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No.13 | Spring 2018

Vulnerabilities Slow Growth

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Acknowledgements

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

The report is produced twice a year by a team led by Ekaterina Vostroknutova and Marco Hernandez (Task Team Leaders). This issue's core team included World Bank economists working on the countries in the region (with additional contributions to specific sections): Agim Demukaj, Sandra Hlivnjak (External section), Edith Kikoni, Sanja Madžarević-Šujster (Labor section), Darjan Milutinovic, Asli Senkal (Growth and Outlook sections), Lazar Šestović (Outlook section), Hilda Shijaku (Monetary and Fiscal sections), Bojan Shimbov (External section), and Johanna Jaeger and Christoph Ungerer (Financial Sector section). Additional contributions were made by: Stefanie Brodmann, Maria Davalos, Charl Jooste, Alena Kantarovich, Trang Van Nguyen, Monica Robayo, Alanna Simpson, and Cevdet Cagdas Unal.

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

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1. Overview

GDP growth in the Western Balkans slowed from 3.1 percent in 2016 to an estimated 2.4 percent in 2017. Regional growth in 2017 is less optimistic than the 2.6 percent expected when the Fall issue of this report was published. It slowed in Serbia due to a harsh winter and stalled in FYR Macedonia, where the political crisis deterred both public and private investment. Bosnia and Herzegovina (BiH) grew at a rate similar to the last two years. The dynamism of the smaller economies of Albania, Kosovo, and Montenegro drove regional growth in 2017, with support from higher growth in trading partners, a pickup in commodity prices, and the execution of large investment projects.

Although job growth was slower than in 2016, in the first nine months of 2017 190,000 new jobs were created in the region. Labor force participation increased in most countries, as more people entered the labor market and found jobs. Over 80 percent of new jobs were in services, mostly retail and wholesale trade, supported by growth in consumption. Although unemployment fell in most countries, it still ranges from 13.5 percent in Serbia to 30.4 percent in Kosovo. Poverty continued to fall despite rising food and energy prices.

Even though revenues improved, not all countries took the opportunity to reduce fiscal deficits. Serbia and Bosnia and Herzegovina recorded surpluses in 2017, but in the rest of the region, deficits continued, driven by the high amount of recurrent spending, often on poorly targeted social benefits and subsidies. Albania, Montenegro, and Kosovo are now working to revive growth-enhancing capital investment. Careful financial, public investment, and budgetary management will help ensure that fiscal risks associated with investments are minimized, which should relieve pressures on medium-term debt sustainability.

Table 1.1. The growth trajectory, 2016–19f

Real GDP growth, percent

	2016	2017e	2018f	2019f
Albania	3.4	3.8	3.6	3.5
Bosnia and Herzegovina	3.1	3.0	3.2	3.4
Kosovo	4.1	4.4	4.8	4.8
Macedonia, FYR	2.9	0.0	2.3	2.7
Montenegro	2.9	4.3	2.8	2.5
Serbia	2.8	1.9	3.0	3.5
Western Balkans	**3.1**	**2.4**	**3.2**	**3.5**

Source: Central Banks and national statistics offices; World Bank estimates and projections.

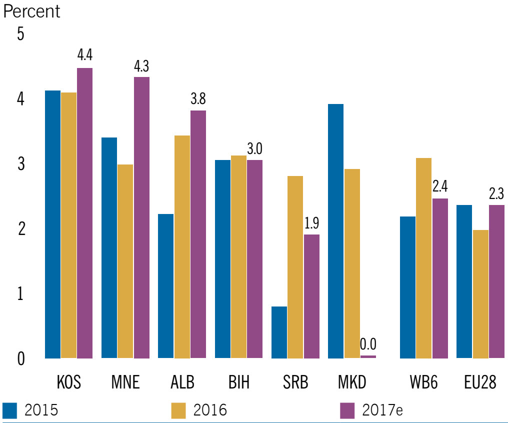
External vulnerabilities intensified in some countries. Current account deficits widened in several countries despite growth in exports because, except in Kosovo and FYR Macedonia, imports overwhelmed exports. A particularly cold winter necessitated more energy imports, and large infrastructure projects and higher consumption demanded more machinery, equipment, and goods from abroad. A current account sustainability analysis suggests that Western Balkan countries need to reduce external deficits in the medium term.

Bold structural reforms are necessary if the region is to grow sustainably over the medium term. Regional GDP growth is projected to rise from 2.4 percent in 2017 to 3.2 percent in 2018 and 3.5 percent in 2019. Countries are expected to grow faster, pushed up by projected stronger growth in Europe, except for Albania, where moderation is expected as large investment projects are completed, and Montenegro, which is expected to undergo a much-needed fiscal consolidation. Among risks to the outlook are trade protectionism, normalization of interest rates globally, and low potential growth and uncertainty about domestic policy or policy reversals. These risks can be mitigated by rationalizing spending to build fiscal space for growth-enhancing reforms, and by a more strategic approach to boost competitiveness. Policies to lift physical and human capital, expand labor force participation, and improve market institutions should help raise growth potential and reduce inequality.

2. Regional growth slowed, despite a favorable external environment

Because of weaker growth in FYR Macedonia and Serbia, real GDP growth in the Western Balkans slowed from 3.1 percent in 2016 to an estimated 2.4 percent in 2017 (Figure 2.1). In Serbia, where GDP growth was 1.9 percent in 2017, a severe winter and a summer drought subtracted at least 1 percentage point (pp) from growth because of lower agriculture and energy production. In FYR Macedonia, which did not grow at all in 2017, the prolonged political crisis led to a steep decline in public and private investment. However, Bosnia and Herzegovina, the second largest economy in the region, grew steadily by an estimated 3 percent, and the dynamism of the smaller economies also helped drive regional growth. Higher investment and a recovery in commodity prices supported growth in Albania, Kosovo, and Montenegro, supplemented by consumption in Albania and Montenegro and services exports in Kosovo and Montenegro.

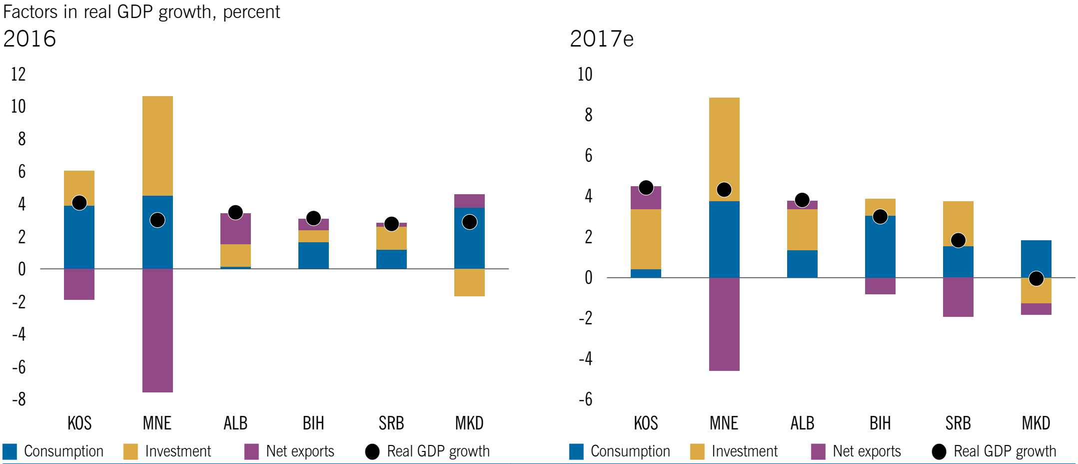
Figure 2.1. Regional economic growth slowed in 2017.



Source: National statistical offices data; Eurostat; World Bank staff estimates.

Infrastructure investment was robust, and commodity exports rose (Figure 2.2). In 2017 public investment and FDI-financed private projects led growth in Montenegro (5 pp), Kosovo (3 pp), and Albania (2.1 pp). The investment contribution in Serbia (2.3 pp) was partly due to a change in inventories (1 pp), as execution of the public investment program was

Figure 2.2. In 2017, countries grew faster when investment was solid.



