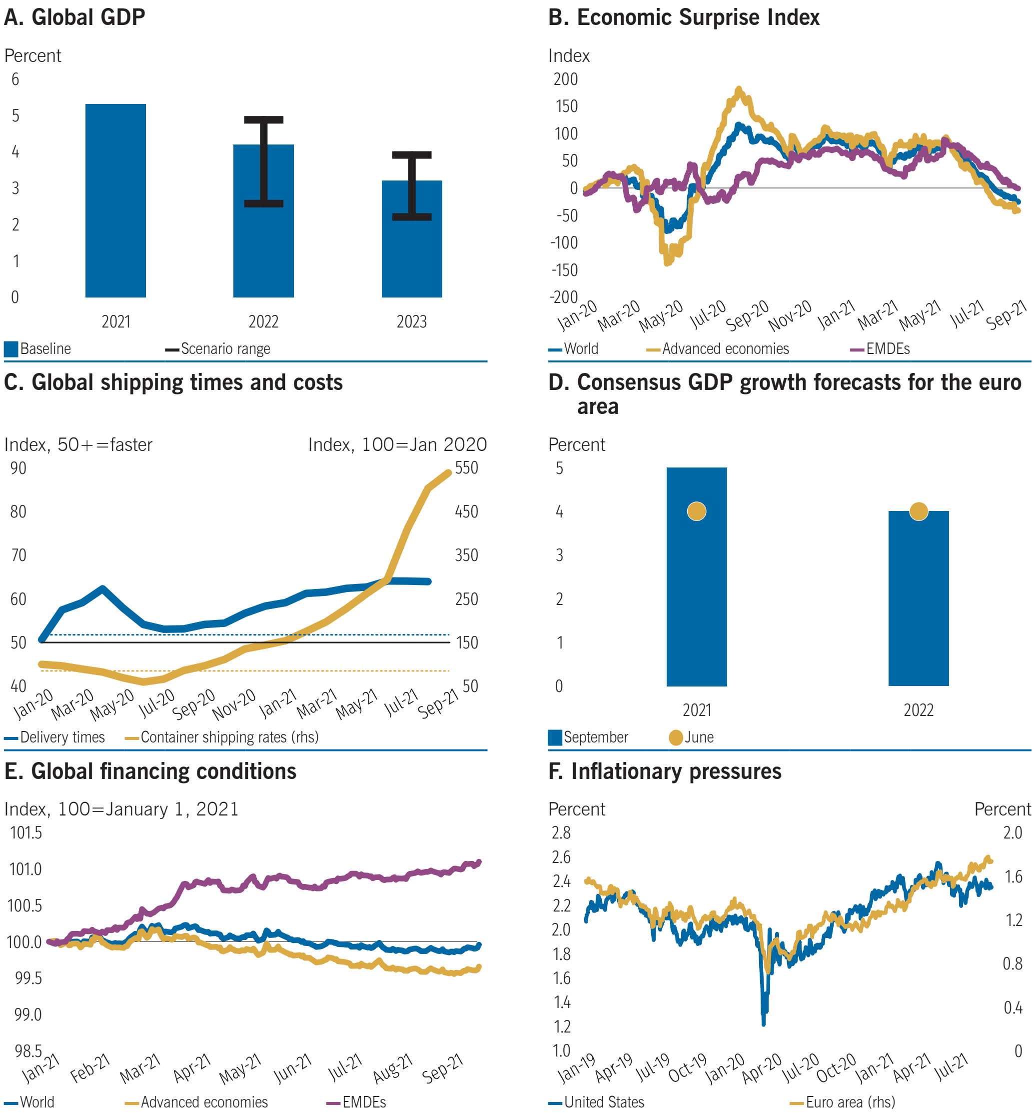
The outlook is subject to a series of risks, mostly geared to the downside (Box 9.2). A prolonged pandemic and the rise of new variants domestically and internationally could adversely affect growth and confidence. International travel bans and further disruption in global trade may weaken domestic production and export of goods and services. In the absence of fiscal consolidation, especially for countries with high debt, like Albania, Montenegro, and North Macedonia, refinancing risks could arise if external financial market demand tightens. Debt sustainability may become a concern, while access to finance may become more expensive as monetary tightening starts. In the financial sector, risks are linked to the increase in nonperforming loans. Political polarization risk also remains high. In Bosnia and Herzegovina, the current political deadlock could be further amplified in the pre-election period, adversely affecting implementation of the adopted socioeconomic program needed to address the country's development challenges and pave the way for EU accession. The deterioration in performance of state-owned enterprises, as seen recently in Serbia with Telekom Srbija and Air Serbia, could also add new fiscal pressure. Yet, positive developments may also emerge around EU accession and around the substantial new EU funding envelope focused on investments for green and digital transition, and implementation of structural reforms.

Box 9.2. The global economy is expected to see a strong rebound, but continues to be subject to key downside risks.

The global economy is experiencing a strong rebound but the continued spread of COVID-19 weighs on the near-term outlook. Following a collapse in global economic activity from the pandemic, a cyclical recovery has been underway since the trough in 2020Q2. Global activity has been supported by improving domestic demand on the back of vaccination progress, especially in major economies. In emerging market and developing economies (EMDEs), including those in the Western Balkans, a generally supportive external environment has further propelled the rebound. According to the June 2021 edition of *Global Economic Prospects*, global output is projected to expand 5.6 percent in 2021 and then moderate to 4.3 percent in 2022 (Figure 9.4A). The forecast assumes that activity in major economies stabilizes, including in the euro area, and macroeconomic support continues to be withdrawn. The spread of more transmissible variants, however, has prompted renewed mobility restrictions and casts a long shadow over the strength and durability of the recovery. For EMDEs, obstacles from the pandemic, including highly unequal vaccine access, are partly offsetting some of the benefits of firming demand.

Box 9.2 continued

Figure 9.4. Global economic developments.



Source: Bloomberg; Consensus Economies; harperpetersen.com; Haver Analytics; World Bank; WTO; Bolt et al. (2018); Kose, Sugawara, and Terrones (2020); Oxford Economics; World Bank.

A. Blue bars show baseline data from Global Economic Prospects June 2021 database. Yellow whiskers indicate the scenario ranges from Oxford Global Economic Model simulations compared to the baseline scenario.

B. Citi's Economic Surprise Index measures the degree to which economic data are either beating or missing expectations. Last observation is September 28, 2021.

C. Global manufacturing suppliers' delivery times, Purchasing Managers' Index (PMI), and the HARPER PETERSEN Charter Rates Index (HARPEX) for container shipping rates. PMI data are inverted by subtracting data from 100; therefore, increasing (decreasing) PMI data indicate faster (slower) delivery times. Container shipping rates are monthly averages of weekly data and reflect price developments on the charter market for container ships. Dashed lines indicate long term averages over the period January 1998–December 2019 for delivery times and February 2018–December 2019 for container shipping rates. Last observation is August 2021 for delivery times and September 17, 2021 for container shipping rates.

D. The average forecast for the months indicated from Consensus Economics.

E. Goldman Sachs country-specific financial conditions indexes, which track borrowing costs, exchange rates, and equity valuations. GDP-weighted aggregates are calculated using 2021 GDP measured at average 2010-19 prices and market exchange rates. Sample includes 10 advanced economies, the euro area, and 14 EMDEs (excluding China). A reading above 100 indicates tightening of financial conditions. Last observation is September 17, 2021.

F. Last observation is September 21, 2021.

Box 9.2 continued

Global activity, while robust, likely plateaued in the first half of 2021. Many countries' recoveries have faltered in the second half of 2021, with incoming economic data pointing to a loss of momentum amid the ongoing effects of the Delta variant (Figure 9.4B). This slowdown has been most evident in countries with severe COVID-19 outbreaks; in EMDEs, this has been compounded by low vaccination rates, partly owing to highly unequal vaccine access. The expansion in the global composite Purchasing Managers' Index (PMI) has been dampened by the subsequent rise in global new COVID-19 cases in 2021Q3, with services activity in EMDEs particularly affected. The recovery in global goods trade has eased with growth in 2021Q2, slowing to about a third of its pace in the previous quarter, and has continued to lose momentum at the start of 2021Q3. Survey data point to further softening moving forward, with the manufacturing PMI for new export orders slipping in 2021Q3 due to substantial supply bottlenecks and strains in global value chains. Ongoing shipping delays and shortages of raw material have resulted in record-high backlogs (Figure 9.4C).

The euro area—a key trading partner for the Western Balkans—continues to experience a sustained recovery. Following two consecutive quarters of contraction, GDP growth in the euro area bounced back in the second quarter of 2021, expanding 9.2 percent (QOQ, saar), prompting an improvement in private-sector forecasts for 2021 growth (Figure 9.4D). Despite this strong rebound, output in 2021Q2 remained about 2.5 percent below its 2019Q4 level. Nevertheless, the recovery has been underpinned by firming services activity following the relaxation of mobility restrictions and an accelerated vaccine rollout. Although incoming composite PMI data indicate that activity in the euro area continued to be strong in the third quarter, mounting supply and shipping bottlenecks have weighed on manufacturing production. These record-high backlogs have also contributed to the increase in prices, with inflation reaching a decade high of 3 percent in August.[20]

The outlook continues to be subject to key downside risks, particularly in the context of the pandemic and its scarring effects on the economy. In a downside scenario of a protracted pandemic, global growth over the next two years would falter to a pace similar to the anemic recovery that followed the global financial crisis. A lingering pandemic could further exacerbate the unevenness of the recovery, as limited vaccine access and hesitancy would continue to hinder widespread vaccination. As a result, years of hard-won gains in per capita income growth and poverty reduction could be further lost. Even in the relatively robust baseline, per capita income catch-up with advanced economies has slowed and even reversed in some cases. By end-2021, about 100 million people are expected to have fallen back into extreme poverty globally.

The risk of financial market stress also remains pronounced, especially following last year's rapid buildup of government and corporate debt. In an environment of elevated debt, financial stress could be triggered by any of a number of shocks that unexpectedly increase borrowing costs (Rogoff 2021).[21] Although global financial conditions have remained relatively benign in 2021, they have tightened for EMDEs since June (Figure 9.4E). Conditions could abruptly tighten if major economies began to remove monetary policy accommodation faster than expected. Throughout the year, pockets of market volatility have been triggered by concerns over above-target inflation in the euro area and United States—both of which have announced tentative plans to start tapering

20 The European Central Bank (ECB) shifted its monetary policy strategy in July 2021, raising its inflation target to 2 percent—compared to its previous target of close to but below 2 percent—and affirming it would tolerate moderately higher, transitory inflation. Nevertheless, the ECB recently announced plans to start slowing its pandemic emergency bond purchases.

21 A sudden increase in interest rates could stem from a rise in risk aversion, inflation, or expectations of faster monetary tightening.

Box 9.2 continued

bond purchasing programs at the end of this year—which has led to an increase in market-based forecasts on inflation and in expectations of further rate hikes in the near future for the United States (Figure 9.4F). For the Western Balkans, a sudden tightening in external financing could generate risks associated with debt rollover and currency mismatches, especially in those economies that have substantial upcoming redemptions or borrowed heavily in foreign currency.

A resilient recovery, and sustainable growth going forward, would require regionwide efforts on advancing structural reforms and accelerating the low-carbon transition. When compared to EU peer countries, key areas in which the Western Balkans lags behind, and that would bring the bulk of growth, are business regulation and the quality of institutions—that is, governance (Box 9.3). If business climate reforms are implemented, together with the necessary policies to support labor market participation and formal employment, private investment could provide further support to growth and would allow for growth to translate into poverty reduction. Further strengthening the independence of public institutions, especially the judiciary, would not only improve countries' prospects of joining the EU, but would ensure a level playing field for all businesses and entrepreneurs, hence favoring a more equitable recovery. Digitalization and boosting internet penetration are also expected to open new growth avenues for the six countries.

The structural reform agenda should be accompanied by a firm commitment to prudent fiscal management. On the revenue side, it is of the utmost importance to improve compliance, incentivize formalization, and boost revenues, especially for Albania, which has the lowest revenue collection in the region. On the expenditure side, enhancing targeting and efficiency of spending would help deal with shrinking fiscal space going forward and would reorient spending toward growth-enhancing items. Learning from each other by implementing those structural reforms to close the gap with the best performer among the Western Balkan countries in each of the key dimensions, would raise average growth in the region by almost 2 percentage points in the next decade (Box 9.3).

A region-wide effort is also required to promote green growth. This could be done by, for example, promoting efficiency gains, expanding green industries and technologies, supporting green jobs, and proactively building up resilience to climate and disaster risks. Adequately pricing carbon would not only provide incentives to focus on green recovery but would also offset the adverse impact of the EU Carbon Border Adjustment Mechanism the Western Balkan exports competitiveness (Chapter 10).

Box 9.3. Learning from each other would help to boost economic convergence in the Western Balkans.

Structural reforms can boost GDP growth through their impact on the three standard inputs of a production function: capital, labor, and productivity (or efficiency). Structural determinants of potential GDP growth are identified by separately studying capital, labor, and productivity—the channels through which these determinants may work. The analysis builds on the approach introduced by Bouis and Duval (2011), Barnes et al. (2013), and Johannson et al. (2013), and elaborated on by Egert and Gal (2016) and recently applied for Argentina by Lusinyan (2018) and for Serbia by Rovo (2020). Cross-country reduced-form panel data regressions are estimated for the capital-to-output ratio and the employment rate. Efficiency is estimated through stochastic frontier analysis, which allows for the computation, for a given sample of countries, of the maximum amount of output, given the factors of production and technology available and conditional on structural and macro variables. The analysis highlights the role of crucial structural characteristics in accelerating growth, including institutional quality, labor market rigidities/regulations, product market regulations and competition, digital economy, and human capital.

Table 9.1. Top 4 structural reforms needed to close the gap with Germany: Regulations, governance, financial development, and digitalization.

Albania	Bosnia and Herzegovina	Kosovo	Montenegro	North Macedonia	Serbia
REG	REG	GOV	REG	GOV	REG
GOV	GOV	FIN	GOV	REG	GOV
DIG	DIG	DIG	DIG	DIG	DIG

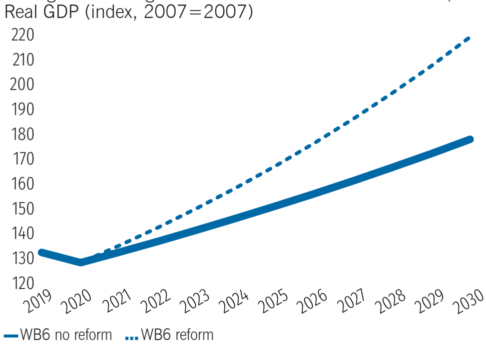
Note: DIG refers to digitalization as proxied by the share of individuals using internet in the previous three months (WDI, 2018); FIN refers to financial development as proxied by credit to the private sector (as a share of GDP – WDI, 2018); GOV refers to governance as proxied by the governance effectiveness index (WDI, 2018); REG refers to regulations as proxied by the business regulatory quality index (Fraser, 2018).

Reforms in the business environment, governance, and digitalization would contribute the most to growth and close the gap with the EU best-performing countries. Based on the assumption that the six countries have the capacity—in terms of plans and resources—to implement reforms promptly and simultaneously, it is possible to simulate the change in annual GDP growth from closing the gap in critical structural areas relative to one of the best-performing countries in Europe (namely, Germany) over a period of 10 years. All six countries would benefit from improving the regulatory environment for businesses and the quality of institutions, that is, governance. In addition, advancing digitalization is critical for boosting growth (Table 9.1).

Learning from the Western Balkans best performer in each dimension would add 2 percentage points to the average real GDP growth for the region. Closing the gap with the best performer among the Western Balkan countries in each dimension, would speed the recovery process, boost the average economic growth in the region by about 2 percentage points, and accelerate convergence with the EU (Figure 9.5).

Figure 9.5. Western Balkan convergence.

Average real GDP growth: reform vs. no-reform scenarios, Real GDP (index, 2007=2007)



Box 9.3 continued

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10. *Spotlight*: From a green recovery to green transition in the Western Balkans

Environmental sustainability is a pressing global concern

Across the world, environmental sustainability is moving from the periphery to the mainstream of the growth and macro-fiscal stability agenda. Multiple environmental crises, including climate change, biodiversity loss, and pollution, pose existential risks to humanity and immediate systemic risks to the prosperity, sustainability, and resilience of nations. The preferences of global consumers and investors are changing, and green technologies and business models are disrupting more markets. Green policies are reshaping economic landscapes and greening the environmental footprint of economies and are becoming a decisive factor in international competitiveness and in the ability to attract international finance and investment.

The small, open economies of the Western Balkans are no exception. As a neighbor of the European Union (EU), an unequivocal leader in global climate action, both access to the EU market and expected EU financial assistance will crucially depend on the progress made by the Western Balkans in greening their economies. Therefore, this spotlight highlights the macro-fiscal challenges and drivers of greening the region's growth in the rapidly changing world. Sector greening challenges and opportunities will be highlighted in the next edition of the *Regular Economic Report*.

The post-pandemic policy environment has changed

Having just suffered sharp economic downturns during the COVID-19 pandemic, the six countries of the Western Balkans now find themselves rethinking their long-term development strategy. Do they continue with a brown recovery, using existing means of production, or fundamentally shift their economies to a green growth model? Leapfrogging to green growth is far from easy, especially in the short term. Traditional, brown industries are familiar, supported by "sticky" brown skills and jobs, established value chains, and market infrastructure. Reliable, local, and cheap coal (when externalities are excluded) combined with cheap labor gives the industry of the region a competitive advantage and undoubtedly contributes to the attraction of foreign direct investment. Green alternatives to business-as-usual drivers of short-term recovery from COVID-19 and long-term growth are not that obvious, especially as fiscal space has narrowed, and the higher debt burden after the crisis has restricted the set of choices that governments can make when it comes to large investments. Pursuing a business-as-usual growth model post-COVID-19 carries the risk of locking in growth on an unsustainable (brown as opposed to green) trajectory.

Furthermore, business-as-usual is no longer available to the countries of the Western Balkans. The external environment is going through a fundamental structural change. Global strides toward action on climate change, biodiversity loss, air and plastic pollution, and other existential environmental crises are changing the foundations of economic activity, consumer choices, and investor behavior everywhere. And closer to home, the European Green Deal is providing a new set of markers for the region's future growth trajectory, especially in the context of the countries' EU accession aspirations. The EU accounts for almost 70 percent of the region´s total trade, which makes it the largest trading partner for each of the Western Balkan countries. Trade between the EU and the region has risen by almost 130 percent over the past 10 years, with the total trade between these two partners reaching EUR 55 billion before the crisis. Old choices will not work in the new environment.

The EU Carbon Border Adjustment Mechanism (CBAM) proposed by the European Commission is the first tangible manifestation of the costs that could be faced by countries that continue a business-as-usual growth model. The July 2021 EU CBAM legislative proposal applies to the import of selected goods from the most emission intensive and trade exposed sectors covered by the EU's Emissions Trading System (EU ETS), such as electricity, cement, fertilizers, steel and aluminum. The proposal stipulates that, from 2026, EU importers of these goods will be required to buy carbon certificates corresponding to the carbon price that would have been paid, had the goods been produced in the EU under the EU ETS. The price of these certificates will gradually approach full EU ETS price over 10 years, as free allowances in EU are phased out by 10 percent a year. Once non-EU producers show that they have already paid for the carbon used in the production of the imported goods, the corresponding cost can be fully deducted for the EU importer. Since, as mentioned, the EU is the largest trading partner for the Western Balkan countries, the CBAM is expected to eventually affect the terms of trade for carbon-intensive goods exported to the EU, unless Western Balkans levy comparable carbon pricing to producers at home.

The EU CBAM was designed to have a targeted and limited impact, but what comes next could be a game changer. Initial World Bank analysis suggests a small overall impact of the CBAM proposal on the Western Balkans, although some manufactured goods exported to the EU could be significantly affected. The current CBAM proposal covers only direct emissions of carbon from the production processes of the selected goods. Going forward, however, the EU is likely to expand the CBAM to cover more sectors and more products after 2030.[22] In future, import tariffs could also cover emissions from electricity and heat used during production and eventually all emissions in the value chain of exporting companies. When this happens, the emissions intensity of the power grid will have a decisive impact on the competitiveness of the Western Balkan products in the EU and other countries that may decide to apply CBAM alongside EU. More countries, like Japan and Canada, are already contemplating similar trade measures as part of a more ambitious climate policy packages. This would limit opportunities for the Western Balkans to redirect exports of carbon-intensive goods away from the EU towards other markets. The World Bank carried out global simulations that showed that a larger group of countries introducing CBAM covering value

22 Publicly stated by Gerassimos Thomas, Commission's Director General for the Taxation and Customs Union.

chain emissions would significantly influence global trade flows, incentives to cooperate on climate action, stranded assets, as well as GHG emissions.[23] Western Balkan exporters with high carbon footprints may also face other barriers in accessing markets and finance, as global consumers, investors, and financiers are greening their preferences.

Shifting to a green growth pathway will require new and different investments in hard and soft infrastructure

Catching up with the infrastructure investment backlog and compliance with the EU environmental *acquis* is a known and manageable challenge of EU accession. The costs of alignment with the EU climate policy package and implementing the EU environmental *acquis* will be high, and massive infrastructure investments are needed. It is indisputable, however, that the benefits to accession countries are higher than the costs. Crumbling municipal and environmental infrastructure make Western Balkan cities less livable than their EU counterparts. Under-provisioned and poor-quality basic municipal services, such as water, sanitation, transport, and waste management in many cities drive people away and deter both domestic and foreign investment. Unaccounted water losses, for example, in capital cities of the Western Balkans are strikingly high, particularly in Tirana (73.6 percent) and Sarajevo (75.2 percent). Wastewater coverage is well below 100 percent in most of the capital cities and well below that of countries overall. EU pre-accession funds and, later, cohesion and structural funds, could help pave the way for closing this environmental infrastructure gap.