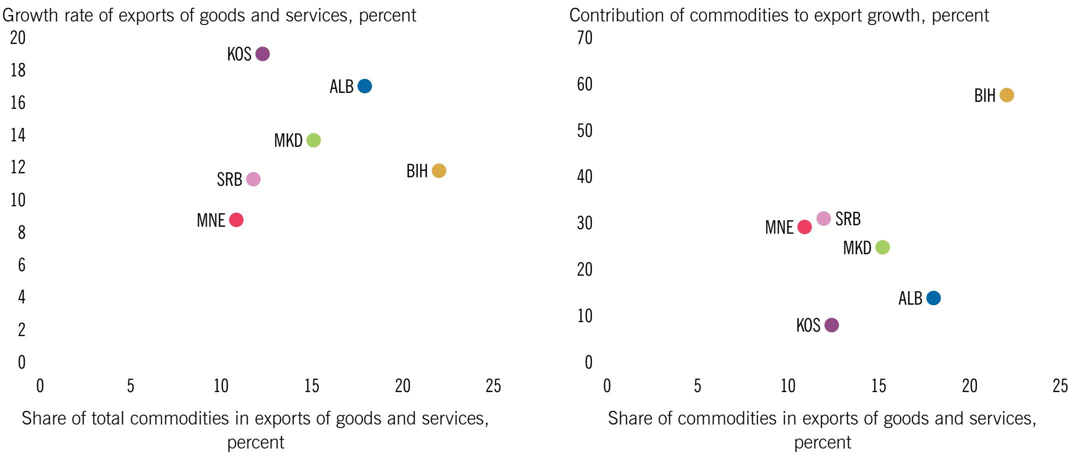
Source: National statistical offices; World Bank estimates.

slow. In FYR Macedonia, a fall in investment subtracted 1.1 pp from growth.

Although the external environment remained favorable, in 2017 net exports contributed less to growth, overwhelmed by higher imports for energy projects, consumption, and investment. Western Balkan countries where base metal and mineral commodities constitute an important share of the export basket benefitted from the rise in global commodity prices (Figure 2.3). However, the combination of rising oil prices and energy imports necessitated by the harsh winter reduced the contribution of net exports to growth; though that contribution was positive in Albania (0.4 pp), and Kosovo (1.1 pp), net exports subtracted from growth in Serbia (-1.9 pp), Bosnia and Herzegovina (-0.8 pp), FYR Macedonia (-0.7 pp), and Montenegro (-4.5 pp). As demand rose in the Euro Area, Albania, Montenegro, Kosovo, and FYR Macedonia benefitted from rising commodity prices and higher tourism-related exports. In Montenegro, rising imports linked to large infrastructure and tourism investments negated the growth contribution of exports. In Bosnia and Herzegovina and Serbia the moderately negative contribution of net exports to growth was due to higher imports of energy, intermediate, and capital goods.

Consumption continued to make a major contribution to growth, supported by higher employment and increasing consumer credit. Consumption accounted for around 90 percent of output in the Western Balkans, contributing 3.7 pp to growth in Montenegro and 3 pp in Bosnia and Herzegovina. In Albania, a sustained recovery in employment, wages, and household credit boosted private consumption, and public consumption was also positive as public wages rose. Private consumption grew, buoyed by rising employment, growing credit to households, and higher wages in Serbia, FYR Macedonia, and Montenegro, and by services growth in Bosnia and Herzegovina. Consumption growth stimulated job creation in wholesale and retail trade (services). While consumption is important at this level of development in the Western Balkans, because its growth is adding to the pressure on the external account from rising imports, it might stunt future growth.

Figure 2.3. Recovering commodity prices pushed up export growth in the Western Balkans.



Source: Central banks and national statistical offices; World Bank staff estimates.

3. Job creation may be tapering off

About 190,000 new jobs were created in the Western Balkans in the 12 months up to September 2017, with employment going up in all countries. The average employment rate in the Western Balkans has been increasing by 1.2 pp annually, reaching 44.2 percent in September 2017 (Figure 3.1). Employment in Montenegro and Serbia grew fastest, reaching a historical high of 48 percent for Montenegro and a close to historical high in Serbia at 48.2 percent. Albania became the only country in the region where employment rose above 50 percent. Even without economic growth, public programs helped FYR Macedonia's employment rate to improve slightly, to 44.5 percent. Despite a steep catch-up of 1.3 percentage points, employment in Kosovo is still low at 30.4 percent, however, and in Bosnia and Herzegovina it is stayed stubbornly below pre-crisis levels (Figure 3.2).

Services accounted for over 80 percent of new jobs in 2017. In all Western Balkan countries, wholesale and retail trade accounted for the bulk of new jobs, supported by growth in private consumption. Services were the most important factor in employment growth in all countries except Kosovo, where industry led (Figure 3.3). Additional impetus came from greater demand from the EU for Kosovar metal and Serbian automotive products. Also helping to raise employment were information and communication technologies and administrative activities (Kosovo), public programs (in FYR Macedonia, where about a third of new jobs were supported by employment subsidies), trade services, and agriculture (Bosnia and Herzegovina and Kosovo).

Yet the pace of job creation is slowing. The annualized rate of employment growth in the

Figure 3.1. More jobs were created in 2017.

Employment rate, 15+ years old, percent, and 2016–2017 increase, pp

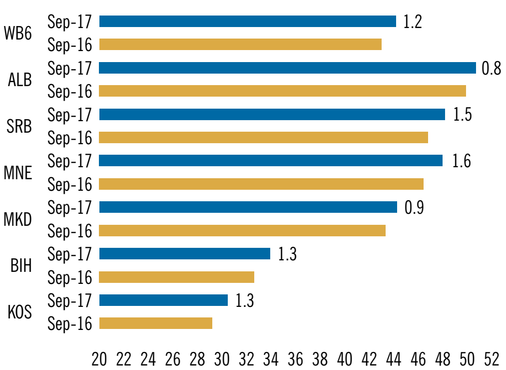
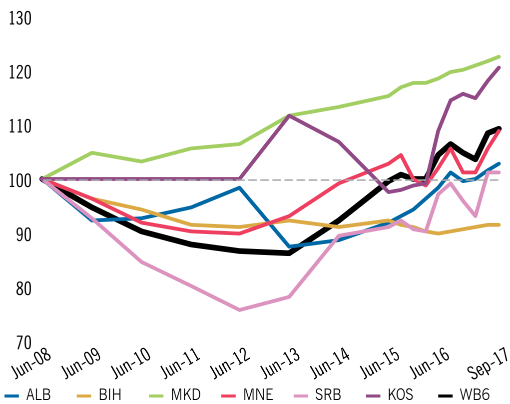


Figure 3.2. Only in Bosnia and Herzegovina is employment still at pre-crisis levels.

Employment index, Q2 2008=100



Source: National statistics offices, Labor Force Surveys, and World Bank staff estimates.
Note: Because Kosovo data combine two series of different frequencies; they may not be comparable.

Figure 3.3. Services created most new jobs.

New employment of 15+ years old, Jan–Sep 2017, in thousands

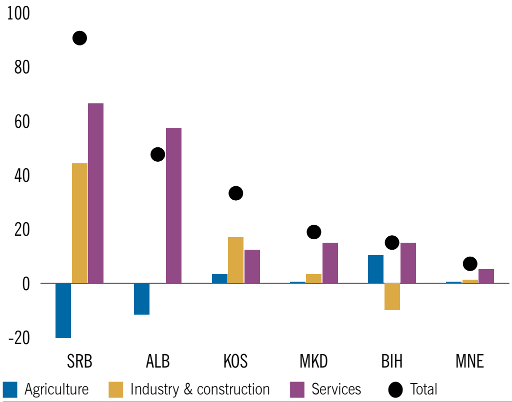
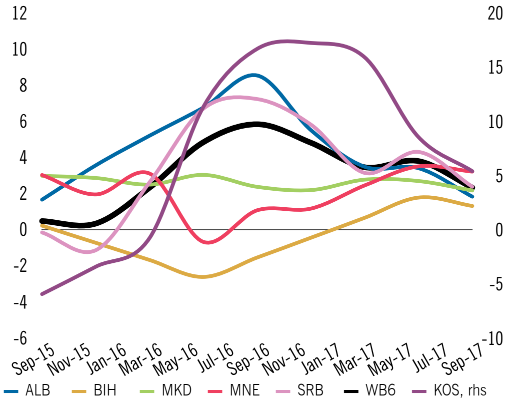


Figure 3.4. Job creation slowed in 2017.