Investments in climate-resilient infrastructure are also needed to protect against flooding and drought, and to ensure water security. In 2014, historic flooding caused over EUR 2 billion in damage and loss in Bosnia and Herzegovina (equivalent to nearly 15 percent of the country's GDP), and over EUR 1.5 billion in damage and loss in Serbia (nearly 5 percent of Serbia's GDP). In 2017, record temperatures buckled train tracks; fueled dozens of fires across the Balkans; caused a drought in Serbia, which led to a drop in agricultural output of nearly 10 percent; and forced Albania to spend EUR 200 million on energy imports amidst a devastating drought. These extreme events serve as a reminder of just how vulnerable the region is to climate-related shocks. As weather patterns become more uncertain in the region, governments need to take increasingly proactive approaches to ensure the safety and prosperity of communities.

Given the region's legacy of energy- and emission-intensive infrastructure, with sticky "brown" skills and jobs, the green growth trajectory looks for many stakeholders like a tall order. Energy intensity in the region remains three times higher than in EU countries, on average. The gap is the highest in Bosnia and Herzegovina and the lowest in Albania, although the energy intensity gap has been narrowing over the past two decades.

For all Western Balkan countries, except Albania, CO_2 emissions per dollar of GDP are significantly higher than in EU countries[24]

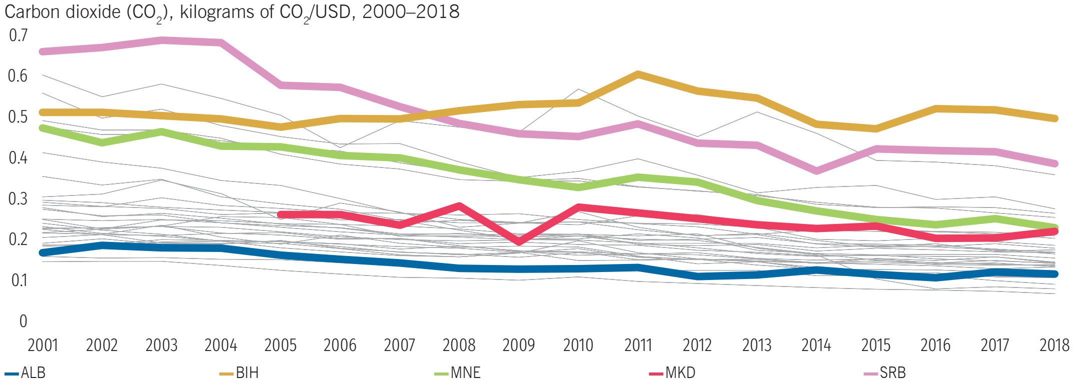
23 Peszko et al. 2020; Peszko, van der Mensbrugghe, Golub 2020; Peszko et al 2021.
24 Consistent data for Kosovo were not available.

(Figure 10.1). Bosnia and Herzegovina stands out in particular as being more carbon-intensive economy than any EU member state. Interestingly, carbon intensities of output for Bosnia and Herzegovina and Montenegro have been quite stable over the last 20 years, while all other Western Balkan countries saw a consistent decrease.

About 83 percent of gross available energy (primary energy use) in the Western Balkans comes from fossil fuels (Figure 10.2). This compares with 70 percent in the EU, on average. Coal and lignite (46 percent of the total) dominates in the power generation and heavy industry, and oil (29 percent of the total) dominates in transport. The penetration of natural gas for power generation is low (8 percent of the total). Renewable energy accounts for only 17 percent of gross available energy and is dominated by biomass used in residential heating (10 percent of the total), and hydro (6 percent). Investment in new renewables, such as wind and solar, has been negligible. The energy mix is similar across Western Balkan countries, with the exception

Figure 10.1. Higher carbon intensity of GDP in the Western Balkan than in EU.

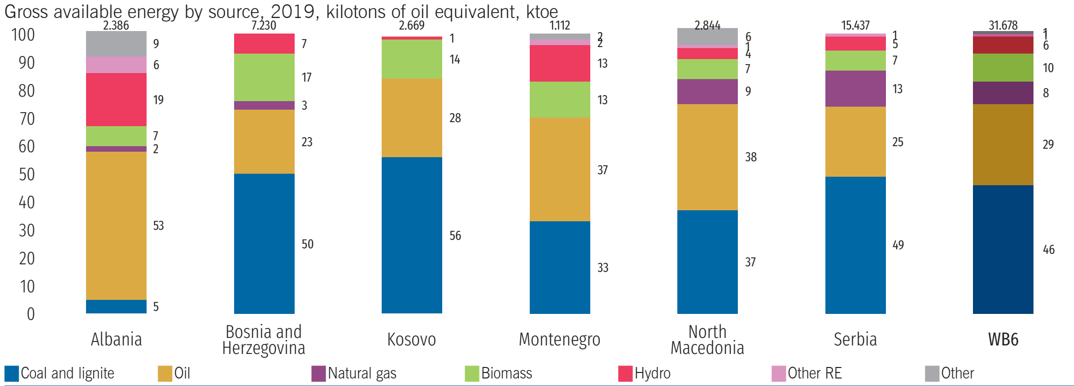
Carbon dioxide (CO_2), kilograms of CO_2/USD, 2000–2018



Source: https://data.oecd.org/air/air-and-ghg-emissions.htm.
Note: Thin grey lines represent carbon intensity of individual EU members states.

Figure 10.2. High reliance on fossil fuels in primary energy use.

Gross available energy by source, 2019, kilotons of oil equivalent, ktoe



Source: Eurostat.

of Albania, where the contribution of coal is more limited, and oil and hydro have a larger share.[25]

All Western Balkan countries (except Albania) rely on domestic coal (lignite) for power generation, and they are producing their own lignite to fuel power plants. In 2019, Kosovo generated about 95 percent of its electricity from domestic lignite, followed by Serbia, Bosnia and Herzegovina, North Macedonia (about 60–70 percent), and Montenegro (44 percent). Of all types of coal, lignite has the lowest energy density, a low heating value and a high moisture content. For this reason, it is uneconomical for long-distance transport and export. It is mainly used in the power plants that are integrated with the nearby mines. In such a configuration, it represents a reliable power source with low generation cost (assuming externalities are excluded). Fuel prices are predictable and unaffected by global market volatility. The commercial viability of lignite, however, deteriorates dramatically when the costs of environmental damage (both local and global) are added to the fuel price. Therefore, electricity systems based on lignite are strongly exposed to the risks of local environmental regulations, citizen protests, and carbon pricing, both on domestic and export markets. Albania is the only producer of crude oil and small amounts of natural gas in the region and has a coal-free power grid.

If the EU extends the CBAM to scope 2 emissions,[26] the carbon footprint of electricity generation will become a critical factor affecting the export competitiveness of Western Balkan products, because all producers use electricity from the grid. In the past, preferences for local coal and resistance to imported gas have been driven by energy security concerns, which traditionally were equated with energy self-sufficiency. A new concept of energy security based on diversification of energy sources, molecules, technologies, and trade routes is the essence of the EU energy policy and is slowly being internalized by decision makers in the Western Balkans.

Perhaps one of the most pressing issues in the cities of the region is poor air quality, which is commonly the leading environmental contributor of death and disability. The extreme population exposure to fine particles—PM2.5—that occurs every winter is principally the result of emissions from domestic heating (coal and wood-fired stoves and boilers, and the domestic burning of waste) and, to a lesser extent, coal power plants and industrial installations. The transport sector's contribution is relatively smaller but persists throughout the year and is exacerbated by an aging vehicle fleet (especially old diesel vehicles) and congestion. Agriculture is also a seasonal contributor due to the burning of agricultural waste. Other major factors include dust from industry, quarrying, and poor waste management practices. It is estimated that as a result of exposure to ambient PM2.5 air pollution, 3,300 people die prematurely every year in Bosnia and Herzegovina, 1,600 people in North Macedonia, and 760 people in

25 Source: Eurostat.
26 So that, for example, an exporter of vehicles would need to pay a carbon tax at the border for carbon content of electricity used to produce these vehicles.

Kosovo.[27] According to World Bank estimates, annual economic costs of ambient air pollution in these three Western Balkan countries ranged from US$240 million to US$1.38 billion in 2016.[28] The PM2.5 concentrations in some region's cities rival that of big cities like Beijing, Mumbai, and New Delhi.[29] Western Balkan countries (especially Serbia) are also in violation of the emission limits on the sulphur oxide (SO2), nitrogen oxides (NOX) and dust (PM) emissions embodied in the Energy Community Treaty. According to the European Commission Economic and Investment Plan,[30] the 16 coal-fired electricity plants in the region emit more SO2 than all 250 similar plants in the EU.

There are some tensions between decarbonization strategies and the reduction of air pollution and GHG emissions. For example, removing SO2 emissions warms the climate, investing in filters for coal-fired power plants significantly reduces air pollution but slightly increases GHG emissions; the introduction of electric vehicles will not necessarily reduce GHG emissions if the source of the electricity is coal; and putting a price on carbon encourages households to switch from clean gas and LPG to biomass and waste which are the key sources of population exposure to air pollution. These tensions do not justify inaction on any of these major market failures but require joint application of coherent air quality and climate policy instruments to ensure that one environmental problem is not solved by aggravating another. Depending on the relative stringency and urgency of climate and air pollution policies, the operators of the coal power plants will face incentives either to retrofit coal units and install highly efficient end-of-pipe air pollution control installations or retire coal plants earlier and switch to less-polluting fuels, such as natural gas or renewable energy. Therefore, integrated calibration of multiple climate, air pollution and fiscal policy instruments is important to steer firms' choices toward socially cost-effective outcomes.

Reforms will be needed to make the trajectory of growth in the Western Balkans most sustainable

While income indicators, such as GDP, measure the annual production generated by a country's use of its assets, they do not inform whether this production level can be sustained in the future because they do not capture the changes to its productive asset base. Income can be understood as the annual return that a country derives from its wealth. Therefore, the key to increasing economic well-being in the future lies in building national wealth. The World Bank developed the world's most comprehensive, government balance sheet-compatible accounts of the collective wealth of nations, known as the Changing Wealth of Nations.[31]

Creation and maintenance of wealth requires savings in order to finance investment in assets, as well as good institutions,

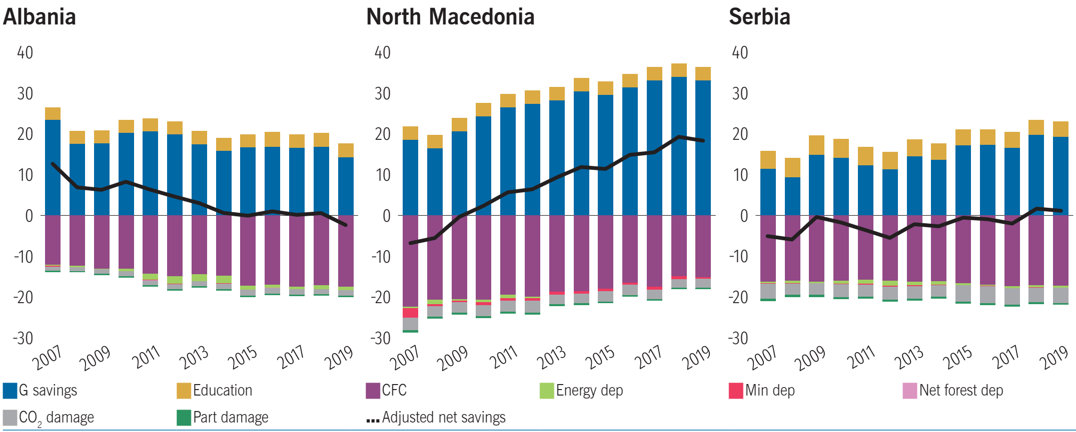
27 The World Bank country assessments of air quality management in the Western Balkans: Bosnia and Herzegovina, Kosovo, and North Macedonia: https://openknowledge.worldbank.org/handle/10986/33557.
28 Western Balkans Regular Economic Report No 17, Spring 2020.
29 In Skopje (North Macedonia), PM2.5 levels are more than four times the safe level recommended by the World Health Organization (WHO), over eight times the safe level in Tetovo (North Macedonia), and three times the safe level in Sarajevo (Bosnia and Herzegovina).
30 An Economic and Investment Plan for the Western Balkans, the European Commission, 6.10.2020.
31 Lange, Wodon, and Carey. 2018; World Bank 2021.

policy incentives, and governance to make productive use of those assets. One of the indicators the World Bank uses is adjusted net savings (ANS), developed originally by Hamilton and Clemens (1999). It tracks sustainability of development over time as a proxy for the change in wealth.[32] ANS does not capture all wealth components but its interpretation is simple: if ANS as a percentage of gross national income is negative, it indicates that the country is consuming more than it is saving, which will undermine long-term sustainability; if ANS is positive, then it is adding to wealth and future economic well-being. Albania stopped accumulating wealth around 2015 and has been depleting the basis of its future growth in 2019, mainly due to a drop in savings and investments with simultaneous accelerated write-offs of the aging produced assets (Figure 10.3). In contrast, North Macedonia has been accumulating wealth at an increasing rate since 2009, due to an improving ratio between investments in, and depreciation of, assets. Serbia had been losing wealth until 2018 but started accumulating asset value since 2018 due to the increased gross savings rate.

The ANS alone does not inform whether the depreciated and accumulated assets are green or brown, and hence whether a country is becoming better or worse prepared to manage a transition risk. The green transition can be viewed as a supply shock with accelerated obsolescence of the capital stock. This should be offset by investment in new greener asset classes. Therefore, accelerated capital turnover can be an indicator of green transition, but more detailed information about the type of fixed assets formed and written off would be needed to make this statement. Western Balkan countries may want to start monitoring the portfolio in their national balance sheets to track whether their net fixed capital formation is green or brown.

Figure 10.3. Are the Western Balkans accumulating or depleting their wealth?

Adjusted net savings (ANS) as a percentage of Gross National Income



Source: World Bank Changing Wealth of Nations.

Notes: CFC: Consumption of fixed capital. The complete data set available to calculate ANS was not available for Bosnia and Herzegovina, Kosovo and Montenegro.

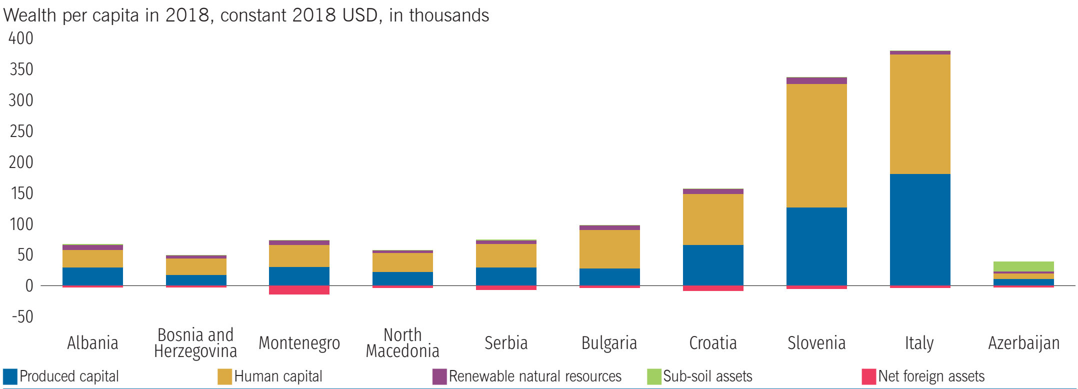
32 ANS is measured as gross national savings minus depreciation of produced capital, depletion of subsoil assets and timber resources, and air pollution damage to human health, plus a credit for expenditures on education.

While Western Balkans energy systems depend on fossil fuels, their economies do not. The wealth structure in the Western Balkans is typical of diversified, middle-income net fuel importers, although the value of wealth per capita is much lower than in EU member states (Figure 10.4). Human capital[33] dominates total wealth per capita (usually in the range of 50 to 60 percent), followed by produced assets (buildings, infrastructure, machines, intellectual property, and so forth), which account for 35 to 50 percent of total wealth on average in the region. The value of natural capital is usually below 10 percent in EU member states and 10 to 15 percent in the Western Balkan countries, but in all of them renewable assets (forests, agricultural land, and protected areas) have much higher value than the value of subsoil assets (fossil fuels and minerals), the latter accounting for a mere 2 percent or less of total wealth per capita across continental Europe, including the Western Balkans. Even for the largest coal producers, coal deposits represent a negligible share of total wealth.

The wealth structure of the Western Balkans is in stark contrast to those of the fossil fuel-dependant countries. For example, Azerbaijan, which represents a typical asset portfolio of a fossil fuel-dependent country, has 44 percent of total wealth embedded in oil and gas and only 23 percent in human capital (Figure 10.4). Export data confirm this pattern. Across the region, the share of fossil fuels in total exports is negligible for all coal producers in the region and reached around 8 percent in 2019 in Albania due to its crude petroleum exports.

The value of natural capital in the Western Balkan region has been dominated by renewable assets (forests, agricultural land, and protected areas), rather than underground resources. Per capita, the value of renewable natural capital during 2010–18 increased in Albania, slightly decreased in North

Figure 10.4. The structure and value of wealth per capita in Western Balkan and selected comparators



Source: World Bank Changing the Wealth of Nations 2021 database.

33 CWON uses the lifetime earnings approach to estimate the value of human capital. According to this approach, human capital is estimated as the total present value of the expected future labor income that could be generated over the lifetime of the women and men currently living in a country, including those self-employed (Jorgenson and Fraumeni 1989; Fraumeni 2008; Hamilton and Liu 2014). The calculation of the lifetime income approach uses data by age and gender on population, employment and labor force participation, education, earnings profiles, and survival rates.

Macedonia, and remained more or less constant in Bosnia and Herzegovina, Montenegro, and Serbia. In high-income economies, renewable natural wealth per capital was increasing.[34]

Better management can evoke more value from abundant natural resources in the Western Balkans. These would require policy incentives to improve resource management practices in agriculture, forestry, and fisheries.[35] Tourism in the Western Balkans is already a key generator of income derived from natural assets, such as beautiful coastlines, rivers, and mountain ranges. Subsoil natural assets (fossil fuels and minerals) have not only represented a small share of natural wealth per capita, but were also losing their value and hence significance as the basis for future growth.

The ambitious climate policies in the Western Balkans will have important implications for coal-related assets and labor, but are unlikely to represent a systemic macro-fiscal risk to their economies. The Western Balkan countries score high on the World Bank index of preparedness for low-carbon transition, with relatively low exposure and relatively high resilience to transition risk. The key determinant of relatively low exposure is the insignificant share of fossil fuel rents in GDP and fossil fuel exports in total export revenue.[36] Therefore, parting with the legacy of the brown growth model should not create the same systemic disruption in the Western Balkans, as in the countries which derive over half of their exports and budget revenues from exports of oil and gas. The macro-fiscal challenge can however be large, with non-trivial political cost and inflationary pressure of increasing taxes on fossil fuel-based energy. Managing the just transition of workers and communities in the mining regions, and shifting capital from stranded assets in coal power plants and mines to new productive green assets, may be a significant though managable challenge. The most difficult process will be to deal with social distributional and political economy issues, although several new EU member states went through this process. The large part of additional revenue from higher energy and carbon taxes may need to be used as transfers to ease the impacts of higher energy prices instead of increasing green investments or lowering taxes on income. Furthermore, the support of the EU funds can significantly enhance opportunities for the affected communities. The next section explores how well the Western Balkans are positioned to harness green transition opportunities and develop new sources of comparative advantage in a rapidly greening world.

The decision whether to stay brown or go green is a risk management problem. Signing up for the green transition is like joining a free trade area. Even if there is a multitude of evidence to show the benefits, these are hard to estimate and will appear at an unspecified time in the future, whereas the costs (in terms of assets, jobs, and livelihoods) are tangible and specific and occur in the short term. Nonetheless, for the Western Balkans external pressures like the EU CBAM; the EU accession process, with its financial assistance; and the visible market preferences for a low

34 World Bank, 2021.
35 For example, overfishing reduced the value of marine fisheries in Albania from US$37 million in 2005 to US$6 million in 2018 (in constant 2018 USD). At the same time better management of protected areas increased their value from US$85 million in 2005 to US$4.6 billion in 2018 (CWON 2021).
36 Peszko et al. 2020.

environmental footprint of traded goods and services make the expected benefits more tangible, specific, and time bound. Therefore, embarking on a green transition for the Western Balkans is not a problem of decision making under deep uncertainty, as for some of the world's large fossil fuel exporters,[37] but a risk management problem with probabilities of external green drivers easier to assign, although not always easy to agree on internally.

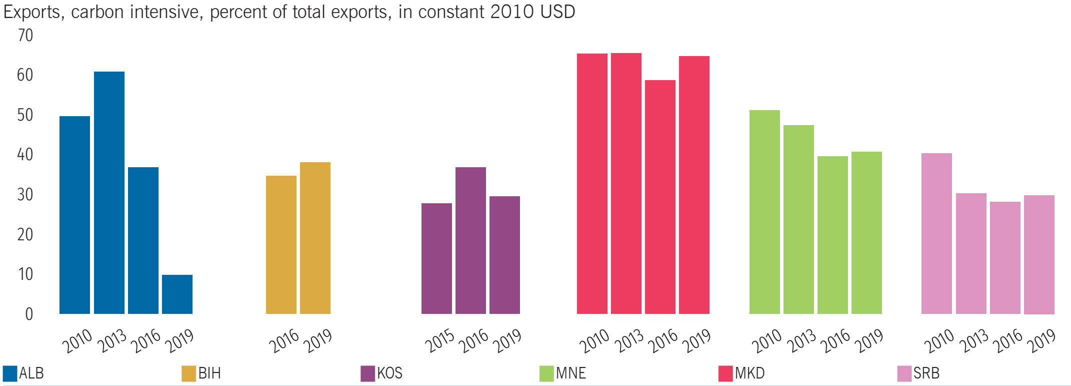
The economies of the Western Balkans need to accelerate the shift towards green, complex, and competitive products

Greening the product and export mix will be an important condition of future economic growth, especially given the economic geography of the Western Balkans. With a growing number of countries making net-zero emission pledges, global demand is beginning to shift away from fossil-fuel based production and toward cleaner technologies and more environmentally friendly products. As new growth opportunities in green product markets open, cultivating competitiveness in these areas is a fundamental way for countries to harness benefits from the transition to the green economy. The region's geographic proximity to European markets offers particularly attractive avenues for export-driven economic growth, provided that countries follow sustainable development trajectories that meet the environmental and other standards of the EU market and the increasingly green preferences of European consumers and investors. Europe, a global leader in the green transition, offers not just a large market for goods and services, but also access to investment, technology, and know-how, to say nothing of pre-accession and structural funds. The 2019 *European Green Deal* is not just another environmental strategy, but, according to EU authorities, it is a new long-term growth model that provides the broad markers for an economic development trajectory for EU member states and their trading partners.