Annual employment growth, percent



Source: National statistics offices, Labor Force Surveys, and World Bank staff calculations.
Note: Because Kosovo data combine two series of different frequencies, its data may not be comparable.

Western Balkans fell from 4.8 percent in 2016 to 2.3 percent in September 2017 (Figure 3.4). The adverse weather that hit employment in agriculture slowed job creation growth to 1.9 percent in Albania in September 2017, and to 2.4 percent in Serbia, compared to 5.5 percent and 5.8 percent a year earlier, respectively. In Bosnia and Herzegovina, where agricultural commodities are apparently less susceptible to cold winters, growing employment in agriculture helped the services sector to flip employment growth to positive. The Macedonia Employs program ensured steady 2.5 percent annualized employment growth there, mitigating the lack of economic growth. In Montenegro, robust growth in construction and tourism pushed employment to 3.2 percent, up from 1.2 percent in 2016. In Kosovo, the slowdown from 17.2 to 5.3 percent was due to a base effect. The regional participation rate averaged 53.5 percent in September 2017—up only 0.3 pp since September 2016, with the largest gains in Kosovo (3.3 pp) and Serbia (1.1 pp) and likely losses of people of working age due to emigration (Box 3.1).[1]

Despite slower job creation, unemployment declined in all countries in the region except Kosovo (Figure 3.5). As of September 2017, there were 1.24 million people unemployed—5.6 percent less than a year ago. The largest decline in the number of unemployed was 18 percent in Bosnia and Herzegovina, but this was due to declining labor force participation as people emigrated or stopped searching for work. Encouragingly, though, long-term unemployment in Bosnia and Herzegovina, decreased by nearly 3.4 pp, although at 82 percent in 2017 it is still a very high percentage of the unemployed. In Kosovo, unemployment worsened as more people, particularly youth, entered the labor force as job creation slowed. The lowest unemployment rate in the region was Serbia's, with an annual average of 13.5 percent in 2017, although it rose

1 Aging is another factor affecting labor force participation in Western Balkan countries (see: World Bank and wiiw "Western Balkans Labor Market Trends 2018").

Box 3.1. Emigrants: Usually working-age and highly educated

Emigration has a powerful effect on demography, labor markets, and economic development in the region. Between 1990 and 2015 emigration from the Western Balkans more than doubled, to about 4.4 million. For decades emigration has helped to relieve the lack of local job opportunities. When emigrants leave for jobs, the remittances they send back are an important source of income for the recipients. At the same time, however, because remittance inflows expand disposable incomes, they increase reservation wages and thus reduce incentives to work, particularly for secondary earners in the household.

Figure B3.1.1 Emigration has been rising since 1990.

Emigration as a percentage of residents, 1990–2015

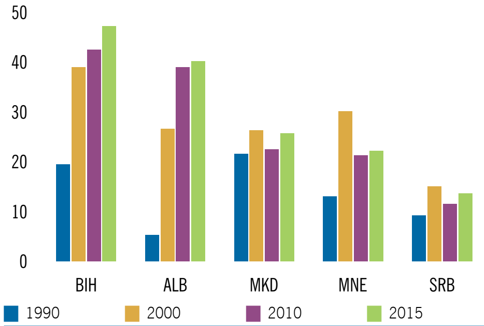
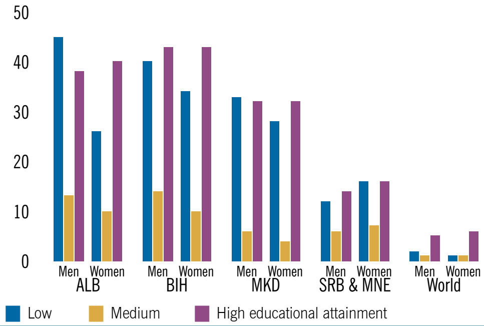


Figure B3.1.2 Emigrants tend to be of working-age and more educated.

Emigration by gender and education, percent 2010



Notes: Low educational attainment includes lower secondary schooling, primary schooling and no schooling; medium educational attainment includes a high-school certificate or equivalent; and high educational attainment includes levels of education higher than a high school certificate or equivalent. The stock of migrants as share of resident population does not include intra-regional migration in the Western Balkans. For any given education level and year, the emigration rate is defined as the total migrant population from a given source country divided by the sum of the migrant and resident population in the same source country.

In some countries more than 40 percent of the resident population has emigrated, notably Albania, Kosovo, and Bosnia and Herzegovina. In 2015, the main destinations of emigrants from the region were Austria, Germany, Greece, Italy, and Switzerland. Emigrants tend to be of working-age and more highly educated, with women making up an increasingly large share. Better coordination between the sending and receiving countries with respect to the mobility of highly skilled workers, including students and researchers, and a tighter focus on knowledge transfer and involvement of the diaspora would enhance the positive aspects of migration for both individuals and societies.

Source: World Bank and wiiw (Western Balkans Labor Market Trends 2018) based on UN Statistics (2015) and the IAB Brain Drain Database.

in the last quarter of 2017 to 14.7 percent. By September 2017, three countries reached their historically low unemployment rates (though still very high by international standards): 13.6 percent in Albania, 14.8 percent in Montenegro, and 22.1 percent in FYR Macedonia. Of the jobless, two-thirds had been seeking work for over a year.

Youth unemployment in the Western Balkans declined to 31.5 percent in September 2017 (307,000 fewer young people unemployed), 6 pp below the September 2016 rate. It was lowest in Albania, at 26 percent, followed by Montenegro and Serbia, both below 30 percent. Meanwhile, Bosnia and Herzegovina, Kosovo, and FYR

Figure 3.5. Unemployment is lower but still remains high.

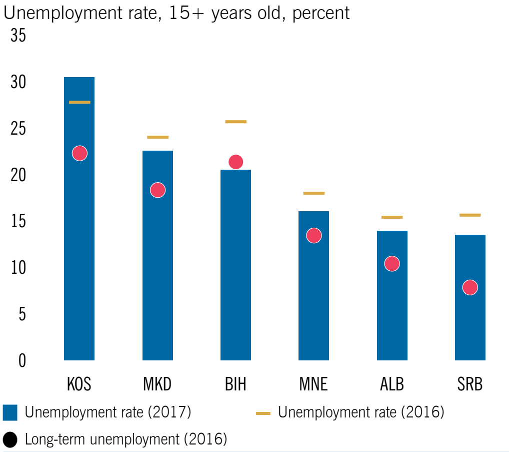
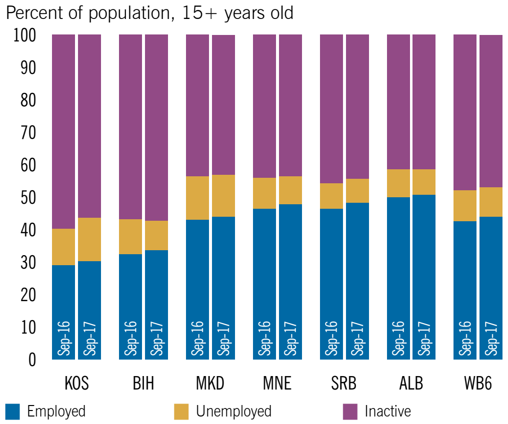


Figure 3.6. More people found jobs, but progress is slow.



Source: National statistics offices, Labor Force Surveys, and World Bank staff estimates.
Note: Because Kosovo data combine two series of different frequencies, they may not be comparable.

Macedonia all had youth unemployment rates around 50 percent. In fact, Kosovo's reached 53.2 percent as more young people entered the labor market while fewer jobs were created than in 2016. In addition to substantial skill mismatches, a relatively high minimum wage could be a disincentive for hiring low-skilled and young people (Box 3.2).

Wage pressures are rising. After several years of economic growth, discussions about raising the minimum wage have begun. In Albania, real wages for formal jobs picked up in 2017 in construction, energy, and tourism, tracking the rising demand for labor. In Serbia, the average real wage increased by 0.9 percent, with private-sector wages recovering faster as public sector-wages were reined in as part of the fiscal consolidation. In FYR Macedonia, wages continued upward in 2017; helped by the increased minimum wage and low inflation that helped raise real net wages by 1.2 percent y-o-y, led by manufacturing, construction, and services. The pattern in Bosnia and Herzegovina is similar, with real wages growing by 0.4 percent in 2017. Led by cuts in public sector wages required by fiscal consolidation, after having gone up by 3.8 percent in 2016, real wages in Montenegro fell back by 0.4 percent.

With inflation still low, growth and jobs lifted people out of poverty. In 2017, the average poverty rate for Albania, Kosovo, FYR Macedonia, Montenegro, and Serbia dropped by an estimated 1 percentage point from a year earlier, to a projected regional poverty rate of 23.1 percent.[2] This implies that in these countries, around 117,000 people were lifted out of poverty during 2016–17.[3] Rising inflation, especially in food and energy prices, is starting to affect lower-income households where food consumes more of household budgets. To sustain recent welfare improvements, countries across the region will need to continue creating jobs and boost labor earnings.

2 Poverty rates are World Bank estimates based on data from national authorities. The regional average estimate excludes Bosnia and Herzegovina due to problems calculating PPP welfare aggregates.
3 Poverty figures reflect the upper-middle-income-country standardized benchmark of living on less than US$5.5 a day in 2011 PPP terms.

Box 3.2. Youth wages and job seeking

Wage levels differ remarkably within the region. Measured in purchasing power parity (PPP), in 2016, Montenegro and Bosnia and Herzegovina had the highest wages, and Albania was far behind at the bottom of the wage scale. Yet Albanian wages have gone up the most since 2010, and FYR Macedonian wages have largely stagnated in PPP terms. Interestingly, when looking at the distribution of wages, in FYR Macedonia, Montenegro, and Serbia, there are many people earning a low wage, and few people earning a high wage, since the mean wage in these three countries is about 20 percent higher than the median wage.

Figure B3.2.1. Wages in the region differ dramatically.

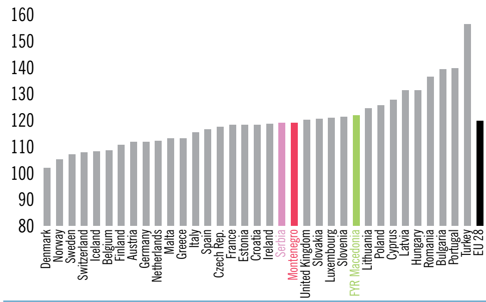
Average gross monthly wage, Euros at PPP

	2010	2011	2012	2013	2014	2015	2016	Change 2016–10, %
ALB	602	627	650	605	784	807	774	28.6
BIH	1,271	1,334	1,381	1,382	1,385	1,393	1,375	8.2
MNE	1,478	1,497	1,485	1,465	1,470	1,502	1,523	3
MKD	1,235	1,197	1,219	1,193	1,223	1,254	1,239	0.3
SRB	1,042	1,095	1,142	1,134	1,135	1,130	1,128	8.3
KOS	.	.	990	986	1,059	1,160	1,169	18.1

Note: For Kosovo, percentage change of wages is for 2016/2012.

Figure B3.2.2. They are also unequally distributed.

Mean to Median Wage Ratio, in percent, 2014



While the number of employees who make less than two-thirds of the median wage is well above the EU average of 17.2 percent, it is highest among the youngest workers—above 40 percent in Montenegro and above 30 percent in the FYR Macedonia and Serbia—and considerably lower among employees 50 and older. This is a common feature throughout the Western Balkans—in former Yugoslav countries, labor market regulation called for a mandatory premium for work experience (irrespective of length of service with the current employer). In 2014 the premium was still in force in FYR Macedonia, Montenegro, and Serbia, but in the latter labor market reforms of 2015 changed that. In FYR Macedonia, the annual premium was 0.5 percent per year of work experience; in Montenegro it was progressive, starting at 0.5 percent and rising gradually to 1 percent with 20 years of experience.

Figure B3.2.3. Share of workers earning low wages is high, when put in European perspective.

Share of low wage earners, percent, 2014

Figure B3.2.4. Over a third of the low wage earners are young people.

Age structure of low wage earners, percent, 2014

Sources: World Bank and wiiw (Western Balkans Labor Market Trends 2018) based on data provided by national statistical offices and Structure of Earnings Survey, 2014.

4. Though revenues rise, sustainability requires better management of spending

Bosnia and Herzegovina and Serbia recorded fiscal surpluses in 2017, but elsewhere in the region deficits edged up (Figures 4.1 and 4.2). Both Bosnia and Herzegovina and Serbia improved tax collection and spent less on interest payments and public investments. By contrast, Montenegro recorded the largest increase ever in its deficit, 2.3 percent of GDP, despite spending less on wages and social benefits. Deficits edged up elsewhere in the region—revenue gains and savings on debt service were not enough to compensate for higher spending. But while in Albania it was on public infrastructure, and energy subsidies, in FYR Macedonia and Kosovo (which also increased public investment) higher revenues were used up on ad hoc social transfers.

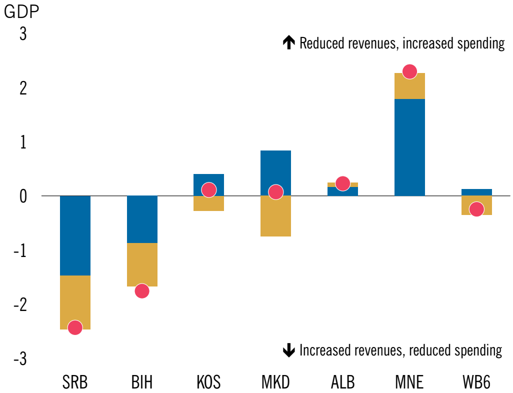
Revenues rose in all countries except Montenegro (and remained stable in Albania). The gains, close to 0.4 percent of GDP on average for the region, were mainly driven by better performance of indirect taxes, in particular higher collection of value-added taxes (VAT), which on average contribute more than half of total revenues. More determined collection by Bosnia and Herzegovina of both indirect and direct taxes through tighter controls and measures to reduce smuggling, and higher social security contributions and profit taxes in Serbia supported revenue growth of 0.8 and 1 percent of GDP, respectively. In FYR Macedonia, although domestic demand fell, revenues increased by 1.3 percent of GDP as better VAT collection and higher labor contributions compensated for lower income in special revenue accounts and other taxes. Revenues in Albania remained steady as a percent of GDP. In Kosovo, revenue gains resulted from higher personal income tax revenue, supported by higher employment and wages, and improved VAT collection, which compensated for less corporate tax income, lower property tax collections, and a reduction

Figure 4.1. Except in Bosnia and Herzegovina and Serbia, deficits edged up, 2015–17.

Fiscal deficits, percent of GDP

Figure 4.2. Revenue gains were used to increase spending in most countries.

Contribution to change in the fiscal deficit, 2017e, percent of GDP



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

Figure 4.3. Higher spending went mainly to capital investment and social benefits.