In the last decade most countries in the Western Balkans maintained relatively high reliance of exports from carbon-intensive sectors, suggesting exposure to the low-carbon transition risk. Figure 10.5 shows that only Albania made a major shift away from carbon-intensive exports—from 60 percent in 2013 to just 10 percent of total exports in 2019. Albania was also the only country in the region which reduced the absolute value of exports from carbon intensive sectors in constant USD. This hedges the risk of the EU CBAM and other potential future "green" barriers to foreign market access. Other countries have made some progress but remain more vulnerable to transition risk. The share of carbon-intensive exports in total exports in 2019 was less than a decade ago, but still over 60 percent in Montenegro, 40 percent in North Macedonia, and 30 percent in Serbia Bosnia and Herzegovina. Except Albania, and Kosovo, the remaining countries reversed the trend in the last three years and became even more dependent on carbon-intensive exports. Furthermore, each of them also increased the value of exports from carbon-intensive sectors in absolute, constant USD between 2016 and 2019.

37 Peszko et al. 2020.

Figure 10.5. Western Balkan countries have been slowly decreasing reliance on exports from emission-intensive sectors, but it remains high except in Albania.



Source: World Bank staff using UN Comtrade 2-digit SITC for all but Kosovo.
Note: Emission-intensive sectors include production of coal, coke and briquettes, petroleum, petroleum products, gas, fertilizers, minerals, chemicals, rubber, plastics, iron and steel, ferrous and non-ferrous metals, non-metallic minerals, pulp and paper.

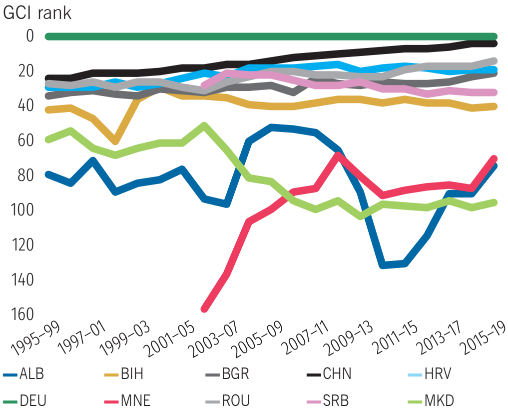
Despite a carbon intensive energy mix, the Western Balkan countries are relatively well endowed to manage a low-carbon export transition, but the export product mix will have to change significantly to stay competitive. This section applied the Green Transition Navigator[38] to explore what existing and potential green competitive strengths are in global markets the region can rely on. The findings suggest that while the wealth structure in the Western Balkans is conducive to a green economic transition, the product and export structure will need to be significantly changed to stay competitive in the green global economy, and particularly in the EU market.

While posing important challenges, for example, via the EU CBAM, the green transition also presents opportunities for the Western Balkans to discover new products and new markets. The *Green Complexity Index (GCI)* tracks countries' historical capacity to competitively export products that are *green* (meaning they have potential use or applications in the green transition such as renewable energy generation, air pollution monitoring, or waste management, but not necessarily a low carbon footprint in their production), and *complex* (meaning they tend to involve more technologically sophisticated capabilities). Competitiveness in complex products is important as product complexity enhances countries' overall economic growth and diversification prospects.[39] Serbia, the highest ranked country in the Western Balkans, is ranked 33rd on the GCI followed by Bosnia and Herzegovina which ranks 41st (Figure 10.6). Both held relatively stable ranks over the past two decades. The ranking of other Western Balkan countries is much lower and volatile, with Montenegro 71st, Albania 75th, and North Macedonia 96th in recent years. Close EU neighbors: Bulgaria, Croatia, and Romania rank above Serbia, at 15th to 22nd place. Germany has consistently held the top GCI rank, with its strong manufacturing

38 The Green Transition Navigator (Andres and Mealy 2021) is an online tool (https://green-transition-navigator.org/) that draws on over 20 years of detailed data to showcase new metrics of green competitiveness and future green diversification potential across 231 countries and territories. Due to lack of data, Kosovo is not included in this analysis.
39 Hidalgo and Hausmann, 2009; Hausmann et al., 2014.

capabilities for green technologies, while China rapidly increased its GCI ranking to 5th during 2015–19.

Figure 10.6. Green Complexity Index ranking, Western Balkans and selected countries.



Source: Bennet Institute[40].

There is significant potential for new green competitive opportunities

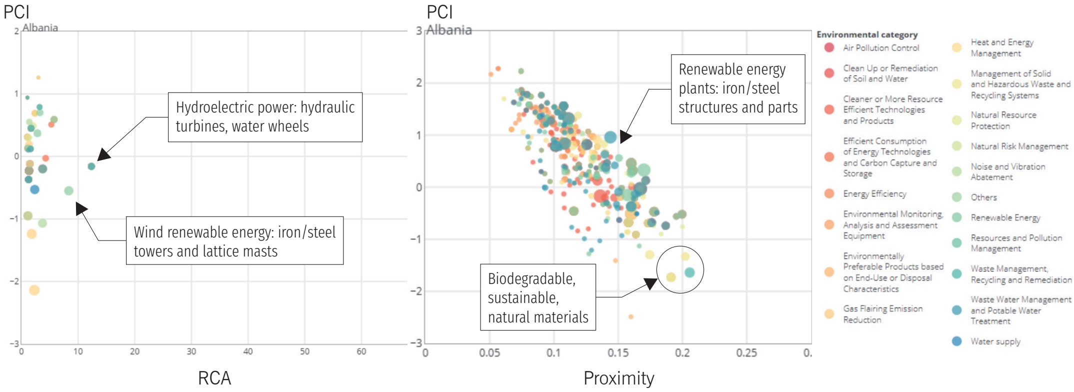
Green Competitive Strengths (GCS) and Green Potential Opportunities (GPO) indicators can help identify each country's potential to develop international competitiveness in specific green and complex products. Both indicators rely partly on the *Product Complexity Index (PCI)*, which measures technological sophistication of specific products,[41] and hence technological and knowledge spillovers they provide to the rest of the economy. For the *Green Competitive Strengths (GCS)* the PCI is combined with *Revealed Comparative Advantage (RCA)*, which measures a country's competitiveness in specific green products and is calculated as the share of a country's exports in a given product divided by the share of that product in global exports. GCS reveals the green competitive strengths of a country at the product level.[42] Serbia and Bosnia and Herzegovina are currently competitive in a greater number of green products, mainly those used in renewable energy and wastewater management, compared to the rest of the Western Balkans (Figure 10.7). Across the region, comparative advantage in green products is low, however—barely above 1—indicating that the countries will need to make an extra effort to become competitive in the international green product space. Furthermore, most of Albania's and Montenegro's competitive green products tend to be less complex, with few exceptions, such as components for hydropower plants, spectrometers, optical instruments, and chromatographs. Interestingly, North Macedonia has fewer green competitive products overall, but relatively more green products with a higher revealed comparative advantage (RCA>30), such as air equipment for pollution control and rail transport.

***Green Potential Opportunities (GPO)* provides an indication of green products that each Western Balkan country is not yet competitive in (RCA<1) but might be able to develop competitiveness in the future,** because of their proximity to current capabilities, including skills, know-how, or factors of production.[43] The proximity measure

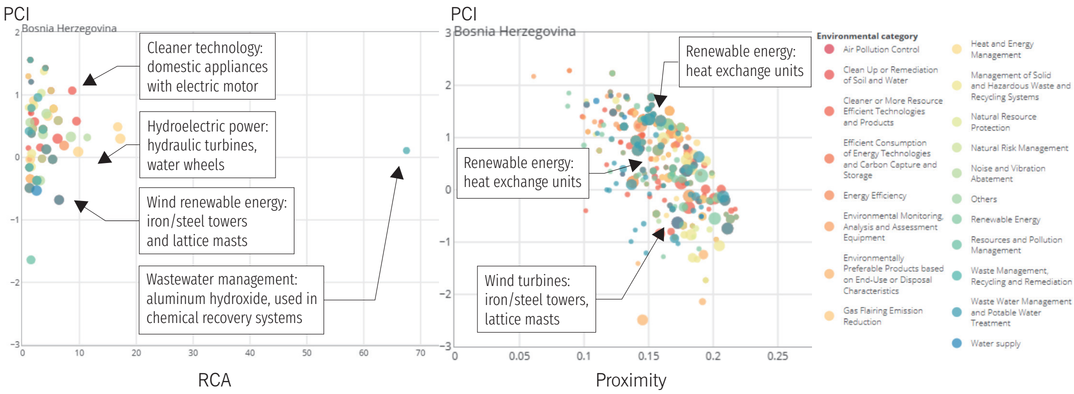
40 https://www.bennettinstitute.cam.ac.uk/media/uploads/files/Economic_Complexity_and_the_Green_Economy.pdf
41 Hidalgo and Hausmann, 2009; Mealy et al 2019.
42 The bubbles represent green products each country is currently competitive in (RCA > 1). The y-axis plots each product's PCI, and the x-axis plots the RCA. Products that have higher RCA values are more competitively exported by the country. Products are colored by the environmental category and sized by the country's current proximity (measuring the product's similarity to the country's current productive capabilities). The data are based on trade values averaged over the 2015-2019 time period.
43 Hidalgo et al 2007; Neffke et al, 2011; Hidalgo et al 2018.

Figure 10.7. Green competitive strengths and potential opportunities in the Western Balkans.

Albania: Green Competitive Strengths… …and Green Potential Opportunities.



Bosnia and Herzegovina: Green Competitive Strengths… …and Green Potential Opportunities.



Montenegro: Green Competitive Strengths… …and Green Potential Opportunities.

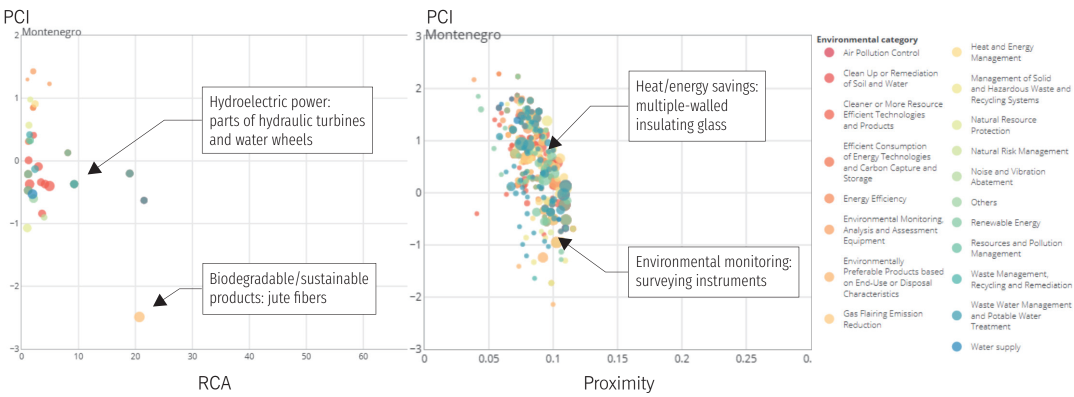
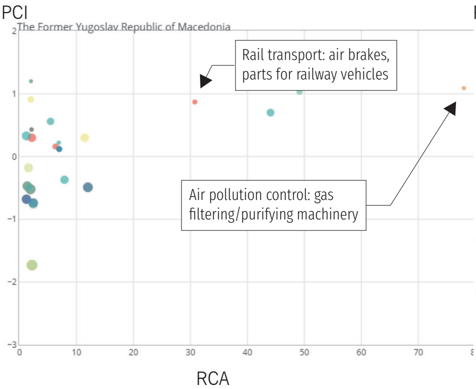
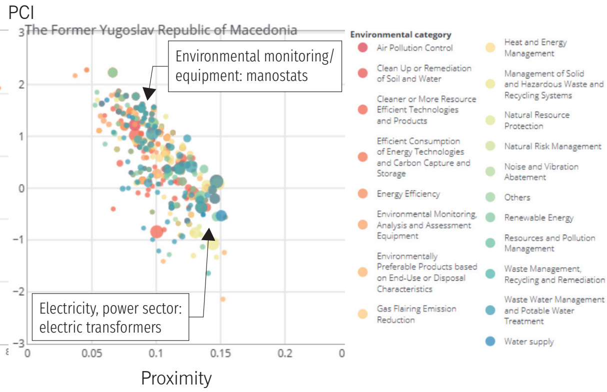


Figure 10.7. Green competitive strengths and potential opportunities in the Western Balkans (continued)

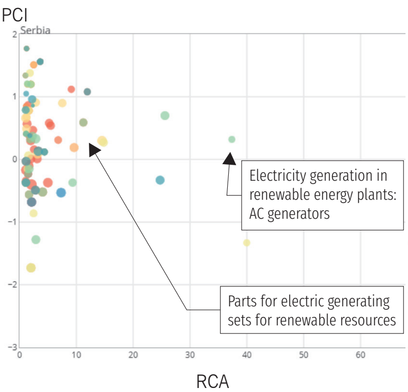
North Macedonia: Green Competitive Strengths…



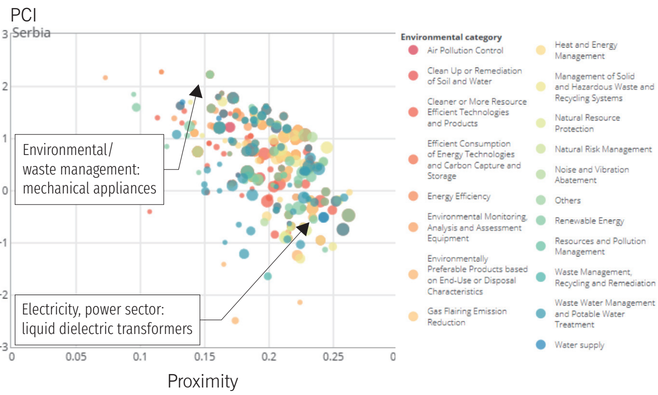
…and Green Potential Opportunities.



Serbia: Green Competitive Strengths…



…and Green Potential Opportunities.



is calculated on the basis of the conditional probability of developing competitiveness in a product, given all the other products a country is currently competitive in. In the GPO figures (Figure 10.7, right-hand panels), the downward slope across all Western Balkan countries indicates that the more proximate green products tend to be less complex.[44] This is a common trend for less developed countries with more limited technological capabilities. In contrast, the same figure for Germany would have a positive slope, with high proximity to high-PCI green products, reflecting its advanced manufacturing base and significant existing expertise in green products. Green potential outlooks for Bosnia and Herzegovina and Serbia look relatively strong, with manufacturing parts for the renewable electricity generation being most proximate to their current production capabilities. Montenegro's current capabilities seem to be furthest from the competitive green and complex products. The potentially competitive green products that are close to current capabilities in Albania have low complexity.

The green competitiveness analysis showed that Western Balkan countries have some competitive strengths in a mix of green and complex products. While Serbia and Bosnia and Herzegovina have stronger revealed comparative advantage in more green complex products than the rest of the Western Balkans, this analysis has highlighted several key green competitive strengths in each country. Looking ahead, new strengths can be developed in the region to take further advantage of the likely rise in demand for products with environmental applications. Although currently brown skills and capabilities dominate, the educated and dynamic population in the region, manufacturing sophistication, and tighter integration with EU green innovation and demand engines create an environment conducive to quick transition to specialization in competitive green and complex products.

This experimental analysis with a new and still evolving tool (Green Transition Navigator) should not be misinterpreted as a call for the government to initiate vertical industrial policies to push specific products. It is, rather, an initial effort to map the existing and potential strengths and weaknesses that should inform the importance and urgency of improving the incentives for the private sector to innovate and develop new green and complex products rather than continue pushing brown products onto increasingly reluctant markets.

Greening growth drivers can be an important incentive for much-needed innovation and productivity-driven growth. It also looks like a condition to stay competitive, especially in the EU market, and expand access to finance and investors.

Policy priorities for a green transition in the Western Balkans

Increasing savings and investments to make growth more sustainable and resilient to external shocks may be a challenge in the aftermath of the COVID-19. The pandemic left countries with the limited fiscal space and

44 The y-axis plots each product's PCI, and the x-axis plots the proximity of each new product to existing capabilities. Products that have higher proximity to the country are likely to be easier for it to transition into in the future. Products are colored by the environmental category and sized by the country's current RCA in them. The data are based on trade values averaged over the 2015–2019 time period.

elevated debt. Therefore, it is essential that the policy incentives attract investors to productive and green fixed assets that are resilient to the risk of climate change and to the impact of low-carbon transition, such as the EU CBAM. Investments in softer assets, such as creative, productive, and healthy citizens; mutual trust, better governance and institutions; and in region's natural endowment will be as important as investments in produced "hard" assets. Such diversification of comprehensive wealth is essential to boost productivity, sustainability, and attractiveness to investors who bring new capabilities, skills, and good jobs.[45]

While the leaders of the Western Balkans made concrete environmental policy commitments in the 2018 Sofia Declaration,[46] the incentives on the ground for firms and consumers are still lagging behind. The Western Balkans will require significant investment, both public and private, foreign and domestic, to unlock growth potential and decarbonize their economies. The demand for green investments is latent rather than effective, however. Policy and institutional incentives still favor "brown" rather than "green" activities. The legacy of the close relationship between the government and fossil-fuel-dependent industrial interest groups and political patronage weakens the institutions needed to navigate green structural transformation. Without reforming policy incentives, economic agents may not be willing to invest in low-carbon technologies, services, and business models and to seek financing for them. Some motivation for greening the private sector is generated by the demand pressure from EU importers and investors who seek low-carbon supply chains, but this is not enough.

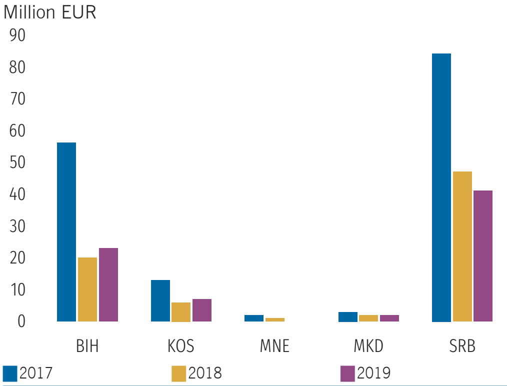
A comprehensive environmental regulatory system that comes with the EU accession provides coherent incentives to facilitate alignment with the multiple dimensions of the EU Green Deal. The EU's environmental legislation consists of about 300 acts: regulations, directives, decisions, and recommendations. They are joined by numerous communications and policy guidelines drawn up by the Commission. Eventually, a full compliance with the acquis is essential for accession, but transitional arrangements are always agreed for new member states.

Before the full compliance with EU environmental acquis, interim incentives will be needed to attract investors in modern green assets and prevent further accumulation of brown assets. Fiscal policy will be central to making green investments attractive in the short term. Together with expected future compliance with EU laws, it would prevent further accumulation of polluting assets. The key will be to correct often distorted prices for energy to ensure that they convey incentives to reduce carbon emissions, and air and water pollution, and enhance the sustainable use of natural resources. The fiscal strategy in some countries, for example, Serbia, includes the goal of lowering the fiscal burden on labor. This opens the opportunity for green fiscal reforms by gradually shifting the tax base from economic goods, like income, to economic "bads", like pollution and wasteful use of resources.

45 Gill et al. 2014; Peszko et al. 2020; World Bank 2021.
46 https://www.consilium.europa.eu/media/34776/sofia-declaration_en.pdf

Scarce fiscal space in many Western Balkan countries is wasted by the simultaneous subsidization of renewable and coal-based electricity. According to the Energy Community Secretariat, direct subsidies to electricity production from coal and lignite in five Western Balkan countries fell significantly between 2017 and 2019, but still cost the public approximately EUR 73 million in 2019.[47] The highest coal subsidies in absolute and per kWh of electricity produced were in Bosnia and Herzegovina and in Serbia[48] (Figure 10.8).

Figure 10.8. Direct subsidies provided to coal/lignite electricity producers in the Western Balkans.



Source: World Bank staff based on Miljević (2020).

Excise taxes on polluting fuels and products provide the most obvious avenue for aligning fiscal incentives with green transition aspirations. Increase of energy tax rates, combined with a reduction of more distortionary payroll taxes, could also improve fiscal efficiency and mobilize resources for a post-COVID-19 recovery in a less disruptive manner. International experience and literature suggest that shifting the tax base from income to fossil fuels can raise domestic revenue in a way that makes growth environmentally sustainable while reducing economic distortions.[49] Collecting excise taxes is easier than income taxes. It would incentivize energy efficiency, clean technology innovation, and facilitate transformation of the Western Balkan countries into modern, complex, resource-efficient and competitive economies. Integrated with explicit taxation of carbon emissions and local pollution, such a fiscal reform would align national tax policy with incentives to implement EU environmental legislation and help negotiate a reduced CBAM and facilitate access to EU markets.

The Western Balkan countries benefit from a template green fiscal reform. In July 2021, the EC announced a legislative proposal to revise the EU Energy Taxation Directive (ETD), 2003/96/EC, with the main objective of aligning the taxation of energy products and electricity with EU energy and climate policies. In the legislative proposal of new ETD published in July 2021, the minimum tax rates were significantly increased, especially for the most carbon-intensive fuels. The rates of diesel taxes were increased to the level of petrol taxes per energy unit (GJ). This translates into a much higher tax rate per liter. Most exceptions, especially for energy and carbon-intensive uses, were eliminated. In the Western Balkans, excise taxes on petrol and diesel in transport and electricity in the region are more or less comparable with the minimum rates of the existing and new Directive, although except in Serbia, the diesel tax per liter is equal to or lower than on petrol, incentivizing the use of

47 Albania does not use coal for electricity generation.
48 Miljević 2020.
49 IMF 2019; Pigato 2019.

Table 10.1. Energy excise taxes in the Western Balkans and selected EU countries compared to proposed ETD tax rates.

	Albania	Bosnia and Herzegovina*	Kosovo	Montenegro	North Macedonia	Serbia	Old ETD	New ETD proposal
Unleaded petrol €/liter	0.301	0.383	0.385	0.549	0.352	0.492	0.359 (10.53 € /GJ)	10.75 € per GJ
Diesel as a motor fuel €/liter	0.301	0.357	0.36	0.44	0.294	0.506	0.330 (8.55 € /GJ)	10.75 € per GJ
Diesel heating (non-business) €/liter	..	0.230	0.36.	0.207	0.102	0.066	0.021 (0.54 € /GJ)	0.9 € per GJ
Natural gas as a motor fuel €/Gj	0.065	0.230	0.150	0	0	0.216	2.6	7.17
Natural gas for heating and electricity (for business) €/Gj	0.065	0.230	0.150	0	0	0	0.15	0.6 €
Natural gas for heating and electricity (for non-business) €/Gj	0.065	0.204	0.150	0	0	0.056	0.3	0.6
Coal and coke (for business) €/Gj	0	0	0	0.3	0	0	0.15	0.9
Coal and coke (for non-business) €/Gj	0	0	0	0.3	0	0	0.3	0.9

Source: World Bank staff calculations, based on data from European Commission Ministries of Finance.
Note: *includes road fees; Gj=gigajoule.

more polluting fuel. Other fuels, especially coal and gas, are not taxed in the region or are taxed at low rates, especially compared to the new high minimum rates proposed in the revised ETD (Table 10.1).

Gradual reforms of energy taxation need to be complemented by explicit carbon pricing. The proposed ETD aligns the relative rates of energy taxes more closely with their climate impact but does not fully reflect the costs of carbon emissions, especially for fuels used for generation of electricity. Without additional carbon pricing the implementation of ETD alone would not be enough to incentivize green transition in the power and heating sector. The ETD is based on the principle that taxation should be levied on end products, regardless of inputs used in their production. If electricity is the end product, then the energy products used as inputs, such as coal or gas are exempt. The exemption is not mandatory, however, and member states may choose to tax both the coal used in a thermal power station and the ensuing electricity for environmental reasons (Article 13).[50] Most member states exempt coal and gas used for power generation because their carbon content is covered by explicit

50 Vasques 2021.

carbon prices under the EU ETS, but during the transition to the EU ETS, the efficient alternative is to gradually increase coal and gas taxes in proportion to their carbon content. So far, Montenegro is the only country in the region with an explicit carbon price. In 2020, the country adopted legislation on an Emissions Trading System (ETS) to smooth the transition of combustion installations to the EU ETS. The allowance prices will equal the average price of EU allowance prices from the previous year with a minimum price of EUR 24 per ton of CO_2. There are large benefits for Western Balkan countries of acting regionally in harmonizing energy and carbon prices with EU. Doing so would help address the risk of carbon leakage and tax competition within the region if energy and carbon taxes differ significantly between individual Western Balkan countries connected by the same power grid.

Some Western Balkan countries apply fiscal instruments, such as taxes and fees, to manage local pollutants of air and water and to encourage circularity of products and materials that are harmful as waste, such as plastics. An initial review of current practices, conducted by the World Bank, identified opportunities to significantly improve design of these instruments to make them more effective and raise more revenues. This includes aligning their incentive effect with the "polluter pays" principle, improving administrative efficiency of tax collection, reducing distortionary impact on business, and mitigating regressive burden on households.

To enable a green transition, public expenditure and EU financing will play an important role. The EU's Economic and Investment Plan will not be enough to deliver the green transition. The challenge will be to rebalance public spending from brown to green economic activities and redefine the role of a state from the system of patronage to infrastructure provider, market regulator, and guarantor of a level playing field among economic agents. Future competitive position of the Western Balkans in the integrated EU market will depend on early innovation and entry of new disruptive firms. In line with EU state aid rules, public finances will increasingly need to reduce the effect of crowding-out private finance and leverage private investments and financing. There is considerable room for more efficient and effective use of public environmental expenditures in line with the international good practice.[51]

A green energy transition will be challenging socially and politically, and stranded assets will have to be managed. Accelerated retirement of coal power plants and closure of coal mines is a task facing all Western Balkan countries except Albania. The costs of stranded assets will need to be transparently and fairly allocated between asset owners and the public. Workers and communities depending on coal mining and coal-intensive industries will need to be assisted in making a smooth transition to new and green jobs. The government's role in the transition process needs to be multifaceted and proactive. A well-planned and systematic process of coal mine closure and layoffs is essential for supporting the reallocation of affected workers to alternative jobs and at the

51 E.g. OECD. 2021. Recommendation of the Council on Good Practices for Public Environmental Expenditure Management. OECD/LEGAL/0345 https://legalinstruments.oecd.org/public/doc/175/175.en.pdf

same time mitigating the economic, social, and political costs of transition. Governments do not have to deliver everything themselves, but they do need to provide strategic direction and leadership, coordinate across stakeholders, arbitrate competing interests, and provide adequate financing that represents an investment in transition.[52] The green transition in the Western Balkans is manageable, if incentives are aligned, social, distributional and political economy issues are addressed, and the costs of stranded assets is smoothed over time and allocated without creating systemic risks or large contingent fiscal liabilities. Financing can play a pivotal role in navigating green transition. The region has access to facilities like the Economic and Investment Plan for the Western Balkans, providing EUR 9 billion between 2021 and 2027, or the Western Balkans Investment Framework, as well as long-term financing provided by financial and capital markets and multilateral financial institutions.

Aligning the growth strategy of the Western Balkan countries with the European Green Deal is an investment in igniting a completely new growth strategy—more productive, sustainable, inclusive, and resilient to external shocks. This is no longer about making mainstream growth more environmentally friendly. It is about putting the core of the economy on a green and sustainable track. Many of the key fault lines and key structural barriers that were holding back growth across the economies of the Western Balkans before the crisis have become even more apparent today. These include not just the challenge of re-orienting the growth model from brown to green investments, but longstanding barriers to private sector job creation such as human capital weaknesses; governance challenges; and regulatory barriers to the flow of goods, services, and ideas. If ever there was a time to prioritize reforms to stimulate growth and investment, then this is it. And if ever there was a time to make the structural change away from a business-as-usual, unsustainable, brown development path toward a greener future, then now is the time.

52 Bulmer et sl. 2021.

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Country Notes

Albania

- Albania's economic recovery in 2021 is stronger than anticipated, as travel, construction, and extractives bounced back and private investment, consumption, and public spending surged.
- Macroeconomic policies have supported the recovery, although higher public spending has led to a further rise in the debt-to-GDP ratio.
- Employment and labor force participation recovery was slower and real wages are increasing.
- Economic uncertainty remains high as COVID-19 cases are increasing again amidst low vaccination rates.

Recent Economic Developments

Growth has rebounded in 2021, after the pandemic hit the Albanian economy hard. GDP in 2020 fell by 4 percent, and the government incurred additional public debt to mitigate the economic losses through increased spending. Growth rebounded by 5.5 percent in the first quarter (Q1) of 2021. Although most sectors experienced economic recovery, energy and construction contributed the most, by 1.7 and 1.1 percentage points, respectively, the latter partly related to reconstruction efforts following the 2019 earthquake. Among services, only trade remained subdued. Business sentiment indicators, an increase in construction permits issued, and growth in foreign trade and fiscal revenues suggest the rising growth trajectory is likely to continue in Q2. Tourist arrivals for the first seven months of 2021 were only slightly lower than those during the same period in 2019, suggesting a strong rebound of tourism in the summer months.

Increased vaccination rollout, remittances, credit growth, and recovery in the economic activity in trading partners boosted consumer and business sentiment and domestic demand, which expanded by 4.8 percent year-on-year (YOY) in Q1 2021. Investments contributed the most, expanding by 21.1 percent, and public consumption grew by 5.2 percent YOY. Private consumption, while recovering, is still below its pre-pandemic level and in line with the slower recovery in the labor markets. For 2021, GDP is projected to increase by 7.2 percent.

The labor market started its recovery in Q2. As of Q1 2021, the labor market, continued to shrink in terms of employment and labor force participation, largely due to employment in agriculture. Employment increased marginally by 1.1 percent in Q2 due to employment in construction and manufacturing, while agriculture continued to shrink. Labor force participation also increased, by 1 percent; around 34,000 workers left the labor force in Q2 2021 compared to a pre-pandemic Q2 2019. The unemployment rate declined to 11.6 percent from 11.9 percent in the same quarter of 2020. Formal real wages rose by 2.9 percent in Q2 2021, partially because of an increase in the minimum wage.

Inflationary pressures have started to build up. Supply-side shocks, increased inflation in trading partners, and demand expansion drove an increase of average inflation of 1.8 percent in Q2 from 0.9 percent in Q1. Food and oil prices contributed the most. With employment yet to recover, domestic pressures remain subdued[53] but are expected to intensify with the expansion of demand and continuing monetary and fiscal stimuli. While inflation is picking up, inflation expectations are still anchored, hence, monetary policy continued to support demand through keeping the policy rate at its historical minimum. Low liquidity risk premia in the domestic financial market ensured a smooth transition of the monetary stimulus into lower interest in the money market, government securities, and credit to the private sector. Consumer mortgages and investment loans for businesses led an expansion of credit to the private sector by 7.7 percent YOY by June 2021.

Despite higher revenues, the fiscal deficit remains elevated. Budget revenues in H1 2021 were 20.1 percent higher YOY and 3.6 percent above the same period in 2019. To a large extent, this increase reflects a statistical base effect, as the second quarter of 2020 marked the peak of restrictions on movement and economic activity. The increase in excise goods imports and, to a lesser extent, the increase of commodity prices, has also affected value-added tax (VAT) revenues, which contributed 5.2 percentage points to total revenue growth. The deficit for the first half of the year was 25 percent lower than the same period in 2020. The government also reduced VAT reimbursement arrears of 10 billion lek.[54] An increase in revenue collection and new debt allowed the government to increase spending. Through a normative act, in July 2021, the government temporary suspended the fiscal rule of a declining debt to GDP specified in the Organic Budget Law, and postponed the target of reaching a positive primary balance to 2024.[55]

Public debt is set to rise again. The government successfully met its financing needs by issuing Eurobonds in 2020, which increased debt[56] to a new high of 78.6 percent of GDP. At the same time, the country's buffers remain low in case of a new pandemic wave. In the absence of fiscal consolidation, refinancing risks could arise if external financial market demand tightens and interest rates increase.

External imbalances narrowed in the first half of 2021. Inflows from remittances and a surplus in trade of services compensated the higher demand for imported goods, a reflection of increasing investment and consumption. The current account narrowed by 9.6 percent in the first half of the year. Remittances grew by 24.4 percent YOY. Foreign direct investment (FDI) declined slightly, by 1.7 percent, but the tendency was upward in Q2, particularly in hydrocarbons. The stock of reserves, estimated to cover 8.4 months of imports, further increased in August as the International Monetary Fund released EUR160.7 million in Special Drawing Rights to the country's reserves.

Outlook and Risks

The strong projected growth rebound to 7.2 percent in 2021 is subject to a smooth vaccination rollout, no further lockdowns, and continued recovery in services, led by

53 Core inflation stood at a stable 1.4 percent.
54 VAT arrears reimbursement net out gross revenues and are not recorded as a separate item in the government accounts.
55 The fiscal rule includes an escape clause in the case of an emergency, which applied in 2020.
56 Includes arrears to the private sector.

tourism, and construction. Over the medium term, private consumption is projected to become again the primary driver of GDP growth. Private investment could provide further support to growth if business climate reforms are implemented. Meanwhile, the current account deficit is expected to expand to 9.4 percent of GDP, as high infrastructure investment demand brings imports growth to 29 percent in 2021. With exports bouncing back, the current account deficit should gradually shrink to 7.0 percent by 2023. Service exports, including tourism and fast-expanding business process operations, should narrow the current acount deficit over the medium term.

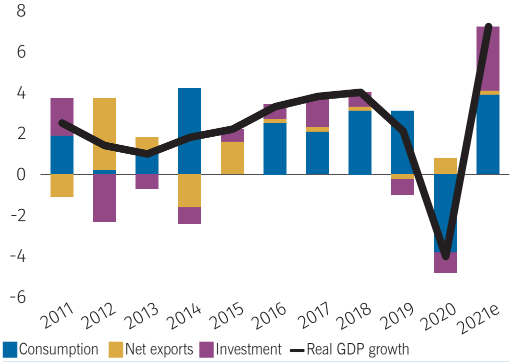
Strong growth is expected to help boost public revenues to 27.4 percent of GDP during 2022–25. Beyond 2021, spending will likely be constrained by limited fiscal space, as public debt is projected to increase to 78.6 percent of GDP in 2021, before declining gradually over the medium term.

However, economic prospects remain uncertain as daily cases have started increasing again. Further, by August 2021, the vaccination rate stood at only around 20 percent. If reinstated, new containment measures would delay the recovery of activity and employment, especially in services and manufacturing.

Fiscal space could further deteriorate in such a downside growth scenario and in the absence of strengthened revenue collection. In this scenario, the government may need to cut capital spending to prevent an increase of the debt-to-GDP ratio. Moreover, with more reliance on external financing, exchange rate, interest rate, and refinancing risks remain elevated. A key medium-term reform priority is to boost revenue collection and achieve fiscal consolidation while creating space for growth-enhancing spending.

Economic activity is expected to rebound in 2021.

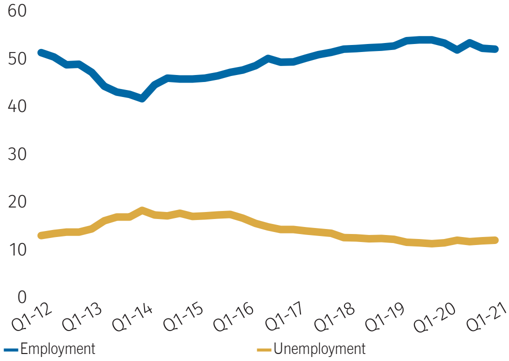
Contributions to growth, percent



Source: INSTAT and World Bank staff calculations.

The labor market is yet to recover.

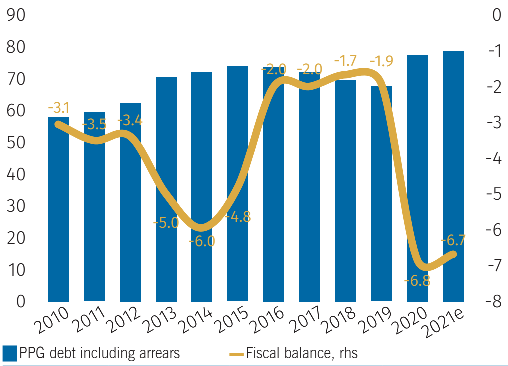
Percent



Source: INSTAT.

Strong fiscal stimulus was used to support the economy, but at the cost of increasing public debt.

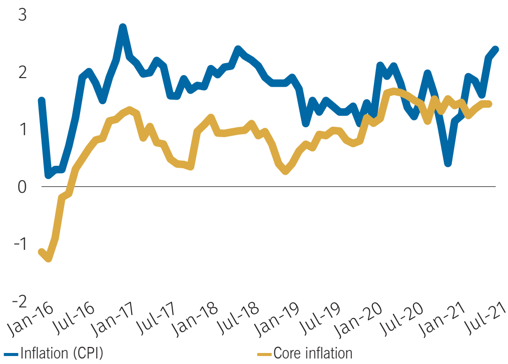
Percent of GDP



Source: INSTAT, MoFE and World Bank staff calculations.

Inflationary pressures are building up.

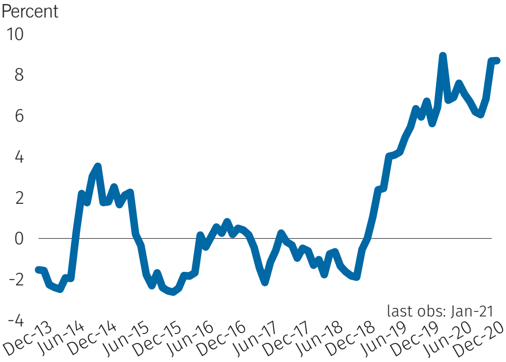
Percent



Source: Bank of Albania; World Bank staff calculations.

Credit growth supported demand expansion.

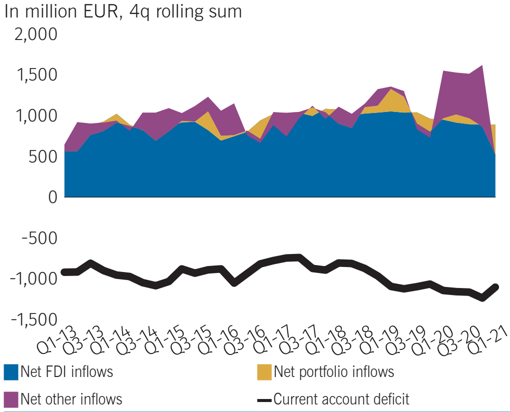
Percent



Source: Bank of Albania; World Bank staff calculations.

The current account deficit narrowed and was partially financed by FDI and government borrowing.

In million EUR, 4q rolling sum



Source: Bank of Albania; World Bank staff calculations.

ALBANIA	2018	2019	2020	2021e	2022f	2023f
Real GDP growth (percent)	4.1	2.2	-4.0	7.2	3.8	3.7
Composition (percentage points):						
Consumption	3.1	2.5	-3.8	3.9	1.9	2.7
Investment	0.7	-0.9	-1.0	3.1	-0.4	0.5
Net exports	0.2	0.6	0.8	0.2	2.3	0.5
Exports	1.4	2.0	-8.6	6.6	3.9	2.1
Imports (-)	1.1	1.4	-9.4	6.4	1.6	1.6
Consumer price inflation (percent, period average)	2.1	1.4	1.6	2.4	2.8	3.0
Public revenues (percent of GDP)	27.5	27.2	26.3	27.8	27.4	27.4
Public expenditures (percent of GDP)	29.2	29.2	33.2	34.4	30.2	30.4
Of which:						
Wage bill (percent of GDP)	4.5	4.6	4.8	5.0	4.5	4.4
Social benefits (percent of GDP)	11.6	11.9	12.9	12.6	12.0	11.8
Capital expenditures (percent of GDP)	4.8	4.5	6.3	7.5	5.6	5.1
Fiscal balance (percent of GDP)	-1.7	-1.9	-6.8	-6.7	-2.8	-3.0
Primary fiscal balance (percent of GDP)	0.5	0.1	-4.7	-4.6	-0.7	-0.6
Public debt (percent of GDP)	64.9	63.7	75.1	75.4	74.9	73.1
Public and publicly guaranteed debt (percent of GDP)	69.5	67.4	77.2	78.6	76.7	74.9
Of which: External (percent of GDP)	30.4	29.1	35.9	38.6	35.3	32.4
Goods exports (percent of GDP)	7.7	6.6	6.1	7.6	7.5	7.5
Goods imports (percent of GDP)	30.1	29.7	28.9	33.9	33.5	33.1
Net services exports (percent of GDP)	8.7	9.3	8.1	10.6	13.0	13.6
Trade balance (percent of GDP)	-13.7	-13.8	-14.7	-15.7	-13.0	-12.0
Net remittance inflows (percent of GDP)	5.2	5.2	5.1	4.7	4.7	4.7
Current account balance (percent of GDP)	-6.8	-8.0	-8.8	-9.4	-8.1	-7.0
Net foreign direct investment inflows (percent of GDP)	8.0	7.6	6.8	6.6	7.4	7.0
External debt (percent of GDP)	65.2	60.5	64.7	59.3	53.9	52.9
Real private credit growth (percent, period average)	-3.0	1.5	5.2	—	—	—
Nonperforming loans (percent of gross loans, end of period)	11.1	8.4	8.1	—	—	—
Unemployment rate (percent, period average)	12.3	11.5	11.7	—	—	—
Youth unemployment rate (percent, period average)	23.1	21.5	20.9	—	—	—
Labor force participation rate (percent, period average)	59.4	60.4	59.5	—	—	—
GDP per capita, PPP (current international $)	15,101	15,433	14,816	—	—	—
Poverty rate (percent of population)	32.4	31.8	32.6	30.8	29.3	—

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. Poverty rate calculations based on ECAPOV harmonization using SILC-C data. Nowcasted/projected values start at 2019. Income measures in the SILC and consumption measures in the HBS are not strictly comparable. Poverty is defined as living on less than $5.5/day per person in revised 2011 PPPs.

Bosnia and Herzegovina

- Real GDP contracted 3.2 percent in Bosnia and Herzegovina in 2020 and rebounded by 1.5 percent in the first quarter (Q1) of 2021 driven by a surge in exports and robust growth in final consumption.
- While a full recovery to the 2019 real income level is expected in 2021, the economy is unlikely to catch up with the pre-pandemic growth trajectory unless political bottlenecks are resolved.
- After several years of budgetary consolidation and running surpluses, fiscal deficits are expected until 2023. Public debt is on an upward trajectory.
- Medium-term prospects are mixed. External risks include a slower-than-expected recovery in the European Union (EU), while domestic risks include a prolonged paralysis in governing and, together with upcoming general elections in 2022, is likely to prevent the implementation of much-needed structural reforms.

Recent Economic Developments

The economy rebounded in 2021 on the back of higher consumption and external demand recovery. According to the latest official estimates, real GDP growth contracted 3.2 percent in 2020 compared to the previously published 4.3 percent as manufacturing, wholesale, and retail trade declined less than initially estimated. On the demand side, a larger compression of imports than exports in 2020 helped soften the sharp decline in household consumption and plummeting investments that resulted from the lockdown during the pandemic, but also from political deadlock. Nevertheless, real GDP grew an estimated 1.5 percent in Q1 of 2021 (year-on-year [YOY]) driven by a pickup in private and public consumption and a surge in exports of goods. The surge in exports of goods was caused by higher external demand triggered by a rebound in industrial production in Croatia, Italy, and Serbia, which in turn accelerated growth in manufacturing and production of consumer durables. The increase in private consumption, meanwhile, could be attributed to a combination of pent-up demand including e-commerce, and higher lending to households.

Stronger household consumption and higher international oil prices lifted headline inflation to 1.9 percent in July (YOY). Last year, deflation of 1.1 percent was mainly driven by a drop in the prices of clothes and transportation as oil prices collapsed during the pandemic. However, the strong rebound in transportation prices since April 2021 reflects spillovers from the recovery in international oil prices as the price of Brent oil rose from a low of US$18 in April 2020 to US$75 in July 2021. Together with robust household consumption, the change in food prices also picked up pace since January, resulting in higher headline inflation of 0.4 percent during January–July 2021 compared to -0.7 percent during the same period last year. However, adjusting for food, energy, and administratively regulated prices, as well a tobacco prices, core inflation totaled -0.8 percent YOY during January–July 2021.