Contribution to change in public spending, 2017e, percent of GDP

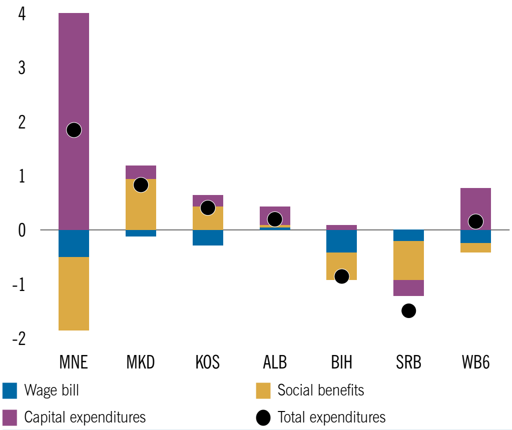
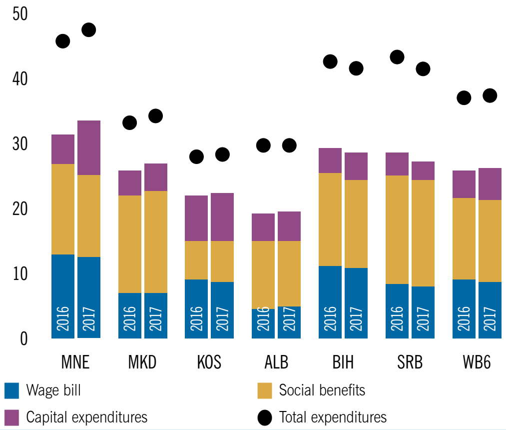


Figure 4.4. Spending is dominated by public wages and social programs.

Estimated public spending, 2017, percent of GDP



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

in customs tariffs as the EU SAA agreements went into effect. Because Montenegro adopted comprehensive tax reforms in 2017 pursuant to fiscal consolidation, among them raising the VAT rate, reducing exemptions and excise taxes, and introducing a new excise on coal, the fall in the country's revenue-to-GDP ratio reflects a base effect due to a large one-off fee collected in 2016 for 4G rights. Recent improvements in revenue performance illustrate opportunities for Western Balkans countries to mobilize more revenue by reducing tax exemptions and improving tax administration.

Although most countries took in more revenue, few used the opportunity to improve fiscal balances, instead spending unproductively on untargeted social benefits and transfers (Figures 4.3 and 4.4). Higher revenues led to higher spending, except in Serbia, where continued consolidation efforts combined with lower public capital investment and lower subsidies to state-owned enterprises, and in Bosnia and Herzegovina. But while Albania ramped up public investment activity, Kosovo and FYR Macedonia channeled it to badly targeted programs. Higher spending in FYR Macedonia's was directed towards health, pensions, subsidies, and social assistance. In Kosovo the increased spending went mainly to a rise in pensions and benefits to war veterans, although it also increased public investment, e.g., on the Route 6 motorway. Montenegro's extra spending was dominated by the construction of Bar-Boljare highway, although in 2017 the government introduced reforms to contain current spending, abolish untargeted social benefits,[4] and reduce spending on public wages.

If growth is to accelerate, the Western Balkan countries need to redirect spending to investment in physical and human capital. In 2017, social benefits and public wages stood at 21.1 percent of GDP in the region, significantly more than the regional capital spending of 5.2 percent of GDP (Figure 4.4). Ensuring

4 The Montenegrin parliament abolished the "lifetime" benefit for mothers of three or more children, which had not only doubled the social benefits budget but also caused many women to withdraw from the labor market.

sustainable fiscal savings through reforms of state-owned enterprises (SOEs) and pensions, better targeting of social benefits, and tighter public financial management down to the municipal level would allow Western Balkan countries to create the fiscal space necessary to improve the quality of infrastructure, education, health, and social protection systems. In the past, these countries initiated investment projects that were unfinished due to lack of resources, accumulated arrears, or generated contingent risks to the budget. Capital spending is inefficient because of deficiencies in public investment management, such as limited medium-term budgeting, lack of ex post project evaluation, and lengthy procurement processes (see Boxes 4.1 and 4.2).

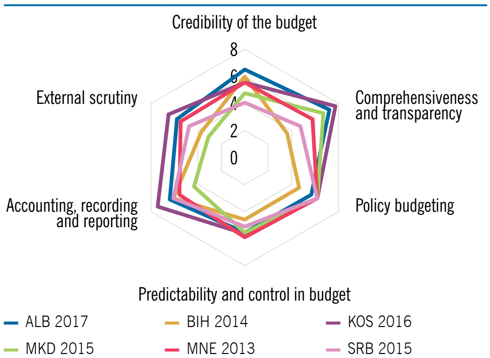
Box 4.1. Albania's management of public finances

Sound public financial management (PFM) is vital to ensure fiscal sustainability, strategic allocation of public resources, and efficient delivery of public services. In recent years, though PFM has been improved in Western Balkan countries have taken efforts in recent years to strengthen their PFM systems. Yet, there is ample room for improving budget transparency and budget linkages to government development strategies; there are also challenges with the quality of budget information available to decision-makers, and a lack of systems to monitor and evaluate results.

In 2017 Albania conducted a Public Expenditure and Financial Accountability (PEFA) assessment to evaluate progress in recent years and to update its PFM strategy. PEFA is a standardized and systematic analysis of PFM performance covering such areas as fiscal discipline, resource allocation, and service delivery that makes it possible not only to assess progress but also to benchmark results with other countries. Preparing the PEFA was a core element of the Albanian Government's PFM strategy for 2014–20.

The PEFA assessment found that the country's PFM system performs similarly to peers in the region but there are gaps in certain dimensions that if bridged could help produce better outcomes (Figure B4.1.1). Albania has made significant progress in fiscal discipline, budget transparency, and the comprehensiveness of and accessibility to budget information. However, there is too little extra-budgetary information, uneven performance by service delivery units, and somewhat opaque transfers to local governments. Moreover, medium-term budget planning (MTBP) needs work.

Figure B4.1.1. Albania's PFM systems meet basic standards, according to PEFA scores.



Albania's budgets are in general more reliable than those of its regional neighbors. The country maintained fiscal discipline in 2014–17 and the quality of its revenue forecasting is better. However, a continuing large variance—averaging 22.8 percent—in the functional composition of budgeted and actual spending undermines budget credibility. In recent years the variance has been affected by clearance of arrears and unanticipated costs related to large investment projects.

Box 4.1 continued

Public investment management (PIM) is a major challenge for Albania. It suffers from fragmented data, inadequate monitoring and evaluation, and no standards for project selection. The government is also vulnerable to fiscal shocks due to failure to monitor, report, and manage such risks as the quasi-fiscal activities of public companies, public-private partnerships, and explicit contingent liabilities resulting from, e.g., disasters, current litigation, and likely court cases.

Reinforcing MTBP and linking it more directly with the government's development strategy would help ensure both fiscal sustainability and more effective services. While the medium-term perspective is already part of macro-fiscal planning and budgeting, the budget's strategic focus is affected by deviations from the official budget calendar, tenuous links to sector strategies, and minimal legislative scrutiny of the MTBP. Also needing attention is building performance-oriented capacity and the efficiency and effectiveness of service delivery. Too much direct contracting erodes the efficiency of service delivery and makes it difficult to get the best value in making government purchases. Better internal auditing could address systemic or performance issues. Performance audits by the Supreme Audit Institution (SAI) are only just being introduced and SAI reports are not yet published so are not subject to public discussion. Moreover, management is generally not responsive to SAI or legislative recommendations, so that opportunities to use resources more efficiently are being missed.

Source: World Bank based on the 2017 Albania PEFA Assessment (https://pefa.org/sites/default/files/AL-Dec17-PFMPR-Public%20with%20PEFA%20Check.pdf)estimates.
Note: Ordinal scale converted to numerical (A = 8; B+ = 7; etc.). For comparability purposes the PEFA methodology of 2011 is used.