The fiscal imbalance continues in 2021. A slump in revenues and higher current spending led to a fiscal deficit of an estimated of 1.8 percent of GDP in 2020, after a surplus of close to 2 percent of GDP the year before.[57] This fiscal shortfall stands in sharp contrast to the authorities' planned deficit of 5.4 percent of GDP in 2020, envisaged to result from measures counteracting the economic impact of the pandemic, in the form of paying minimum wages and contributions to workers in companies severely affected by the pandemic, and from spending through special fiscal funds to stabilize the economy. Instead, current spending declined by 2 percent nominally in 2020 compared to the growth of almost 11 percent in 2019. Thus, the fiscal response to the crisis in 2020 was more pronounced on the revenue side than spending. The fragmented institutions led to inefficiencies and delays in implementation, resulting in the slow release of funds. In 2020, tax revenues fell 7.5 percent in nominal terms, the result not only of a sharp decline in indirect taxes, but also due to deferred tax payments. In 2021, the rebound in economic activity led to an estimated rise in revenues of 3.8 percent (YOY), while delayed spending implementation from 2020 led to total spending increasing 4.5 percent, largely on account of higher public wages and higher social benefits.

The pandemic interrupted the ongoing fiscal consolidation that placed the public debt trajectory on a declining trend. Public debt declined from 42.4 percent of GDP in 2016 to 32.8 percent of GDP at the end of 2019, yet it increased to 37 percent of GDP at the end of 2020, of which roughly four-fifths represents external public debt.

Despite increased economic activity and rising oil prices, the current account deficit narrowed to 1.2 percent of GDP in the first quarter of 2021 compared to 3.2 percent of GDP during the same period last year. In 2020, despite the collapse in investment and decline in household consumption due to COVID-19 that reduced imports more than exports, the current account deficit slightly increased to an estimated 3.3 percent of GDP from 3.2 percent in 2019. The acceleration in exports totaling almost 17 percent during January–March 2021 reflects higher external demand for base metals, machinery, and furniture. In the meantime, imports grew just below 3 percent, which reduced the merchandise trade deficit to 16 percent of GDP in the first quarter of 2021 compared to 20 percent during the same period last year. This reduction in the merchandise deficit accounts for the narrowing of the external shortfall as the services and income surpluses remained robust, at 3.4 percent and 9.7 percent of GDP, respectively. Adjusted for capital transfers, the external shortfall amounted to 0.6 percent of GDP, which was financed by non-debt-creating foreign direct investment inflows (that is, equity and reinvested earnings).

Outlook and Risks

Medium-term prospects are mixed. In the short term, the outlook is positive with real GDP set to expand by 4 percent in 2021. Over the medium term, however, these prospects are dampened by an expectation of growth deceleration to around 3 percent in 2022 and 2023. The shape of the growth trajectory will in part depend on the authorities' success in accelerating the share of the vaccinated adult

57 BiH Global Fiscal Framework for 2022–2024.

population, which currently stands at around 27 percent, while the number of infections is on the rise again. If the health situation does not deteriorate significantly over the next few months, the policy focus could shift to addressing priorities for EU accession and, thus, implementation of the Socio-Economic Program[58], which in turn would allow for more prominent growth over the next few years. In this context, announced investments in energy and infrastructure could solidify a sharper increase in economic activity, supported by a further pickup in private consumption fueled by remittances, a tightening labor market, and domestic lending. Intensified trade with neighbors could keep merchandise export growth rates elevated and, together with a full recovery of travel income and remittances, allow for a current account deficit in the range of 0.5 to 2 percent of GDP over the medium term, which is significantly below the pre-pandemic level of above 3 percent of GDP.

Low investment rates in Bosnia and Herzegovina resulted in per capita GDP hovering around one-third of the EU27 average, a gap significantly larger than other peers in the Western Balkans, such as Montenegro, North Macedonia, and Serbia. Reducing this income gap will be challenging given the overall health situation and, more importantly, the political deadlock, which is fueled by the current policy paralysis of the presidency and council of ministers, and the upcoming parliamentary elections expected to take place in the second half of 2022. As a consequence of the political stalemate, the country may not join the World Trade Organization in November 2021, as initially planned, the central bank board has not been approved, and some other economic measures, such as reducing social contributions, are on hold. While a full recovery to the 2019 real income level is expected in 2021, the country is unlikely to catch up with the pre-pandemic growth trajectory unless political bottlenecks are addressed soon. A full and timely implementation of the Socio-Economic Program would allow for a more rapid convergence to the EU27 average.

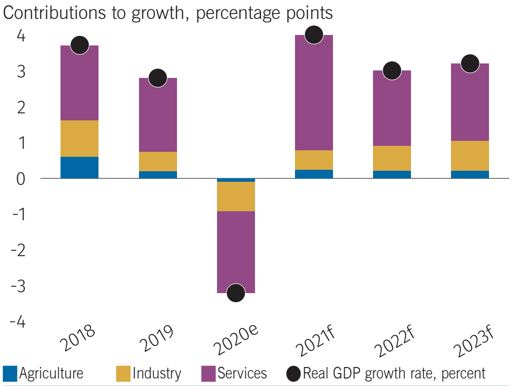
The implementation lag of spending measures approved in 2020 will spill over into 2021 and lift the fiscal deficit to around 3 percent of GDP. The combination of a partial recovery in tax revenues, which are projected to grow by around 2.5 percent in 2021 after dropping by 7.5 percent in 2020, and higher spending on goods and services, the wage bill, and capital expenditures, will broaden the overall fiscal deficit in 2021. Financing from international financial *institutions*, especially the allocation of US$300 million in Special Drawing Rights from the International Monetary Fund, will help meet the larger gross financing need.

As the economy rebounds in 2021, improvements in labor market participation and employment will remain key for growth to translate into poverty reduction. Addressing bottlenecks causing persistent long-term unemployment, such as enhancing formal labor market participation, especially for women, and reducing skills mismatches for youth, will be key. Institutional and governance reforms remain important challenges on the country's development path and road to EU membership.

58 The country's medium-term development plan adopted in January 2020 to tackle key structural reforms and respond to EU accession priorities.

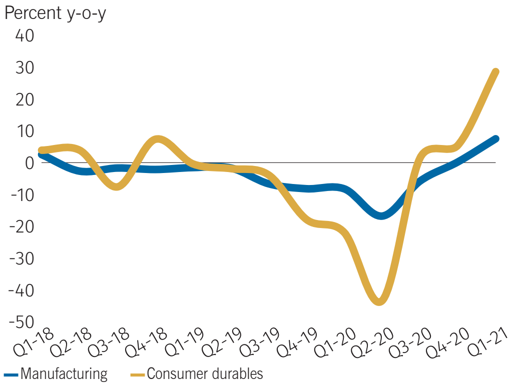
Several risks dominate the outlook. First, a prolonged adverse impact of the pandemic domestically could adversely affect growth in consumption and investment; and second, a prolonged adverse impact of the pandemic in the region or the reintroduction of movement controls if vaccination slows or the vaccine proves ineffective against new variants could dampen external demand for the country's exports. In both cases, this could place Bosnia and Herzegovina on a lower growth trajectory over the medium term. Finally, the current political deadlock could be further amplified in the pre-election period, adversely affecting implementation of the adopted socioeconomic program needed to address the country's development challenges and pave the way for EU accession.

Growth rebounded in 2021 as services and industrial production recovered.



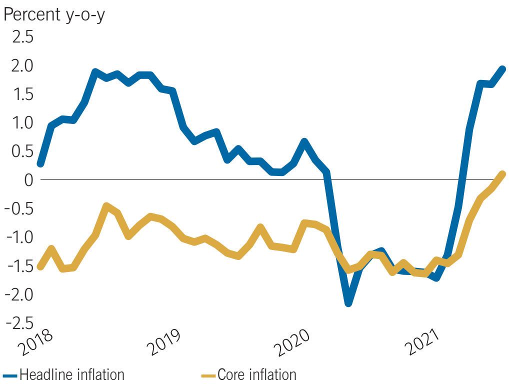
Source: BiH Agency for Statistics and World Bank staff estimates.

The rebound in industrial production was led by manufacturing and consumer durables.



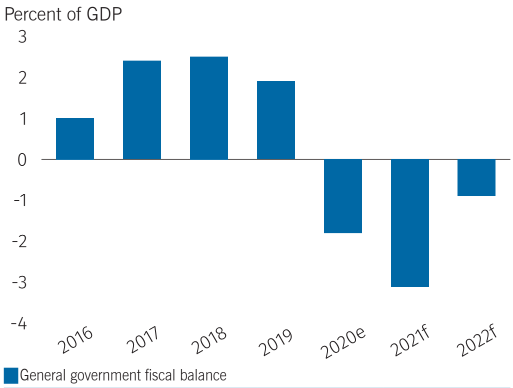
Source: BiH Agency for Statistics.

Inflationary pressures increased.



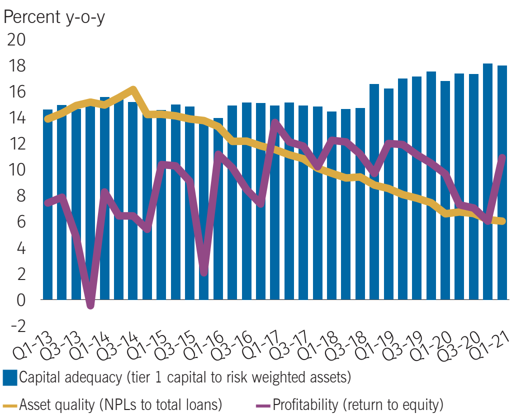
Source: BiH Agency for Statistics.

Fiscal imbalances will likely persist until 2022.



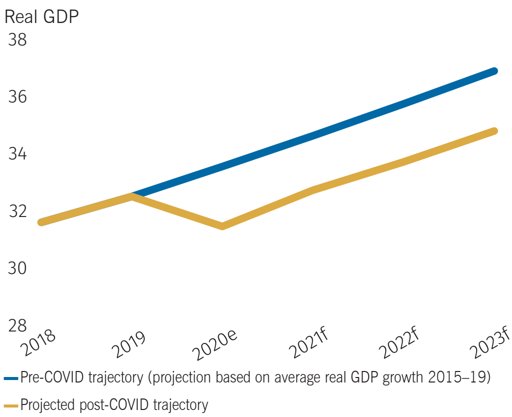
Source: Fiscal authoritie and World Bank staff estimates.

Nonperforming loans in commercial bank portfolios remain high but are on a downward trend.



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

Unless the political deadlock is resolved, the country will remain on a permanently lower growth trajectory.



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

BOSNIA AND HERZEGOVINA	2018	2019	2020	2021e	2022f	2023f
Real GDP growth (percent)	3.7	2.8	-3.2	4.0	3.0	3.2
Composition (percentage points):						
Consumption	—	—	—	4.5	2.8	3.0
Investment	—	—	—	-2.5	-0.6	0.8
Net exports	—	—	—	1.9	0.7	-0.6
Exports	—	—	—	10.1	4.0	3.3
Imports (-)	—	—	—	8.1	3.2	3.9
Consumer price inflation (percent, period average)	1.4	0.6	-1.1	-0.2	0.5	0.7
Public revenues (percent of GDP)	42.7	43.0	42.2	41.2	41.8	42.0
Public expenditures (percent of GDP)	40.2	41.1	44.0	44.3	42.7	41.6
Of which:						
Wage bill (percent of GDP)	10.2	10.9	11.5	11.5	11.4	11.1
Social benefits (percent of GDP)	17.8	18.1	20.0	19.4	18.9	18.8
Capital expenditures (percent of GDP)	2.8	3.1	3.2	3.7	3.1	2.7
Fiscal balance (percent of GDP)	2.5	1.9	-1.8	-3.1	-0.9	0.4
Primary fiscal balance (percent of GDP)	3.2	2.6	-1.1	-2.3	0.0	1.2
Public debt (percent of GDP)	34.2	32.8	36.6	35.8	35.9	37.2
Public and publicly guaranteed debt (percent of GDP)	35.6	34.5	38.8	38.0	38.1	39.1
Of which: External (percent of GDP)	29.9	28.4	30.8	30.0	29.8	30.6
Goods exports (percent of GDP)	31.2	28.8	27.5	33.6	35.4	36.5
Goods imports (percent of GDP)	53.6	51.4	45.9	52.3	53.6	55.9
Net services exports (percent of GDP)	7.8	7.8	4.0	5.9	6.9	7.6
Trade balance (percent of GDP)	-14.7	-14.7	-14.5	-12.7	-11.3	-11.7
Net remittance inflows (percent of GDP)	8.5	8.4	7.4	7.7	7.6	7.5
Current account balance (percent of GDP)	-3.5	-3.2	-3.3	-2.0	-0.6	-1.1
Foreign direct investment inflows (percent of GDP)	3.0	2.0	1.9	2.0	2.1	2.2
External debt (percent of GDP)	66.8	64.1	71.6	70.0	70.3	70.5
Real private credit growth (percent, period average)	5.1	5.2	1.3	—	—	—
Nonperforming loans (percent of gross loans, end of period)	8.8	7.4	6.1	—	—	—
Unemployment rate (percent, period average)	18.4	15.7	15.9	—	—	—
Youth unemployment rate (percent, period average)	38.8	33.8	36.6	—	—	—
Labor force participation rate (percent, period average)	42.1	42.1	47.7	—	—	—
GDP per capita, PPP (current international $)	13,200	13,775	13,424	14,100	14,700	15,250

Sources: Country authorities, World Bank estimates and projections.

Kosovo

- Kosovo's economy is recovering rapidly from the COVID-19 pandemic, with output in 2021 expected to exceed 2019 levels by year-end, but risks to the outlook remain high as the country continues to grapple with the pandemic.
- Economic activity in 2021 is expected to expand by 7.1 percent on the back of a stronger-than-expected rebound in diaspora visits, restored consumer confidence, and higher consumer lending. Exports of merchandise continued their expansion and gradual diversification from 2020.
- However, significant inflationary pressures, primarily from higher import prices, may undermine a stronger recovery in private investment.
- Public revenue is experiencing an unprecedented rebound due to higher economic activity, but also due to higher inflation and tax compliance measures. As a result, and against sluggish public investment execution, the fiscal deficit is expected to decrease in 2021.
- Management of the fourth wave of the pandemic, including through accelerating vaccinations, remains a priority in the near term. In the medium term, Kosovo needs to transition to a more productivity-oriented growth model.

Recent Economic Developments

Kosovo is experiencing a much faster recovery than previously expected. After merely returning to positive territory during the last quarter of 2020, growth gained momentum during the first quarter (Q1) of 2021, reaching 5.6 percent.[59] Firm sales and trade flows until July 2021 exceeded 2019 levels, suggesting a further acceleration in growth for the remainder of the year. As vaccinations hasten in Europe and Kosovo, economic activity is now projected to expand by 7.1 percent in 2021, up by 3.1 percentage points from the spring forecast. Exports and private consumption are expected to provide the highest contribution to growth. Private investment is also expected to add to growth. On the production side, services continue to be the main driver of growth, while the contribution of agriculture remains limited.

The key driver behind a faster recovery is the rebound in diaspora visits that fuel Kosovo's service exports and informal remittances. Exports of services exceeded 2019 levels by June 2021, and by year-end are estimated to exceed 2019 levels by 9.5 percent. Exports of merchandise goods have also maintained a strong pace of growth, but their share of total output remains relatively low at 8.4 percent.

Limited restrictions on economic activity, fiscal support measures, and strong credit growth have bolstered private consumption. Limited containment measures until end-August 2021 enabled the uninterrupted resumption of economic activity and, despite significant delays, improved access to vaccines have enhanced firm and consumer confidence. In addition to social transfers and targeted wage subsidies, the allowed withdrawal of a fraction of pension savings from end-2020,

59 All comparisons are year-on-year unless otherwise stated.

amounting to almost 3 percent of GDP, is likely to have boosted private consumption, especially during the Q1 of 2021. Significant growth in household credit, which reached 16.2 percent by July 2021, also bolstered private consumption.

The recovery has been accompanied by gains in formal employment. According to the Kosovo Pensions Savings Trust, the average quarterly number of active pension contributors increased by 13.6 percent during Q2, indicating an increase of about 40,000 in the number of formal jobs compared to the same period in both 2020 and 2019. At the same time, the average quarterly number of registered jobseekers also dropped significantly—by more than 30 percent compared to the same period in 2020. However, it is still higher than in the same period of 2019.

Inflationary pressures heightened significantly during 2021, in line with global trends, creating challenges for private investment. Consumer price inflation, driven primarily by higher import prices, is expected to reach an annual average of close to 3.5 percent in 2021. Import prices increased by 2.5 percent in Q1 and 7.7 percent in Q2 and are expected to accelerate during the rest of the year, mostly driven by commodity imports. Production prices also increased, followed with a marked increase in the construction price index (17 percent during the Q2 of 2021), driven by higher commodity prices and wages. Construction comprises almost 60 percent of private investment activity[60] in Kosovo.

Exports are recovering rapidly in 2021. Imports are expected to increase by over 30 percent in 2021 to meet the rebound in consumption, exports, and investment, with exports of merchandise increasing by 35 percent. Though growth in exports is expected to outpace the rebound in imports, as imports grow from a higher base, current account deficit is projected to reach 8.5 percent of GDP, up from 7 percent in 2020. At the same time, foreign direct investment, driven by higher dividend repatriation, is expected to drop from 4.1 to 3.8 percent of GDP.

The fiscal deficit is expected to narrow significantly in the context of a strong public revenue performance and sluggish public investment. Public revenues are expected to increase by almost 24 percent in 2021, thanks to a considerable increase in firm turnover and the strong rebound in imports. By end-August 2021, public revenue collection increased by more than 30 percent, with the highest contribution from the value-added and excise taxes and is likely to exceed current budget projections. In addition to the expansion in economic activity, heightened inflation, intensified tax debt collection, and some formalization incentivized by fiscal stimulus measures have also added to revenue growth. The government has announced an ambitious Economic Revival Package amounting to 5.7 percent of GDP, mostly consisting of current expenditures, which is expected to be implemented during 2021 and 2022. Public expenditure is expected to decrease by 1.8 percent compared to 2020, driven mainly by public investment underspending. The fiscal deficit is estimated at 0.9 percent of GDP; a

60 According to Firm Investment Statistics, Kosovo Statistics Agency.

significant drop from last year, and lower than the level planned with the 2021 budget. Public and publicly guaranteed debt is expected to increase from 22.4 percent of GDP in 2020 to 23.2 percent in 2021. Thanks to good revenue performance, domestic debt accumulation will slowdown and fiscal buffers are expected to accumulate.

The financial sector is experiencing strong credit and deposit growth. Credit growth until July 2021 reached 12 percent, with credit to households increasing by 16.2 percent. Deposits increased by 14.5 percent for the same period, with deposits of other nonfinancial corporations increasing by 31.7 percent. Capital adequacy remained above regulatory requirements until July, while nonperforming loans hovered between 2.5 and 2.7 percent from January to July 2021, according to the Central Bank. The Kosovo Credit Guarantee Fund continued to expand its coverage, including through government-subsidized guarantee fees. Its capital is expected to be further bolstered by government grants.

Outlook and Risks

Kosovo is expected to grow over 4 percent in the medium term, contingent on the global course of the pandemic and its successful management. Although growth is expected to decelerate in 2022 from the peak in 2021 of 7.1 percent, over the medium term, growth rate will stabilize at its potential of 4 percent. Given the level reached in 2021, service exports are expected to increase, but at a slower pace. At the same time, with international prices stabilizing in the medium term, Kosovo's commodity exports will also experience slower growth, but maintain the gains experienced over the past two years. Private investment, and public investment, in particular, are expected to pick up and make a higher contribution to growth alongside consumption. Credit growth is projected to continue supporting private consumption increases. Against this backdrop, imports are projected to rise further; hence, the current account balance is expected to deteriorate. Net exports, in line with pre-pandemic trends, are expected to subtract from growth. Remittances are projected to maintain their increase in nominal value and will continue be the main source of financing for the trade deficit. Inflationary pressures are projected to subside, with consumer inflation stabilizing at an average of 1.8 percent.

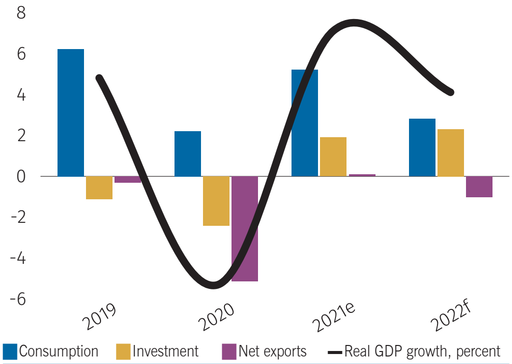
Higher fiscal deficits are likely due to a possible acceleration of public expenditure growth in the medium term. Public revenue and public expenditure are projected to increase by an average of 4 percent and 7.6 percent per year in the medium term, fueling an increase in the level of fiscal deficit compared to 2021. Public revenue growth will decelerate, mainly because of the absence of one-off contributors, such as dividend income, and because of a slowdown in import growth and inflation compared to 2021. Expenditure growth will be fueled by an acceleration in public investment spending, but also increased current expenditure driven by the implementation of the Economic Revival Plan. As a result, fiscal deficit levels are expected to increase from 2021 to an average of 2 percent of GDP over the medium term. With limited availability of privatization proceeds over the medium term, the deficit is projected to be financed primarily through new domestic debt and concessional external debt. Public and publicly guaranteed debt relative to output is projected to rise from 23.2 percent in 2021 to 27.8 percent by end-2023.

However, the outlook is marred by substantial COVID-19 risks. Given the rise of new virus variants and vaccination trends, both in Kosovo and globally, the pandemic risks remain high. Kosovo was hit with a fourth wave of infections in late August 2021, but the pace of vaccinations has accelerated. Given Kosovo's high reliance on diaspora visits, reaching the vaccination coverage target at 60 percent of the eligible population by yearend remains important for mitigating pandemic-related risks and avoiding the imposition of further rounds of strict containment measures that restrict economic activity. Due to the inherent uncertainty of the course of the pandemic, policymakers need to have contingency plans, especially given the high impact of containment measures on public revenue collection, expenditure composition, and financing. Reimposition of international travel restrictions in diaspora-hosting countries could also weigh on growth and the fiscal position.

In the medium term, there is a pressing need to focus policies on tackling constraints to higher productivity growth and investing in human capital. Kosovo needs to grow beyond its current potential to achieve higher living standards and more inclusive development. Thus, reforms should focus on (1) entrenching macroeconomic stability and sound governance; (2) increasing firm productivity; (3) raising farm productivity; (4) enhancing human capital; and (5) boosting exports, competition, and private investment, especially foreign direct investment.

Economic activity is recovering faster than expected in 2021.

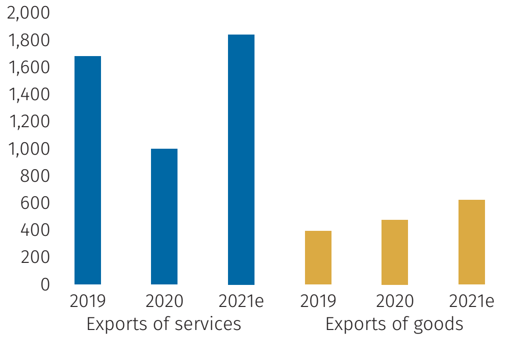
Contributions to growth, percentage points



Source: Kosovo Statistics Agency and World Bank staff calculations.

Exports of services are experiencing a strong rebound.

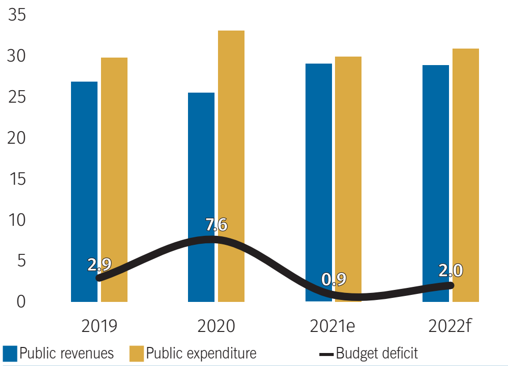
Exports of goods and services, in EUR millions



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

Strong recovery of revenues and under-execution of capital investment are narrowing the deficit in 2021.

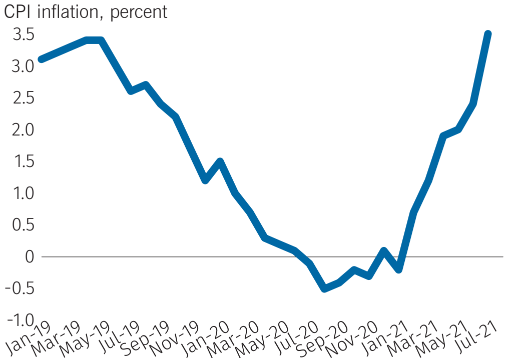
Percent of GDP



Source: Ministry of Finance and World Bank staff calculations.

Inflationary pressures increased in 2021.

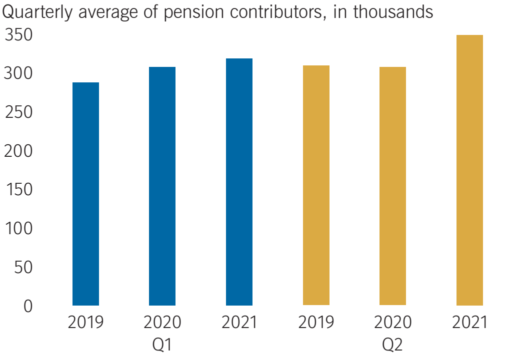
CPI inflation, percent



Source: Kosovo Statistics Agency.

The recovery is accompanied by robust growth in formal employment.

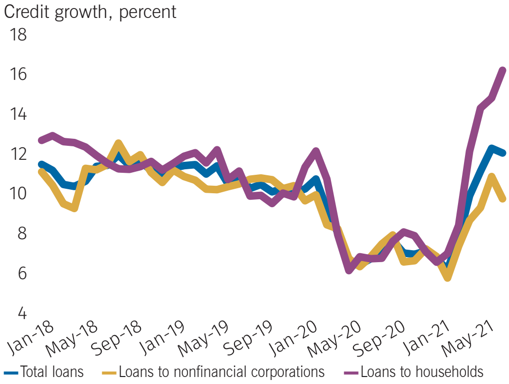
Quarterly average of pension contributors, in thousands



Source: Kosovo Pensions Savings Trust.

Credit growth is supporting the recovery.

Credit growth, percent



Source: Central Bank of Kosovo.

KOSOVO	2018	2019	2020	2021e	2022f	2023f
Real GDP growth (percent)	3.4	4.8	-5.3	7.1	4.1	4.4
Composition (percentage points):						
Consumption	3.9	6.2	2.2	5.2	2.8	2.7
Investment	2.6	-1.1	-2.4	1.9	2.3	2.3
Net exports	-3.1	-0.3	-5.1	0.1	-1.0	-0.7
Exports	2.5	2.2	-8.4	13.7	2.5	2.2
Imports (-)	5.6	2.5	-3.3	13.6	3.5	2.9
Consumer price inflation (percent, period average)	1.1	2.7	0.2	3.5	1.8	1.6
Public revenues (percent of GDP)	26.3	26.8	25.4	28.9	28.8	28.8
Public expenditures (percent of GDP)	29.2	29.7	33.0	29.8	30.8	31.0
Of which:						
Wage bill (percent of GDP)	8.9	8.7	9.8	8.9	8.9	8.9
Social benefits (percent of GDP)	6.2	6.3	7.7	7.5	7.4	7.1
Capital expenditures (percent of GDP)	7.9	7.5	5.6	5.3	6.4	7.0
Fiscal balance (percent of GDP)	-2.9	-2.9	-7.6	-0.9	-2.0	-2.2
Primary fiscal balance (percent of GDP)	-2.6	-2.6	-7.2	-0.4	-1.5	-1.6
Public debt (percent of GDP)	16.4	17.0	22.0	22.7	25.9	27.6
Public and publicly guaranteed debt (percent of GDP)	17.0	17.6	22.4	23.2	26.2	27.8
Of which: External (percent of GDP)	6.2	5.8	7.8	7.8	10.1	11.1
Goods exports (percent of GDP)	5.6	5.6	6.9	8.4	8.6	8.8
Goods imports (percent of GDP)	46.7	45.8	44.2	55.9	56.3	57.2
Net services exports (percent of GDP)	12.8	13.1	5.7	14.8	14.0	14.7
Trade balance (percent of GDP)	-28.2	-27.1	-31.6	-32.7	-33.7	-33.7
Net remittance inflows (percent of GDP)	11.4	11.6	13.8	14.3	14.0	13.6
Current account balance (percent of GDP)	-7.6	-5.6	-7.0	-8.5	-9.6	-9.2
Net foreign direct investment inflows (percent of GDP)	3.4	2.7	4.1	3.8	4.1	4.5
External debt (percent of GDP)	30.5	31.2	37.5	—	—	—
Real private credit growth (percent, period average)	10.1	7.9	7.6	—	—	—
Nonperforming loans (percent of gross loans, end of period)	2.5	2.0	2.7	—	—	—
Unemployment rate (percent, period average)	29.5	25.7	—	—	—	—
Youth unemployment rate (percent, period average)	55.4	49.4	—	—	—	—
Labor force participation rate (percent, period average)	40.9	40.5	—	—	—	—
GDP per capita (US$)	4,388	4,432	4,295	4,560	4,757	5,005
Poverty rate (percent of population)	23.2	20.9	23.4	20.9	18.9	17.0

Source: Country authorities, World Bank estimates and projections.

Note: Poverty rate calculations based on ECAPOV harmonization using HBS data. Nowcasted/projected values start at 2018. Income measures in the SILC and consumption measures in the HBS are not strictly comparable. Poverty is defined as living on less than $5.5/day per person in revised 2011 PPPs.

Montenegro

- After the deep 2020 recession, Montenegro's economy is recovering faster than anticipated.
- Progress with vaccinations, health protocols, and open borders has helped revive tourism.
- Unemployment remains high despite the tourism rebound.
- The large Eurobond issuance in December 2020 has relieved financing pressures in 2021, along with reduced fiscal deficit. Still, careful fiscal and debt management remains critical, as uncertainties loom.

Recent Economic Developments

While tourism was the main culprit for the economic downturn in 2020, it is now driving the economic revival. After a historic recession of 15.3 percent in 2020, the economy has been showing signs of a robust recovery. It is estimated that GDP will bounce back by 10.8 percent in 2021, stronger than previously estimated. This is due to swifter tourism recovery—we now assume that tourism revenues will rebound to 75 percent of their 2019 levels, from 55 percent previously estimated. This rebound will boost exports, which are expected to lead the economic recovery in 2021. Despite lower employment, tourism and household lending are expected to boost private consumption growth. However, government consumption is estimated to decline, while investments are expected to increase only slightly due to delays in public investment projects, supply-chain disruptions, and higher cost of materials.

High-frequency indicators point to a recovery but also show the economy's scars from the pandemic. In the first seven months of 2021, the number of overnight stays in tourist collective[61] accommodations were 56 percent of the 2019 levels, but the peak season started in July, with overnight stays reaching 90 percent of the 2019 level. Data from the national tourism organization point to an equally robust tourism demand in August (July and August usually account for almost half of annual overnight stays). Retail trade strengthened by 6 percent[62] in the first half of 2021. In the same period, an increase of 10 percent in industrial production was largely driven by electricity generation, while construction was at the same level as a year ago.

The recovery has yet to ignite the labor market. Since the pandemic began, the administrative data show a persistent decline in employment, which reached a record low of 149,371 registered jobs in June (compared to 178,178 in June 2020 and 213,488 in June 2019). Loss of jobs was recorded in all sectors, but trade, construction, and tourism have taken the biggest hit, though tourism jobs are expected to have partly recovered due to intensifying tourism activity. Registered unemployed rose from 41,890 in June 2020 to 55,703 in June 2021, of which over 60 percent of newly registered unemployed were women. The government has continued paying wage subsidies and one-off transfers, including incentives for formalization of employment.

61 This includes hotels, holiday facilities, boarding houses, tourist resorts, hostels, and motels.
62 All comparisons are year-on-year unless otherwise stated.

This support has helped to avoid worse labor market outcomes. The Parliament has adopted an increase in the net monthly minimum wage from €222 to €250, effective October 1.

Stronger demand and higher oil prices have pushed up inflation. As economic activity has picked up, so has inflation, and in the eight months it averaged 1.7 percent, with July and August inflation rates reaching 3.1 percent. The increase in inflation was led by rising food, beverage, and transportation prices. Producer prices grew more moderately, and by June the Producer Price Index had increased by 1.3 percent. In the first seven months, nominal wages increased by 1.3 percent, but real wages fell marginally by 0.2 percent.

The financial sector has so far been resilient. In the first seven months of 2021, outstanding loans were up by 7.3 percent, driven by household and non-resident lending. At the same time, deposits were up by 16 percent, most notably for firms, households, and non-residents. The lending-to-deposits ratio declined to 89 percent, back to its pre-pandemic level. By July, new lending surged by 57 percent, though it remained below its 2019 level. The June average capital adequacy ratio was at a healthy 19.2 percent, well above the regulatory minimum. Nonperforming loans increased to 6.3 percent of total loans from 5.6 percent in June last year. The full impact of the crisis on bank asset quality will only be clear once the generous loan moratoriums expire in December and if corporate bankruptcies rise after government crisis response programs are phased out. The Central Bank has commissioned an Asset Quality Review (AQR) to identify stressed assets and make necessary provisions in banks' balance sheets. After delays due to the pandemic, the AQR shall be published in September and may reveal vulnerabilities that would require decisive action by the Central Bank.

External imbalances are expected to narrow as net exports and net income accounts strengthen. In the first half of 2021, exports of goods and services increased by 40 percent, supported by a recovery in tourism and transport services, but also stronger merchandise exports—primarily of electricity, minerals, and metals. In contrast, import growth was more moderate, edging up by 3 percent, largely driven by imports of food, beverages, and oil. Net primary and secondary incomes have further reduced the current account deficit, primarily due to strong net remittances, which increased by 75 percent compared to the same period last year. The current account deficit was financed by drawing down reserves and net foreign direct investment (FDI), although the latter declined by 20 percent. By July, international reserves increased to €1.4 billion, covering 7.7 months of merchandise imports.

The 2021 budget was adopted only in June and introduced more meaningful program budgeting. The budget defines objectives and key performance indicators, although not for all programs. Until the 2021 budget was adopted, the Ministry of Finance and Social Welfare was issuing monthly temporary decisions on financing. The budget proposed by the government initially planned a fiscal deficit of 3 percent of GDP but was eventually increased to 3.8 percent of GDP due to the allocation of €25 million for reintroducing mothers' benefits transfers. The 2021 budget also introduced child benefits for all children until the age of six and financing of textbooks for all primary school students. There is room to raise the inclusiveness and spending efficiency by reviewing the current social protection system to increase its effectiveness and targeting and minimize potential adverse labor market participation effects.

Stronger revenues are supporting fiscal deficit reduction. In the first seven months of 2021, central government revenues increased by 11.3 percent, primarily supported by stronger value-added tax (VAT) and non-tax revenue collection (including dividends from state-owned enterprises). In June, the Law on E-fiscalisation entered into force and is expected to further support VAT collection. Expenditures declined by 4.5 percent, mainly driven by under-execution of capital spending (due to delays in adopting the budget), but also lower spending on goods and services. The government has continued supporting the private sector and households through wage subsidies and one-off support until July. To further support the recovery, the government has also provided €40 million for subsidized loans for micro and small and medium-sized enterprises, which will be administered through commercial banks.

After peaking at 105 percent of GDP in 2020, public debt is expected to decline to 88 percent in 2021. Securing financing through issuance of €750 million in Eurobonds in December 2020 has significantly relieved financing pressures in 2021. By July, the central government net debt was reduced by over €300 million, including a repayment of €227 in Eurobonds in March. Fiscal surpluses in June and July supported the buildup of government deposits, which are expected to cover the remaining financing needs for 2021. The government has reduced fiscal risk by signing a hedging agreement to protect against exchange rate risk as it started repaying the loan for the construction of the first section of the Bar-Boljare highway.

Outlook and Risks

The pandemic continues to pose challenges, as new virus variants raise doubts about the pace of the global recovery. In the second week of September, Montenegro had the fifth-highest number of cases in seven days in the world and is ranked third in the total number of infected people per million inhabitants. The vaccination process started at a fast pace in May, and by mid-September 43 percent of the adult population has been fully vaccinated. The evolution of the pandemic will largely shape the near-term economic outlook.

Assuming a full recovery in tourism in 2022 and 2023, growth is expected to remain strong at 5.6 and 4.8 percent, respectively. Investments are expected to level off in 2022 as the construction of the first section of the highway is expected to be finalized by end-2021. Investment is projected to grow in 2023 supported by projects in the energy sector. The government announced stronger public capital spending starting in 2022, which would further support medium-term growth. However, public investment management challenges should be addressed to ensure stronger economic effects. Private consumption will continue to support growth as employment gradually starts recovering as a result of improved economic activity. The pace of the recovery of low-skills jobs will determine how quickly poor and vulnerable households can recover their pre-crisis income levels. Addressing long-standing job and low labor participation challenges is critical for robust job growth and welfare improvements in the recovery.

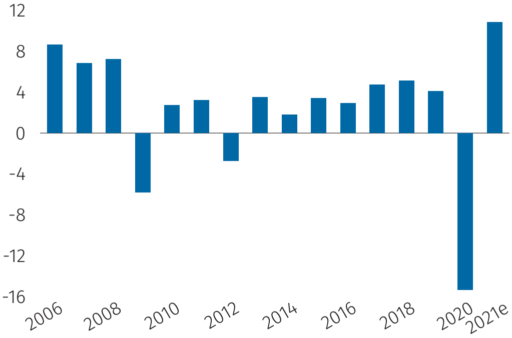
Strong fiscal and debt management are needed to accelerate debt reduction. The fiscal balance is expected to turn into a surplus in 2023, due to lower capital spending and contained expenditures on goods and services and stronger revenues due to the economic recovery. The projections do not assume that the remaining sections of the highway will start by 2023, as fiscal space is projected to remain limited. The government's medium-term plan foresees a primary fiscal surplus of almost 2 percent of GDP in 2022. Running a primary fiscal surplus over the medium term will be critical for debt reduction and will require a sustained consolidation on the spending side. Public debt is expected to decline to 77 percent of GDP in 2022 and further to 70 percent of GDP in 2023, as about €500 million of debt is due for repayment in 2022–23.

External imbalances are expected to narrow and return to pre-highway levels. The finalization of the import-dependent motorway section and stronger exports led by tourism recovery are projected to reduce the current account deficit to 11.2 percent and 9.5 percent of GDP in 2022 and 2023, respectively. Net FDI will continue to largely finance the current account deficit and is expected to remain moderate at around 7.5 percent of GDP.

The outlook is subject to multiple downside risks. Looking at external risks, a new wave of COVID-19 infections in Europe could slow Montenegro's economic recovery. Moreover, inflationary pressures in the United States and European Union may accelerate monetary tightening, which could translate into more expensive external financing. Domestic risks stem from lower vaccination rates and hesitancy, where possible new containment measures could delay the recovery. Political polarization also remains high. Acceleration of structural reforms and a firm commitment to careful fiscal management, however, can reduce investment uncertainty and improve the outlook. Further strengthening the independence of public institutions, especially the judiciary, would not only improve Montenegro's prospects of joining the European Union, but would also support a resilient economic recovery by ensuring a level playing field for all businesses and entrepreneurs.

The economy is recovering faster than anticipated…

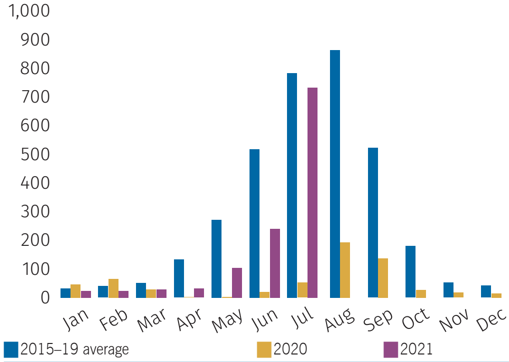
Real GDP growth, percent



Source: MONSTAT and World Bank staff calculations.

…as tourism recovered.

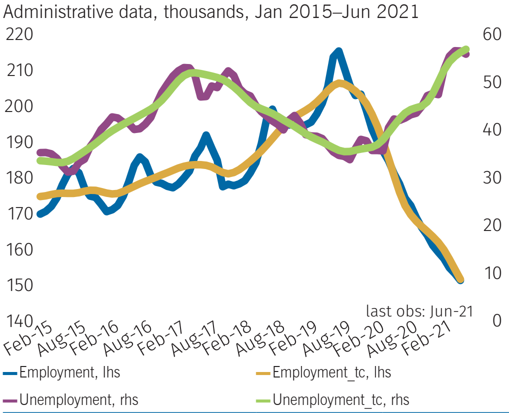
International tourists overnight stays, in thousands



Source: MONSTAT and World Bank staff calculations.

Employment continued falling…

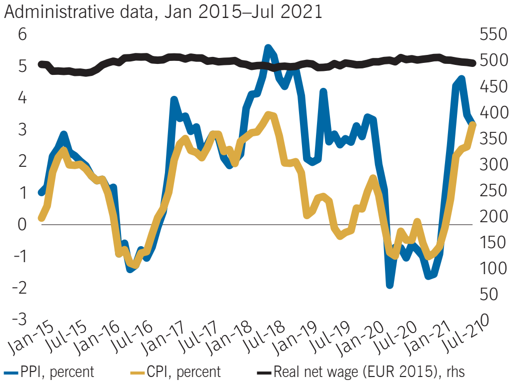
Administrative data, thousands, Jan 2015–Jun 2021



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

…while inflation surged.

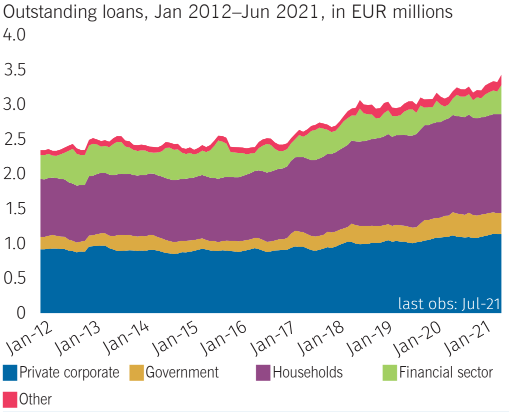
Administrative data, Jan 2015–Jul 2021



Source: MONSTAT data and World Bank staff calculations.

Outstanding loans have been increasing…

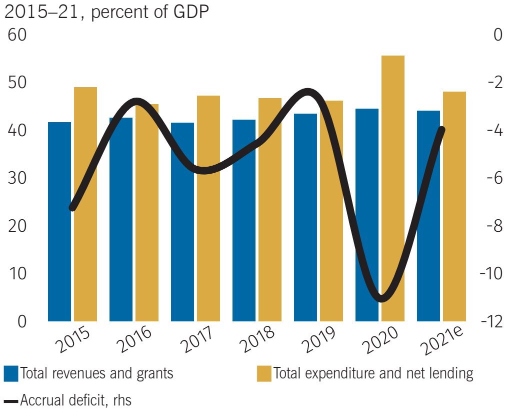
Outstanding loans, Jan 2012–Jun 2021, in EUR millions



Source: Central Bank and World Bank staff calculations.

…while the fiscal position improved.

2015–21, percent of GDP



Source: MoF and World Bank staff calculations.