Countries that undertook fiscal consolidation saw public debt ease (Figures 4.5 and 4.6). A combination of economic growth, fiscal discipline, and active debt management in 2017 brought down the share of public and publicly-guaranteed (PPG) debt in Serbia, Albania, and Bosnia and Herzegovina. In Serbia, with the help of exchange rate movement, PPG debt fell by an estimated 10.6 pp of GDP. Montenegro's overall PPG debt went up from an already high level due to financing of highway construction. In FYR Macedonia PPG debt went down, from

Figure 4.5. Public debt-to-GDP ratios fell in Serbia, Albania, and Bosnia and Herzegovina.

Public and publicly guaranteed debt, percent of GDP

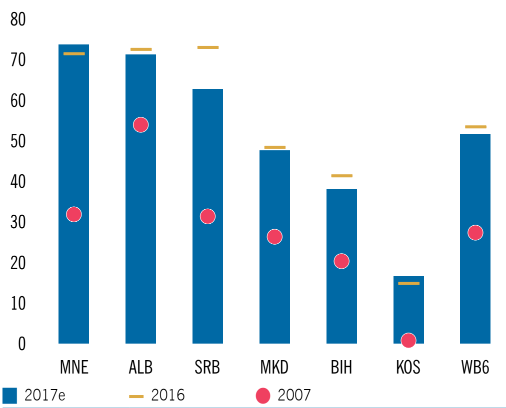
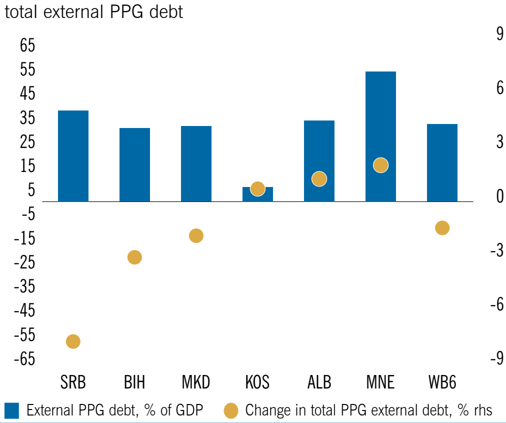


Figure 4.6. Fiscal consolidation brought down external PPG debt in Serbia.

External PPG debt as a percent of GDP, and percent change in total external PPG debt



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

48.5 percent of GDP in 2016 to 46.7 percent in 2017, as the government reduced accumulated deposits to pay down debt. Kosovo's PPG debt, while the lowest in the region (16.5 percent of GDP in 2017), continued to increase due to higher social benefits and better execution of public investment projects.

External PPG debt pressures also declined in countries that took advantage of favorable financial markets (Figure 4.6). Serbia's external PPG debt fell to 38 percent of GDP in 2017, partly due to depreciation of the U.S. dollar, in which about a third of the country's PPG debt is denominated. In Albania PPG debt rose from 32.7 percent of GDP in 2016 to 33.7 percent with the government's strategic move to extend the maturity of debt and lower its cost. The growth of Montenegro's external PPG debt to 54.5 percent of GDP was driven mainly by financing of the Bar-Boljare highway and the increasing share of U.S. dollar-denominated highway loans.

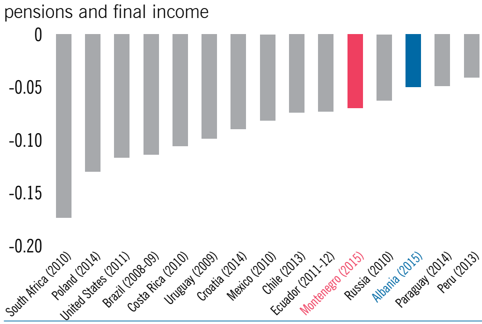
Box 4.2. The distributional impact of fiscal systems in Albania and Montenegro

Fiscal policy can have powerful equity impacts. More and more policymakers are using fiscal-incidence analysis to assess the redistributive effect of a country's tax-benefit system and how fiscal reforms might affect different segments of the population.

The Albania and Montenegro fiscal systems are reducing inequality (Figure B4.2.1). In both, the inequality of market income, measured by the Gini coefficient, is brought down by the combined effect of taxes and contributions, social benefits, and social spending on health and education. Inequality has fallen by 5 Gini points in Albania, and by 7 in Montenegro. Social benefits and spending help reduce inequality; though indirect taxes (VAT and excises) have an un-equalizing effect, it is a very small one. Direct taxes—personal income tax and individual social contributions—are progressive (those with lower incomes pay less).

Figure B4.2.1. In Albania and Montenegro, the fiscal system reduces inequality less than in other countries.

Reduction in Gini coefficient from market income plus pensions and final income



Notes: Data are the percentage change in the poverty rate with respect to the poverty line specified in each study.

Fiscal-incidence analysis can help policy makers to calculate the costs and benefits of reforms. Better targeting of Albania's social assistance program Ndihma Ekonomike, which is just beginning, is expected to enhance the program's impact on poverty. In Montenegro, policy simulations of the distributional impacts of fiscal reforms—a rise in excises and VAT, abolition of the mothers' benefit (partly compensated by an increase in child benefits), and a reduction of public sector wages—have informed the Government's fiscal consolidation program.

Sources: Dávalos M.E., M. Robayo-Abril, E. Shehaj, and A. Gjika. 2018. "The Distributional Impact of the Fiscal System in Albania," World Bank Policy Research Working Paper 8370 (https://www.openknowledge.worldbank.org/handle/10986/29496). Younger, S., and D. Dragani. 2017. "Fiscal Incidence in Montenegro," cited in Montenegro's Public Finance Management Review (World Bank, forthcoming).

5. As inflation rises, monetary policy stays accommodative

Average consumer price inflation in the Western Balkans went up from 0.5 percent in 2016 to 2.3 percent in 2017, driven by stronger domestic demand, higher wages, and higher import prices (Figure 5.1). Food and energy prices rose most (Figure 5.2). Core inflation was negative in Kosovo and much lower than headline inflation in Albania, Bosnia and Herzegovina, and Serbia, suggesting that inflationary pressures will be in check until output and employment growth is somewhat bolder. Higher excise taxes in Montenegro and drought-related food price increases in Albania also contributed to higher prices in 2017. In Serbia, a recovery of consumption and higher prices for food and regulated goods and services pushed inflation up to 3 percent, the region's highest but still within the central bank target band. In Bosnia and Herzegovina and FYR Macedonia, after prolonged deflation inflation reappeared as higher prices of both imported and domestic goods. In Albania, the declining output gap as well as higher import prices pushed inflation to just under the target cap.

Monetary policy continued to support growth, but transmission through the credit channel is reduced. Central banks in Albania (which has a floating exchange rate and inflation targeting) and FYR Macedonia (which has a pegged exchange rate), kept interest rates stable (Figure 5.3). Consistent with low underlying inflation pressures, Serbia's central bank lowered its policy rate twice in 2017, reaching 3.5 percent by year-end. In Albania, the central bank has kept the minimum rate at 1.25 percent since April 2016 and has announced no changes before the second half of 2018. In FYR Macedonia, given subdued prices, sluggish corporate lending activity, and a negative output gap, the policy rate was lowered twice in 2017 in order to support lending activities (see Box 5.1).

Figure 5.1. In most of the region, Inflation rose.

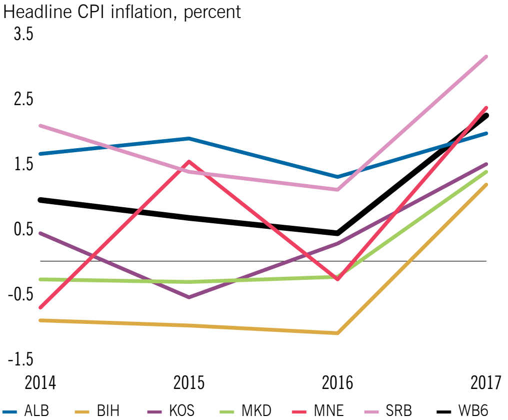
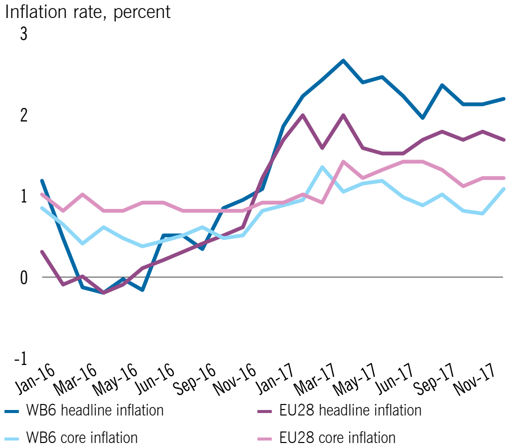


Figure 5.2. Food and energy prices led the way.