MONTENEGRO	2018	2019	2020	2021e	2022f	2023f
Real GDP growth (percent)	5.1	4.1	-15.3	10.8	5.6	4.8
Composition (percentage points):						
Consumption	5.2	2.9	-3.9	3.2	2.8	2.7
Investment	4.9	0.8	-5.8	1.0	-1.2	2.1
Net exports	-5.0	0.4	-5.6	6.6	4.1	0.0
Exports	3.4	2.7	-24.0	21.0	6.8	3.5
Imports (-)	8.4	2.3	-18.4	14.3	2.7	3.5
Consumer price inflation (percent, period average)	2.6	0.4	-0.3	1.9	1.6	1.2
Public revenues (percent of GDP)	42.0	43.3	44.4	43.9	42.2	41.7
Public expenditures (percent of GDP)	46.6	46.0	55.4	47.9	43.1	40.7
Of which:						
Wage bill (percent of GDP)	11.2	11.0	13.5	12.1	11.3	10.7
Social benefits (percent of GDP)	11.7	11.2	13.4	12.3	11.6	11.0
Capital expenditures (percent of GDP)	8.5	8.7	7.5	6.3	3.8	3.7
Fiscal balance (percent of GDP)	-4.6	-2.7	-11.0	-4.0	-0.9	1.1
Primary fiscal balance (percent of GDP)	-2.4	-0.5	-8.3	-1.6	1.4	3.2
Public debt (percent of GDP)	70.1	76.5	105.3	87.7	77.0	69.9
Public and publicly guaranteed debt (percent of GDP)	74.1	80.0	108.7	90.7	79.8	72.5
Of which: External (percent of GDP)	64.6	68.1	97.3	82.2	72.8	65.8
Goods exports (percent of GDP)	9.4	9.4	9.8	9.5	9.6	9.8
Goods imports (percent of GDP)	53.3	51.1	49.0	49.7	47.8	47.3
Net services exports (percent of GDP)	20.1	20.6	4.2	16.4	20.0	21.3
Trade and services balance (percent of GDP)	-23.8	-21.1	-35.0	-23.8	-18.2	-16.2
Net remittance inflows (percent of GDP)	4.0	4.0	5.3	6.4	5.1	4.8
Current account balance (percent of GDP)	-17.0	-14.3	-26.1	-15.2	-11.2	-9.5
Net foreign direct investment inflows (percent of GDP)	6.9	6.2	11.2	7.8	7.4	7.4
External debt (percent of GDP)	163.7	169.0	224.1	—	—	—
Real private credit growth (percent, period average)	6.8	5.5	6.5	—	—	—
Nonperforming loans (percent of gross loans, end of period)	7.4	5.1	5.9	—	—	—
Unemployment rate (percent, period average)	15.2	15.1	17.9	—	—	—
Youth unemployment rate (percent, period average)	29.4	25.2	36.0	—	—	—
Labor force participation rate (percent, period average)	56.0	57.4	53.3	—	—	—
GDP per capita, PPP (current international $)	21,547	23,344	20,505	22,363	23,978	25,442
Poverty rate (percent of population)	15.2	14.5	20.0	17.7	16.3	—

Sources: Country authorities, World Bank estimates and projections.

Note: Poverty rate calculations based on ECAPOV harmonization using SILC-C data. Nowcasted/projected values start at 2018. Income measures in the SILC and consumption measures in the HBS are not strictly comparable. Poverty is defined as living on less than $5.5/day per person in revised 2011 PPPs.

North Macedonia

- A robust recovery is underway in North Macedonia despite the continued adverse impact of the pandemic. However, the improved outlook is subject to downside risks: vaccine hesitancy and the pace of immunization, the appearance and intensity of new virus variants, disrupted supply chains, increased inflationary pressures, and tightening financial conditions.
- The labor market is slowly recovering, creating wage pressures in fast-growing sectors.
- Continued government support measures have helped mitigate the impact of the crisis on households and firms but have further increased public debt.
- Policymakers should gradually shift their focus to policies supporting a sustainable, inclusive, and green recovery that complement and further strengthen the EU accession reform agenda.

Recent Economic Developments

After declining in the first quarter (Q1) by 1.9 percent, domestic output surged at a double-digit rate in Q2. As a result, GDP growth in the first half of the year turned positive at 5.2 percent. Private consumption picked up and investment grew, while government consumption resumed growth in Q2 after dropping early in the year. Exports and imports increased, as well, with imports growing faster, thereby worsening the trade balance. On the production side, growth was observed in nearly all sectors, given the low base effect, with the fastest recovery occurring in trade, transport, tourism, manufacturing, and ICT. Construction surprisingly saw a decline in output in Q2.

High-frequency data for the second half of 2021 point to a moderation in growth. Industrial production turned negative in July (0.6 percent year-on-year [YOY]) as energy and capital goods production turned negative despite a 13 percent YOY rise in exports in July. Car supply firms are experiencing reduced orders as supply delivery delays are mounting. Real retail trade remains strong but slowed to 8.9 percent YOY in July. Tourism numbers spiked as travel opened up during the summer season, which might contribute to further growth in retail trade. The most recent data on the number of issued construction permits in June 2021 points to a prolonged upward trend in the construction sector.

The activity rate in the first half of 2021 picked up from its low in summer 2020, driven by an increase in male labor force participation. The activity rate increased to 56.2 percent or 0.4 percentage points (pps) since Q3 2020. The unemployment rate decreased by 0.2 pps to 15.9 percent since Q4 2020, while the employment rate increased by 0.5 pps, with women contributing to the rise as they moved from unemployment to service sector jobs. The youth unemployment rate remains high at 37.8 percent, up 4 pps compared to the same quarter of 2020.

Wage growth continued in the first half of the year, albeit at a relatively more subdued pace compared to the previous year. Wages increased by 6.3 percent YOY, with the largest increases seen in sectors most affected by pandemic-related restrictions such as transportation, food and accommodation, entertainment, and other services. For the first six months, strong wage growth was also observed in manufacturing, trade, and the ICT sector. In addition, in June 2021, the government adopted changes to trade and labor laws that increase the hourly pay for Sunday and holiday work and reduce the number of working Sundays in the trade sector, thereby adding to existing wage pressures.

Consumer prices continued the upward trend that started at the end of 2020. The inflation rate reached 3.6 percent in August 2021—the highest growth rate since July 2013. The cumulative inflation rate reached 2.7 percent YOY for the first eight months of the year which is still largely within central bank forecast. The increase was primarily driven by electricity, fuel, and food (mainly edible oil) prices, the latter reflecting global price hikes. In July 2021, regulated electricity prices were again on the rise, with this year's increase being offset by a temporary reduction of the VAT rate, which is set to gradually expire by July 2023.

The performance of the banking sector remained strong in the first half of 2021. Credit growth remains solid (6.4 percent YOY in August), providing support to both households and firms. Nonperforming loans, currently at 3.5 percent, could see an upward correction, as last loan moratoriums are being phased out and the duration of crisis takes a toll on some firms. However, the capital adequacy ratio remained high at 17.3 percent, as did the banking sector liquidity ratio, which stood at 22 percent in Q2, with minimal adjustments since the start of the pandemic. Considering the recent positive momentum of the economy, in August 2021, the central bank removed the temporary limit on the distribution and payment of dividends to banks and savings houses' shareholders that was introduced in February 2021.

In the first half of 2021, external imbalances narrowed as current transfers grew. The trade deficit in the first half of 2021 stood at 13.2 percent of GDP (on a 4-quarter rolling basis), down from 13.9 percent in the same period of 2020, while the services balance improved to 4.4 percent of GDP mainly thanks to telecommunication and IT services. The current account deficit declined to 2.7 percent of GDP (on a 4-quarter rolling basis) in the first half of the year. It is projected to increase to 3.6 percent by yearend, largely remaining unchanged compared to 2020. With the rising borrowing needs from the government, external debt increased to 84.8 percent of GDP by March 2021, though it is expected to stabilize at 80.8 percent of GDP in light of the repayment of Eurobonds in July. This is a marginal increase compared to the 2020's level.

Fiscal deficit almost halved in the first half of the year but is set to rise by yearend as per the 2021 budget revision. For the first half (H1), the general government deficit stood at 2.1 percent of GDP; at one-third of the planned deficit in the 2021 budget revision. Total revenues surged by 17 percent YOY, mostly on the back of buoyant VAT collection. In the second part of the year, the collection will be under the impact of the reduced VAT rates for electricity in addition to the already lowered rate for catering services early in the year. Expenditures have increased at a slower pace (4 percent YOY) given more targeted COVID-19 support, and despite an uplift in capital spending of 45 percent YOY.

Public and publicly guaranteed debt[63] increased to 64.4 percent of GDP in H1 given the new Eurobond issuance amid a retained sovereign issuer default rating of BB- with a stable outlook. In July the government repaid the seven-year EUR 500 million Eurobond issued in 2014, which reduced debt to 60.5 percent of GDP. In August 2021, the IMF allocated EUR 134.5 million in Special Drawing Rights in an attempt to boost liquidity across the world. The government aims to use this allocation for budgetary financing purposes.

Outlook and Risks

Economic growth is expected to rebound to 4.6 percent in 2021, returning to the pre-pandemic output level by yearend. The baseline scenario is built on the assumptions that the pace of immunization continues, there are no further lockdowns in 2021, consumer and investor confidence remain high, and external demand continues to be supportive. Growth is expected to continue in 2022 as the economy gradually starts to stabilize. Poverty is projected to resume its modest decline as expected economic growth rebounds in 2021.

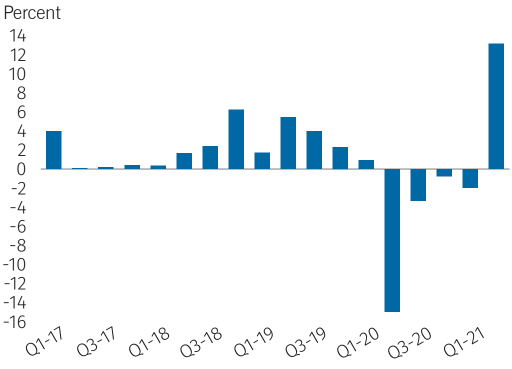
Yet, while the outlook for the near term remains positive, continued containment measures, a slow vaccine rollout, and unresolved structural bottlenecks pose challenges. Weak human capital development and a low labor force participation rate have led to underutilized labor resources amidst a demographic decline. Further, state involvement in the market through direct ownership, tax exemptions, and subsidies remains high. While this helps protect employment in the near term, it also derails fiscal sustainability.

Fiscal deficit is expected to decline but only gradually, following the latest government plans to ramp up capital spending. Over the medium term, public and publicly guaranteed debt will continue its rising path reaching 65.5 percent of GDP by 2023. Countercyclical fiscal policies put in place to mitigate the impact of COVID-19 will need to be gradually withdrawn to address these sustainability concerns. Improving public investment management to help implement the government's Growth Acceleration Plan, which eyes energy, environment, and transport investments, will be critical to support growth as well as avoid fiscal sustainability concerns. As the recovery takes hold, the country will need to boost tax compliance, restructure and reprioritize spending, address long-term bottlenecks, and enhance public finance management efficiency.

To boost potential growth, the authorities need to redirect their attention to structural and institutional reforms, which can unlock growth by addressing the legacies in state-owned companies and network infrastructure; investing in human capital; strengthening the accountability and independence of public institutions, as well as commitment to the rule of law; and promoting private sector innovation and competitiveness. Efforts to boost potential output through structural reforms will need to occur in the context of region-wide efforts to accelerate the low-carbon transition and reduce greenhouse gas emissions.

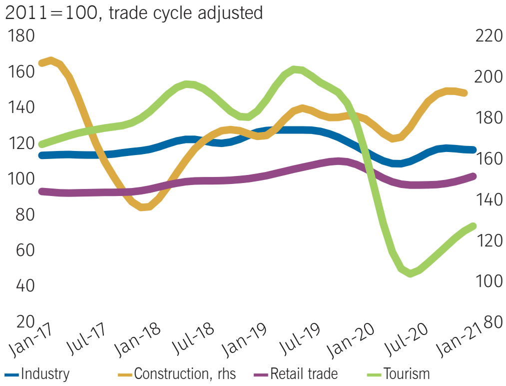
63 It also includes some non-guaranteed debt by SOEs.

The economy is on a recovery path from the 2020 recession…



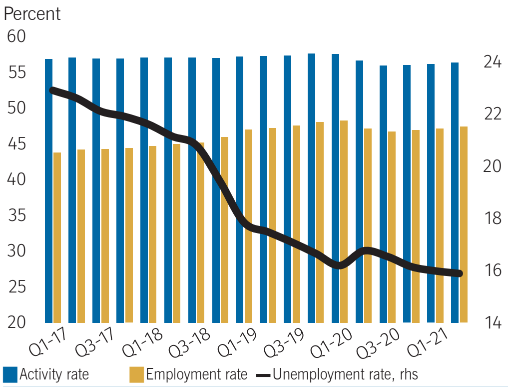
Source: State Statistics Office.

…which is confirmed by high-frequency indicators.



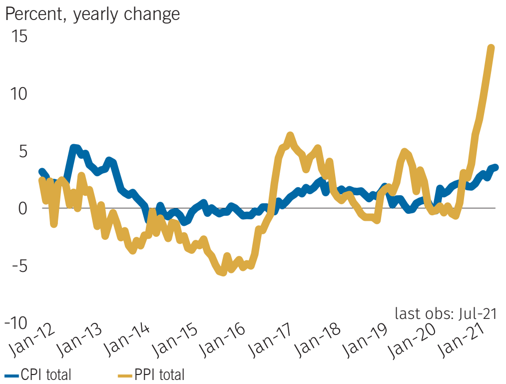
Source: State Statistics Office and World Bank staff calculations.

The labor market resumed positive trends.



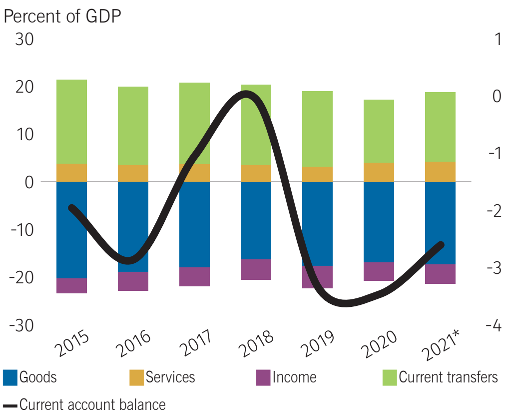
Source: State Statistics Office.

Inflationary pressures are on the rise as demand surges.



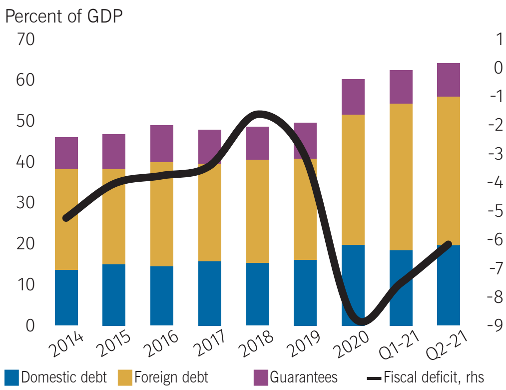
Source: State Statistics Office.

External imbalances narrowed…



Source: National Bank and World Bank staff calculations.
Note: *2021 is a 4-quarter moving average to June 2021.

…while public debt is still on the rise.



Source: Ministry of Finance and World Bank staff estimates.
Note: 2021 deficit is a 4-quarter moving average.

NORTH MACEDONIA	2018	2019	2020	2021e	2022f	2023f
Real GDP growth (percent)	2.9	3.2	-4.5	4.6	3.7	3.4
Composition (percentage points):						
Consumption	2.9	2.4	-2.5	4.1	2.9	1.9
Investment	0.6	3.3	-3.7	1.4	1.7	2.1
Net exports	-0.6	-2.5	1.7	-0.9	-1.0	-0.6
Exports	7.6	4.7	-7.3	5.0	4.7	4.9
Imports (-)	8.2	7.2	-9.0	6.0	5.7	5.5
Consumer price inflation (percent, period average)	1.5	0.8	1.2	2.4	2.0	1.8
Public revenues (percent of GDP)	30.4	31.5	30.2	36.1	36.8	36.5
Public expenditures (percent of GDP)	31.5	33.7	38.4	42.0	41.7	40.6
Of which:						
Wage bill (percent of GDP)	6.3	6.4	7.2	7.3	7.1	6.9
Social benefits (percent of GDP)	15.2	15.7	17.7	17.3	17.0	16.8
Capital expenditures (percent of GDP)	2.5	3.4	3.1	6.1	5.9	5.0
Fiscal balance (percent of GDP)	-1.1	-2.2	-8.2	-5.9	-5.0	-4.0
Overall Fiscal Balance with the Public Enterprise for State Roads	-1.7	-3.1	-8.7	-6.4	-5.2	-4.1
Primary fiscal balance (percent of GDP)	0.1	-1.0	-7.0	-4.3	-3.6	-2.6
Public debt (percent of GDP)	40.4	40.7	51.4	53.9	55.9	56.7
Public and publicly guaranteed debt (percent of GDP)*	48.4	49.4	60.2	62.7	64.7	65.5
Of which: External (percent of GDP)	32.9	32.7	40.2	39.0	38.0	37.0
Goods exports (percent of GDP)	45.4	47.5	44.7	46.0	47.1	48.3
Goods imports (percent of GDP)	61.6	65.1	61.5	63.0	63.5	64.0
Net services exports (percent of GDP)	3.5	3.1	4.0	4.1	4.3	4.6
Trade balance (percent of GDP)	-12.7	-14.5	-12.8	-12.9	-12.1	-11.1
Net remittance inflows (percent of GDP)	1.9	1.7	2.6	2.5	2.3	2.2
Current account balance (percent of GDP)	-0.1	-3.3	-3.5	-3.6	-3.0	-1.8
Net foreign direct investment inflows (percent of GDP)	5.6	3.2	1.9	2.5	2.6	2.7
External debt (percent of GDP)	73.0	72.8	80.2	80.8	78.7	78.9
Real private credit growth (percent, period average)	5.0	6.5	5.7	—	—	—
Nonperforming loans (percent of gross loans, end of period)	5.0	4.6	3.3	—	—	—
Unemployment rate (percent, period average)	20.7	17.3	16.4	15.5	14.3	13.5
Youth unemployment rate (percent, period average)	45.4	35.6	35.7	—	—	—
Labor force participation rate (percent, period average)	56.9	57.2	56.4	—	—	—
GDP per capita, PPP (current international $)	16,518	17,815	17,007	17,790	18,448	19,075
Poverty rate (percent of population)	17.9	16.9	18.0	16.9	15.8	—

Source: Country authorities, World Bank estimates and projections.

Note: Youth unemployment rate is for labor force aged 15-24. Poverty rate calculations based on ECAPOV harmonization using SILC-C data. Nowcasted/projected values start at 2019. Income measures in the SILC and consumption measures in the HBS are not strictly comparable. Poverty is defined as living on less than $5.5/day per person in revised 2011 PPPs.

*Includes also non-guaranteed debt of SOEs.

Serbia

- Serbia's growth recovery in 2021 at 6 percent is projected to be stronger than expected, supported primarily by a strong rebound in private consumption.
- Despite the economic recovery, there was an increase in unemployment rate averaging 11.9 percent in the first half (H1) of 2021.
- The fiscal deficit is gradually decreasing in 2021, despite the continuation of the government's fiscal stimulus program.
- Even though inflation has increased as of late, reaching 4.3 percent in August, the highest level in eight years, it is still within the National Bank of Serbia target band.
- The current account deficit has been lower than projected in 2021, mainly thanks to a strong export performance.
- A return to the previous growth path of around 4 percent is expected to start in 2022 and to continue over the medium term.

Recent Economic Developments

After the pandemic-caused recession in 2020, the economy experienced a recovery in H1 2021. Economic growth resumed in the first quarter (Q1)—with GDP growth up by 1.8 percent, year-on-year (YOY)—but the real recovery was seen in Q2, when output increased by 13.7 percent YOY. Looking at the expenditure side of GDP, consumption and investment pushed the economy, while net exports had a negative contribution to growth. Consumption was pushed by a large increase in private consumption (up 17.6 percent in real terms YOY), while government consumption in fact decreased in Q2 in real terms. Although the export performance was very good recently (up 36.5 percent in Q2, YOY in real terms) the increase in imports was even higher (up 42.9 percent in Q2); thus, the net balance in goods and services made a negative contribution to GDP in Q2 of 7.1 percentage points. Total investment is estimated to have increased by 44.4 percent in real terms in Q2, YOY, thanks to an increase in both public and private investment, thus contributing 9.3 percentage points to GDP growth. The economic recovery in 2021 is broad based, except for the agriculture sector, where output declined by 1.8 percent in real terms in H1. The agriculture sector output suffered from weather-related shocks, which had an impact across different agricultural subsectors and a significant increase in costs of food used in livestock breeding.

Countercyclical measures helped mitigate the impact of the pandemic on the labor market in 2020; however, the situation has somewhat deteriorated in 2021, as some of the government support programs have been unwound. According to the Labor Force Survey (LFS) data, in H1 2021, the unemployment rate increased to 11.9 percent (compared to 9.0 percent, the average unemployment rate in 2020). The labor market improvement in 2020 (when unemployment rate went down to 9.0 percent from 10.4 percent in 2019) was primarily the result of the fiscal stimulus program, since one of the requirements for firms to receive government support was to ensure that total employment remained unchanged or decreased by a maximum of

10 percent. However, despite these measures, the pandemic-related shocks to the economy had an impact on some of the foreign-owned large manufacturers who decided to close their operations in Serbia, resulting in significant layoffs. Wages continued to go up, increasing by 8.6 percent in nominal terms in H1 of the year. Unlike in previous couple of years, private sector wages increased faster than public sector wages (up by 9.4 percent in nominal terms, compared to a 7.5 percent increase in public sector wages). Despite this, on average, in 2021 wages in the public sector were still about 19 percent higher than in the private sector.

The consolidated fiscal deficit decreased significantly over recent months as revenues recovered. General government revenues increased by 25.7 percent in nominal terms over the first seven months of 2021 (compared to the same period of 2020). All sources of fiscal revenue increased with tax revenues going up 26.8 percent YOY over the first seven months and non-tax revenues up by 15.1 percent. At the same time, government expenditures decreased slightly (down 0.6 percent), leading to a much better fiscal result. The consolidated fiscal deficit was just 0.1 percent of GDP by end-July. The central government deficit was 0.7 percent of GDP, while local governments ran a significant surplus over the first seven months. Public debt at end-July 2021 stood at 58.8 percent of GDP, thus only marginally increasing since end-2020.[64] In September 2021, Serbia issued its first green bond (along with the new euro bond). The green bond of EUR1 billion was issued with the seven years maturity and the yield of 1.26 percent, while the euro bond is of EUR750 million, with the maturity of fifteen years and the yield of 2.3 percent.

The current account deficit (CAD) has continued to narrow. The CAD is estimated at 4.1 percent of GDP for 2020, down from 6.9 percent in 2019. Over the first seven months of 2021, the CAD narrowed further and reached 1.5 percent of GDP as a result of improvements in the trade in services and in secondary income. While the surplus in trade in services increased by 48.5 percent over the first seven months of 2021 (in euro terms), the deficit in trade in goods increased by 4.1 percent. Despite an increase in trade deficit, export performance in 2021 was much better than expected as large exporters resumed operations, and exports thereafter. In addition, Serbia saw terms-of-trade improvement in 2021—export prices increased by 6.4 percent, as did import prices, but by a lesser amount at 2.4 percent (over the first eight months of 2021 compared to the same period in 2020). The CAD is again fully financed by foreign direct investment (FDI). Net FDI accounted for 3.9 percent of annual GDP, after growing 25.1 percent in the first seven months of the year. Fitch Ratings affirmed Serbia's sovereign issuer default rating at BB+, with a stable outlook.

Inflation increased gradually over the recent months, in line with the recovery in consumption and the pressures from global energy and food prices. Inflation in 2020, as in Q1 2021, was low and stable, with prices having increased by just 1.4 percent YOY in Q1. However, since April, there was a gradual increase in consumer prices with the consumer price index (CPI) reaching a peak of 4.3 percent

64 This is a share of public debt in a 12-month moving average GDP. The nominal amount of debt is provided by the Ministry of Finance.

(YOY) in August. This was the highest level of inflation since September 2013. The National Bank of Serbia (NBS) remains committed to inflation targeting (3 percent +/–1.5 percent), and the key policy rate has been left unchanged since December 2020, at 1 percent. The money supply increase was also notable: in July 2021, M1 was 13.5 percent higher than a year before. After a small appreciation in 2019, the dinar held steady in 2020 and throughout 2021. At the end of August, the NBS had official foreign currency reserves of EUR 15.6 billion, up EUR 2.1 billion since the beginning of the year, which covers more than six months of imports.

Banking sector performance continued to be robust. Based on preliminary data, banks remained profitable in 2020 although both return on assets (ROA) and return on equity (ROE) decreased. In 2021, ROE increased to 7.3 percent in H1 2021. Liquidity indicators also improved in the first half of the year. Nonperforming loans (NPLs) hit a historic annual low of 3.7 percent in December 2020 primarily because of the resolution strategy introduced in 2015 and the recent crisis mitigation measures. NPLs stood at 3.5 percent in July 2021.

Outlook and Risks

Growth is expected to reach 6 percent in 2021, and to return to about 4 percent over the medium term. Based on the latest data, GDP is expected to rebound in 2021 (up by 6 percent), which is a revision compared to the previous projection of 5 percent. Growth in 2021 is being pushed up by the stimulus package of about 4.5 percent of GDP announced in February, and all components of GDP are expected to increase. The new fiscal stimulus program is smaller and different in structure compared to last year's program (guarantees dominate in this year's package, and there are no further tax deferrals), thus the impact on the economy and labor market performance could be different. This year, the main drivers of growth are expected to be consumption and investment. Over the medium term, the economy is expected to grow steadily at around 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. It is expected that services sector will remain the main driver of economic growth going forward.

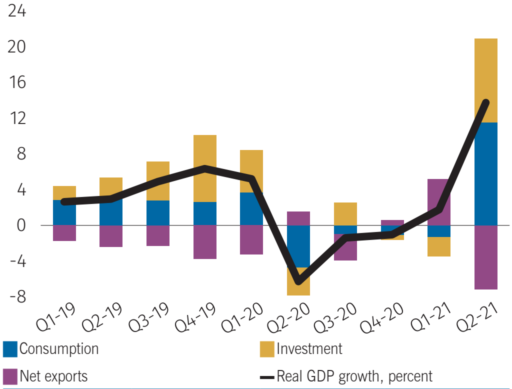
Going forward, the focus of policymakers should be not only on accelerating growth through further structural reforms, but also on greening it. The Serbian economy cannot unleash its growth potential in full unless structural bottlenecks related to governance, labor market, infrastructure, and the tax system are resolved. Green—clean and resilient—growth could be supported by, for example, promoting efficiency gains in use of raw materials and energy, expanding green industries and technologies, emphasizing less polluting and more energy-efficient industries, and proactively building up resilience to climate and disaster risks. Such growth strategy would not only accelerate GDP growth but would create new, high-quality jobs.

Macroeconomic stability will be maintained over the medium term. This year the fiscal deficit could be significantly lower than the one projected under the base-case scenario. Consequently, public debt could start falling as a share of GDP earlier than anticipated. Inflation pressures are mounting as in other countries, but inflation is expected to remain 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 risks relate to external developments—that is recovery of the European and global economies—since those will impact the evolution of exports and FDI, which are both critical for the growth of the Serbian economy. They could be amplified by the ongoing disruptions in global value chains. There are, however, also internal risks to the baseline scenario. The new wave of the COVID-19 pandemic could have an impact on the economy as well, although new lockdowns are not foreseen. Contingent liabilities could affect public finances, particularly those related to the deterioration in the performance of state-owned enterprises, as demonstrated recently by Telekom Srbija and Air Serbia, in addition to other state-owned enterprises that have long been financially troubled. Political developments could distract the government from undertaking necessary reforms, the most important from a growth perspective being those related to improving the business environment, education, and environmental management.

The GDP recovered well in 2021…

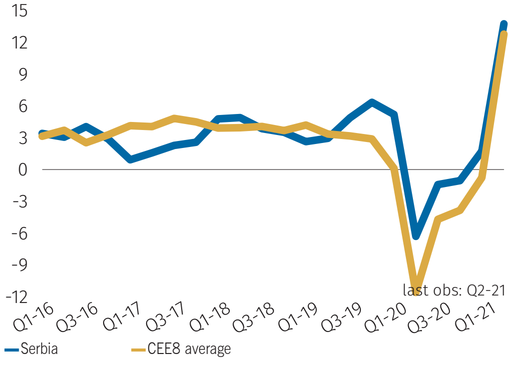
Contribution to growth, percentage points



Source: Statistics Office of Republic of Serbia.

…in line with developments among CEE countries.

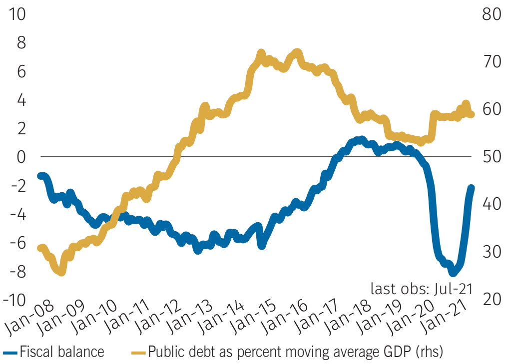
Real GDP change, y/y



Source: Statistics Office of Republic of Serbia and Eurostat.

The fiscal deficit has been reduced and public debt stabilized.

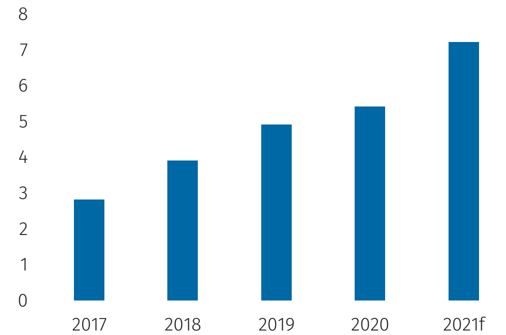
Share in GDP



Source: Ministry of Finance.

Total budgetary expenditures decreased even though capital expenditures increased.

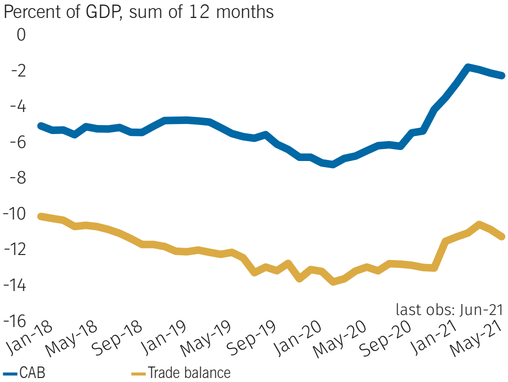
Share in GDP



Source: Ministry of Finance.

The CAD and trade deficit started to increase recently.

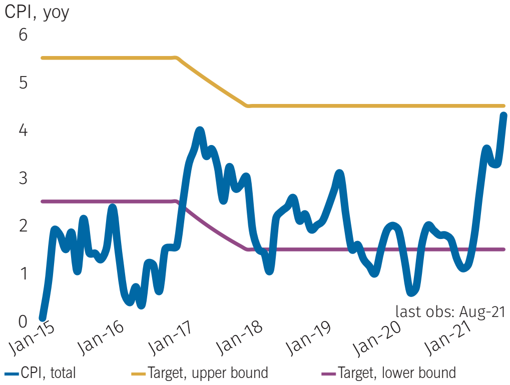
Percent of GDP, sum of 12 months



Source: National Bank of Serbia.

Inflation has been increasing since April.

CPI, yoy



Source: National Bank of Serbia.

SERBIA	2018	2019	2020	2021e	2022f	2023f
Real GDP growth (percent)	4.4	4.3	-0.9	6.0	4.5	4.0
Composition (percentage points):						
Consumption	2.8	2.9	-0.9	3.4	4.2	3.2
Investment	4.2	4.0	-0.1	3.2	0.8	1.3
Net exports	-2.6	-2.6	0.1	-0.5	-0.6	-0.5
Exports	4.3	4.1	-2.3	9.0	4.3	4.0
Imports (-)	6.9	6.7	-2.4	9.5	4.9	4.5
Consumer price inflation (percent, period average)	2.0	1.9	1.6	3.0	2.6	2.6
Public revenues (percent of GDP)	41.5	42.0	41.0	41.7	41.4	41.4
Public expenditures (percent of GDP)	40.9	42.2	49.0	48.7	44.4	43.2
Of which:						
Wage bill (percent of GDP)	9.2	9.5	10.5	10.4	10.0	9.9
Social benefits (percent of GDP)	14.7	14.4	14.7	14.5	14.0	13.9
Capital expenditures (percent of GDP)	3.9	4.9	5.3	7.2	6.3	6.1
Fiscal balance (percent of GDP)	0.6	-0.2	-8.0	-6.9	-3.0	-1.8
Primary fiscal balance (percent of GDP)	2.8	1.8	-6.0	-5.0	-1.1	0.2
Public debt (percent of GDP)	50.8	49.7	53.3	56.3	55.4	52.6
Public and publicly guaranteed debt (percent of GDP)	54.4	52.7	57.8	60.3	58.9	56.1
Of which: External (percent of GDP)	31.4	30.3	33.4	37.0	38.0	40.0
Goods exports (percent of GDP)	35.2	35.7	34.4	39.1	39.7	40.3
Goods imports (percent of GDP)	47.1	47.9	45.5	50.2	50.4	50.7
Net services exports (percent of GDP)	2.3	2.3	2.4	2.3	2.1	2.2
Trade balance (percent of GDP)	-9.5	-9.9	-8.8	-8.9	-8.5	-8.2
Net remittance inflows (percent of GDP)	6.1	5.6	4.5	4.9	4.8	4.7
Current account balance (percent of GDP)	-4.8	-6.9	-4.1	-5.0	-5.0	-4.9
Net foreign direct investment inflows (percent of GDP)	7.4	7.8	6.3	6.1	6.1	6.0
External debt (percent of GDP)	61.3	61.8	65.8	63.7	60.5	58.3
Real private credit growth (percent, period average)	3.7	6.9	9.3	—	—	—
Nonperforming loans (percent of gross loans, end of period)	5.7	4.1	3.7	—	—	—
Unemployment rate (percent, period average)	13.7	11.2	9.7	—	—	—
Youth unemployment rate (percent, period average)	29.7	27.5	26.3	—	—	—
Labor force participation rate (percent, period average)	52.9	52.9	52.2	—	—	—
GDP per capita, PPP (current international $)	17,842	18,972	19,146	20,545	22,044	23,534
Poverty rate (percent of population)	17.9	17.3	17.4	17.1	15.4	—

Source: Country authorities, World Bank estimates and projections.

Note: Poverty rate calculations based on ECAPOV harmonization using SILC-C data. Nowcasted/projected values start at 2018. Income measures in the SILC and consumption measures in the HBS are not strictly comparable. Poverty is defined as living on less than $5.5/day per person in revised 2011 PPPs.

Key Economic Indicators

Key Economic Indicators	2016	2017	2018	2019	2020	2021e	2022f	2023f
Real GDP growth (percent)								
Albania	3.3	3.8	4.1	2.2	-4.0	7.2	3.8	3.7
Bosnia and Herzegovina	3.1	3.2	3.7	2.8	-3.2	4.0	3.0	3.2
Kosovo	5.6	4.8	3.4	4.8	-5.3	7.1	4.1	4.4
North Macedonia	2.8	1.1	2.9	3.2	-4.5	4.6	3.7	3.4
Montenegro	2.9	4.7	5.1	4.1	-15.3	10.8	5.6	4.8
Serbia	3.3	2.0	4.4	4.3	-0.9	6.0	4.5	4.0
WB6	*3.4*	*2.7*	*4.0*	*3.6*	*-3.1*	*5.9*	*4.1*	*3.8*
Consumer price inflation (percent, period average)								
Albania	1.3	2.0	2.1	1.4	1.6	2.4	2.8	3.0
Bosnia and Herzegovina	-1.6	0.8	1.4	0.6	-1.1	-0.2	0.5	0.7
Kosovo	0.3	1.5	1.1	2.7	0.2	3.5	1.8	1.6
North Macedonia	-0.2	1.4	1.5	0.8	1.2	2.4	2.0	1.8
Montenegro	-0.3	2.4	2.6	0.4	-0.3	1.9	1.6	1.2
Serbia	1.1	3.2	2.0	1.9	1.6	3.0	2.6	2.6
WB6	*0.4*	*2.2*	*1.8*	*1.5*	*0.9*	*2.3*	*2.1*	*2.1*
Public expenditures (percent of GDP)								
Albania	29.6	29.8	29.2	29.2	33.2	34.4	30.2	30.4
Bosnia and Herzegovina	41.5	41.4	40.2	41.1	44.0	44.3	42.7	41.6
Kosovo	27.9	27.8	29.2	29.7	33.0	29.8	30.8	31.0
North Macedonia	35.3	33.8	31.5	33.7	38.4	42.0	41.7	40.6
Montenegro	45.3	47.0	46.6	46.0	55.4	47.9	43.1	40.7
Serbia	41.9	40.4	40.9	42.2	49.0	48.7	44.4	43.2
WB6	*36.9*	*36.7*	*36.3*	*37.0*	*42.2*	*41.2*	*38.8*	*37.9*
Public revenues (percent of GDP)								
Albania	27.6	27.8	27.5	27.2	26.3	27.8	27.4	27.4
Bosnia and Herzegovina	42.7	43.8	42.7	43.0	42.2	41.2	41.8	42.0
Kosovo	26.4	26.5	26.3	26.8	25.4	28.9	28.8	28.8
North Macedonia	31.5	31.0	30.4	31.5	30.2	36.1	36.8	36.5
Montenegro	42.5	41.4	42.0	43.3	44.4	43.9	42.2	41.7
Serbia	40.8	41.5	41.5	42.0	41.0	41.7	41.4	41.4
WB6	*35.3*	*35.3*	*35.1*	*35.6*	*34.9*	*36.6*	*36.4*	*36.3*

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

Key Economic Indicators (continued)	2016	2017	2018	2019	2020	2021e	2022f	2023f
Fiscal balance (percent of GDP)								
Albania	-1.8	-2.0	-1.7	-1.9	-6.8	-6.7	-2.8	-3.0
Bosnia and Herzegovina	1.2	2.4	2.5	1.9	-1.8	-3.1	-0.9	0.4
Kosovo	-1.4	-1.4	-2.9	-2.9	-7.6	-0.9	-2.0	-2.2
North Macedonia	-2.7	-2.8	-1.1	-2.2	-8.2	-5.9	-5.0	-4.0
Montenegro	-2.8	-5.7	-4.6	-2.7	-11.0	-4.0	-0.9	1.1
Serbia	-1.2	1.1	0.6	-0.2	-8.0	-6.9	-3.0	-1.8
WB6	*-1.4*	*-1.4*	*-1.2*	*-1.3*	*-7.3*	*-4.6*	*-2.4*	*-1.6*
Public debt (percent of GDP)								
Albania	68.7	66.9	64.9	63.7	75.1	75.4	74.9	73.1
Bosnia and Herzegovina	42.4	36.1	34.2	32.8	36.6	35.8	35.9	37.2
Kosovo	14.1	15.7	16.4	17.0	22.0	22.7	25.9	27.6
North Macedonia	39.9	39.4	40.4	40.7	51.4	53.9	55.9	56.7
Montenegro	64.4	64.2	70.1	76.5	105.3	87.7	77.0	69.9
Serbia	62.8	55.6	50.8	49.7	53.3	56.3	55.4	52.6
WB6	*48.7*	*46.3*	*46.1*	*46.7*	*57.3*	*55.3*	*54.2*	*52.9*
Public and publicly guaranteed debt (percent of GDP)								
Albania	72.3	71.9	69.5	67.4	77.2	78.6	76.7	74.9
Bosnia and Herzegovina	43.8	37.7	35.6	34.5	38.8	38.0	38.1	39.1
Kosovo	14.5	16.4	17.0	17.6	22.4	23.2	26.2	27.8
North Macedonia	48.8	47.7	48.4	49.4	60.2	62.7	64.7	65.5
Montenegro	70.4	69.1	74.1	80.0	108.7	90.7	79.8	72.5
Serbia	68.6	58.7	54.4	52.7	57.8	60.3	58.9	56.1
WB6	*53.1*	*50.2*	*49.8*	*50.3*	*60.9*	*58.9*	*57.4*	*56.0*
Goods exports (percent of GDP)								
Albania	6.7	6.9	7.7	6.6	6.1	7.6	7.5	7.5
Bosnia and Herzegovina	25.7	29.8	31.2	28.8	27.5	33.6	35.4	36.5
Kosovo	5.1	6.0	5.6	5.6	6.9	8.4	8.6	8.8
North Macedonia	36.5	40.6	45.4	47.5	44.7	46.0	47.1	48.3
Montenegro	8.9	8.9	9.4	9.4	9.8	9.5	9.6	9.8
Serbia	34.9	35.9	35.2	35.7	34.4	39.1	39.7	40.3
WB6	*26.3*	*27.9*	*28.5*	*28.5*	*27.5*	*31.1*	*31.8*	*32.4*

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

Key Economic Indicators (continued)	2016	2017	2018	2019	2020	2021e	2022f	2023f
Trade balance (percent of GDP)								
Albania	-16.8	-15.1	-13.7	-13.8	-14.7	-15.7	-13.0	-12.0
Bosnia and Herzegovina	-16.6	-16.2	-14.7	-14.7	-14.5	-12.7	-11.3	-11.7
Kosovo	-27.4	-25.8	-28.2	-27.1	-31.6	-32.7	-33.7	-33.7
North Macedonia	-15.2	-14.1	-12.7	-14.5	-12.8	-12.9	-12.1	-11.1
Montenegro	-22.5	-23.5	-23.8	-21.1	-35.0	-23.8	-18.2	-16.2
Serbia	-6.0	-7.8	-9.5	-9.9	-8.8	-8.9	-8.5	-8.2
WB6	*-12.8*	*-13.1*	*-13.4*	*-13.6*	*-13.7*	*-13.3*	*-12.2*	*-11.8*
Current account balance (percent of GDP)								
Albania	-7.6	-7.5	-6.8	-8.0	-8.8	-9.4	-8.1	-7.0
Bosnia and Herzegovina	-4.8	-4.8	-3.5	-3.2	-3.3	-2.0	-0.6	-1.1
Kosovo	-8.0	-5.5	-7.6	-5.6	-7.0	-8.5	-9.6	-9.2
North Macedonia	-2.6	-0.9	-0.1	-3.3	-3.5	-3.6	-3.0	-1.8
Montenegro	-16.2	-16.1	-17.0	-14.3	-26.1	-15.2	-11.2	-9.5
Serbia	-2.9	-5.2	-4.8	-6.9	-4.1	-5.0	-5.0	-4.9
WB6	*-4.8*	*-5.5*	*-5.1*	*-6.2*	*-5.7*	*-5.6*	*-5.1*	*-4.7*
External debt (percent of GDP)								
Albania	73.5	68.8	65.2	60.5	64.7	59.3	53.9	52.9
Bosnia and Herzegovina	79.1	70.6	66.8	64.1	71.6	70.0	70.3	70.5
Kosovo	33.2	32.6	30.5	31.2	37.5	n.a.	n.a.	n.a.
North Macedonia	74.7	73.4	73.0	72.8	80.2	80.8	78.7	78.9
Montenegro	161.8	159.9	163.7	169.0	224.1	195.5	194.0	193.5
Serbia	72.1	68.9	61.3	61.8	65.8	63.7	60.5	58.3
WB6	*82.4*	*79.0*	*76.7*	*76.5*	*90.6*	*93.9*	*91.5*	*90.8*
Unemployment rate (period average, percent)								
Albania	15.2	13.7	12.3	11.5	11.7	n.a.	n.a.	n.a.
Bosnia and Herzegovina	25.4	20.5	18.4	15.7	15.9	n.a.	n.a.	n.a.
Kosovo	27.5	30.5	29.5	25.7	n.a.	n.a.	n.a.	0.0
North Macedonia	23.8	22.4	20.7	17.3	16.4	n.a.	n.a.	n.a.
Montenegro	17.7	16.1	15.2	15.1	17.9	n.a.	n.a.	n.a.
Serbia	16.4	14.5	13.7	11.2	9.7	n.a.	n.a.	n.a.
WB6	*21.0*	*19.6*	*18.3*	*16.1*	*n.a.*	*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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Western Balkans Regular Economic Report
No.20 | Fall 2021

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