Source: Central banks, national statistical offices, Eurostat, World Bank staff calculations.
Note: Food and energy prices are included in headline but not core price indexes.

Figure 5.3. Monetary policy is accommodative in economies using inflation targeting…

Official policy interest rates, percent

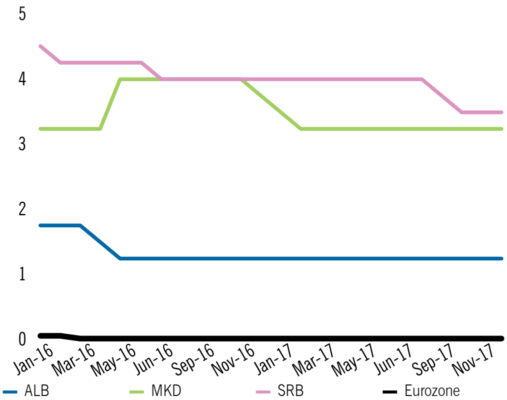
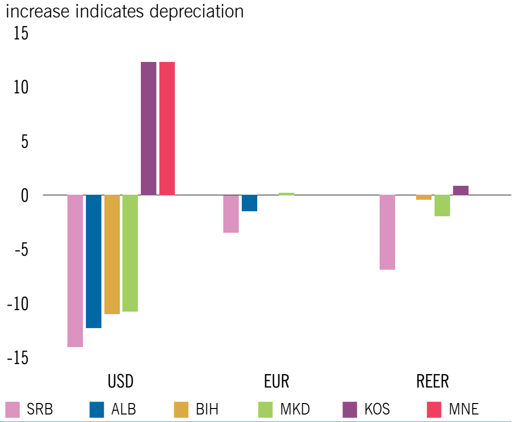


Figure 5.4. …as their currencies appreciated.

Exchange rate changes Dec 2017 to Dec 2016, percent, increase indicates depreciation



Source: National authorities; Eurostat; World Bank staff calculations.

Exchange rate appreciation softened growth, worsening already vulnerable external accounts. In the inflation-targeting countries, exchange rates appreciated against the euro (Figure 5.4). Since it adds to pressures to increase imports, appreciation could be a drag on growth. For example, in Serbia which is also experiencing an appreciation towards its trading partners, net exports declined significantly. In turn, this contributes to current account vulnerability (see Section 7).

Box 5.1. Efforts to reduce euroization

Since the start of the plan-to-market transition, which was marked by high inflation and macroeconomic and political instability, distrust in the local currencies resulted in euroization of deposits. And as economic agents exploited interest rate differentials between foreign currency loans and local currency deposits, so called carry-trade euroization also emerged.

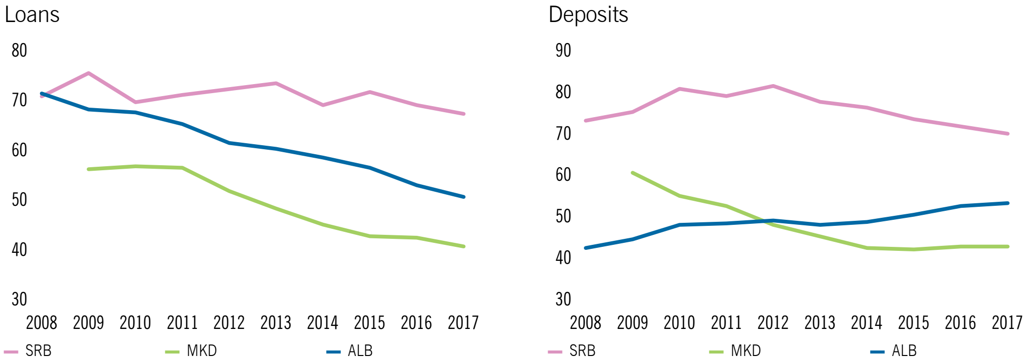
In the Western Balkans, deposit-driven euroization was dominant; euro-denominated loans and deposits currently comprise 70 percent of the total in Serbia and 60 percent in FYR Macedonia. In Albania, carry-trade euroization meant that 70 percent of loans were denominated in euros, but only 40 percent of deposits. Indeed, in Albania, historically interest on local currency deposits has been high, so households and corporations save in domestic currency but borrow in relatively less costly foreign currency.

Concerns about limited interest rate policy transmission and balance sheet mismatches, which increase macroeconomic risks, have led some countries in the Western Balkans to actively seek de-euroization. But reversing it completely has proven difficult (Figure B5.1.1). As awareness of the exchange rate risk and macroprudential tools reduced incentives for foreign-currency borrowing, foreign-currency credit fell gradually, aided by write-offs of nonperforming loans, 75 percent of which were in foreign

Box 5.1 continued

currency. As in other countries in similar circumstances, de-euroization in deposits has been slower than in loans (historically, deposit euroization has only been adequately resolved when transition countries joined the euro area). In fact, in Albania the share of deposits in foreign currency has been going up, from 44.1 percent in 2009 to 53.1 in 2017, and in Serbia and FYR Macedonia it has declined by 11.4 pp and 17.9 pp, compared to the peak level.

Figure B5.1.1. Loan and deposit euroization have both declined, except in Albania.



Source: National central banks and World Bank staff calculations.

Carry-trade euroization is easier to reverse, by correcting mispricing of exchange rate risk, and by measures to make foreign exchange loans less attractive. In 2016 the Bank of Albania changed its policy requirement for reserves in foreign currency to align it with the ECB deposit facility rate. Other measures include safeguarding macroeconomic stability, building up financial sector resilience, and increasing the transparency of financial services. In Serbia, the dinarization strategy, in place since 2012, rests on three pillars: (1) enhancing the macroeconomic environment by keeping inflation low and stable; (2) expanding the market for dinar securities; and (3) building a market for foreign exchange hedging instruments.

Sources: Geng et al. 2018. "Carry Trade vs. Deposit-Driven Euroization," IMF Working Paper No. 18/58; Della Valle et al. 2018. "Euroization Drivers and Effective Policy Response: An Application to the Case of Albania, IMF Working Paper No. 18/21; and World Bank staff.

6. Declining NPLs and expansion of credit offer some support for growth

In 2017, credit outstanding[5] increased everywhere in the region, except in Albania. In Kosovo, the growth of credit to the private sector has been particularly strong, over 11 percent in 2017, as private demand grew with better market conditions and lower interest rates (Figure 6.1). In Montenegro, accelerating private sector credit growth exceeded 6 percent in December 2017, as confidence improved and there was vigorous growth in deposits, a major source of funding for local banks. At 3 to 7 percent, lending remained robust in Bosnia and Herzegovina and FYR Macedonia. However, bucking the regional trend, credit growth in Albania was almost zero, mostly because of loan write-offs. Lending to households has pushed up credit growth; lending to corporations has been more uneven, with few loans to businesses and write-offs of nonperforming loans (NPLs) (Figure 6.2).

Higher lending in domestic currency helped manage currency risks in private portfolios. Central bank measures in FYR Macedonia and Serbia were directed to de-euroizing balance sheets, implementing reserve requirements for foreign exchange-linked deposits, and assigning higher risk weights to unhedged borrowers. After some efforts to reduce lending in foreign currencies, the Bank of Albania launched a comprehensive strategy to reduce the use of foreign currency which came into force in January 2018 (see Box 5.1). Progress in de-euroization has been gradual; outstanding loans in foreign currencies still range from about

Figure 6.1. Credit outstanding rose in most of the Western Balkans in 2017.

Non-financial private sector change in credit outstanding, percent y-o-y

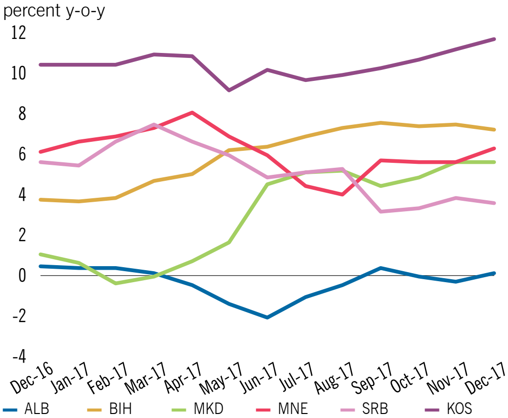
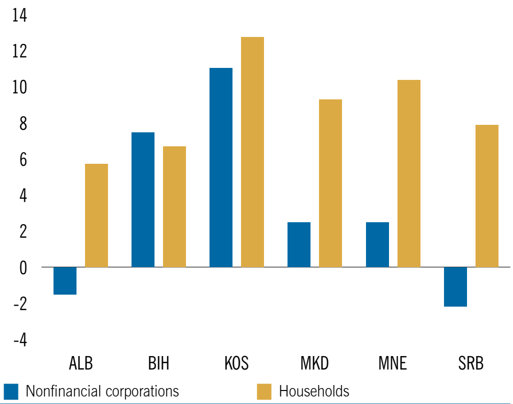


Figure 6.2. Credit to households grew; credit to firms dwindled.

Change in credit outstanding, percent y-o-y in December 2017



Source: IMF IFS; national central banks.

Note: Consistent data on private sector credit growth in Albania, BiH, Macedonia FYR, and Serbia are from the IMF International Financial Statistics (IFS) Other depository corporations surveyed are expressed in local currency. Data for Kosovo come from the same indicator which is expressed in EUR. Data for Montenegro is calculated based on central bank statistics for credit to the economy but not credit to governments and financial institutions.

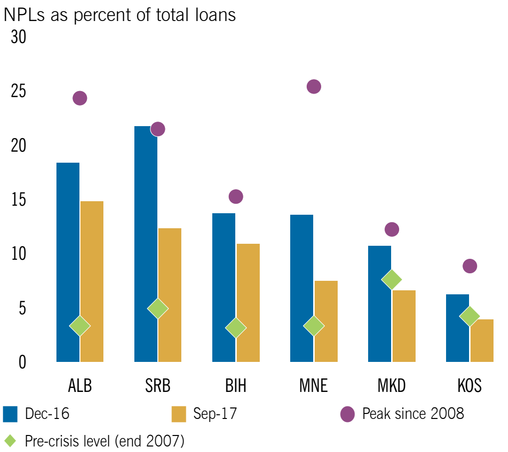
5 Reference to credit here refers to the stock of non-financial private sector credit outstanding. Growth in that stock reflects changes in both new credit and NPL write-offs.

44 percent of total loans in FYR Macedonia to about 67 percent in Serbia. In Albania, the share of foreign currency lending dropped slightly, from 60 percent in mid-2016 to 56.4 percent at end-2017.

Despite still high levels of NPLs, continuing improvement in asset quality is helping drive credit growth. Because NPLs burden bank balance sheets, undermine profits, and erode capital, they make it harder for banks to use the credit channel to support economic growth. NPLs, though declining, are still far above pre-crisis levels, though FYR Macedonia and Kosovo had less exposure to international markets and less need for reforms (Figure 6.3). Recent reforms have helped to reduce NPLs considerably elsewhere: FYR Macedonia, Albania, Montenegro, and Serbia have moved to write off old NPLs and there has been an uptick in NPL sales in Serbia. Kosovo has introduced a new system to enforce collateral recovery, and new insolvency laws are in place in Albania, Kosovo, and the Bosnia and Herzegovina entity Republika Srpska. Albania is also preparing to introduce a system for voluntary out-of-court restructuring. Since Montenegro amended its law on voluntary financial restructuring to facilitate NPL resolution, there has been an estimated 8 percent decline in the NPL portfolio. The regional NPL average was 8.7 percent of total loans as of December 2017. While NPLs have steadily declined from over 20 percent at peak times in Albania (to 13.2 percent in 2017), their levels are still the highest in the region. At 3.1 percent as of December 2017, Kosovo has the lowest.

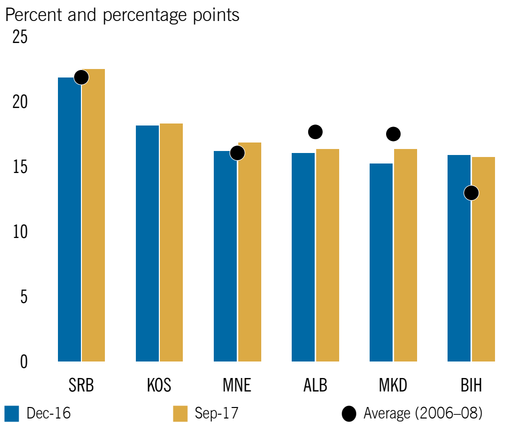
Banks in the Western Balkans are well-capitalized (Figure 6.4) and liquid, through considerable heterogeneity may lead to further consolidation. At end-2017, bank capital adequacy averaged 17.5 percent and the ratio of liquid to total assets was about 29.6 percent (Figure 6.4). Profitability, though low, has held firm, with a regional average return on assets of 1.7 percent. However, the vulnerabilities of domestic banks have renewed concerns about asset quality and the health of specific banks, especially in Bosnia and Herzegovina and Montenegro. In Serbia the quality of state-owned bank assets continues

Figure 6.3. Nonperforming loans are declining.



Source: National central banks.
Note: For Serbia, data are for November 2017.

Figure 6.4. Banks are adequately capitalized.



Source: National central banks.
Note: For Serbia, data are for November 2017.

to be a concern, despite improvements in the banking system as a whole. Further structural changes are likely after the planned sale of some foreign-owned subsidiaries as parent banks realign country exposures and smaller domestic institutions merge in Albania, Bosnia and Herzegovina, and Serbia. The deleveraging of foreign banks has driven up domestic deposits and reduced average loan-to-deposit ratios from over 100 percent in 2011–12 to 83 percent by the end of 2017.

Diversification of funding sources is vital to providing term financing to foster investments, and ultimately economic growth. Financial sectors in the Western Balkans are bank-centric; there is very little capital market activity, negligible penetration of insurance products, and generally insignificant nonbank financial institutions. Identifying alternative sources of funding could be an important driver of innovation and long-term growth for the region.

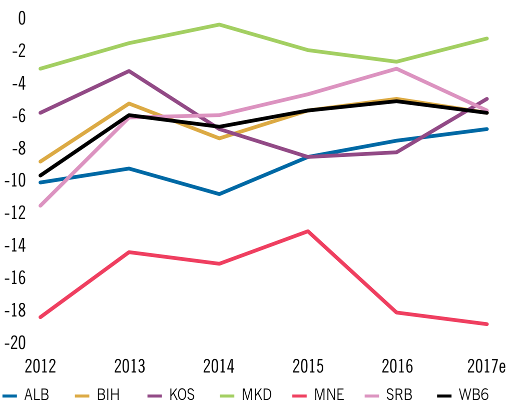
7. Exports grow, but external deficits worsen in some countries

In 2017 external deficits widened in Bosnia and Herzegovina, Montenegro, and Serbia, and narrowed in Albania, Kosovo, and FYR Macedonia (Figure 7.1). Serbia and Kosovo saw the largest changes, in opposite directions, in their current account deficits (CADs); in other countries the changes were relatively small. The CAD in Serbia widened to 5.7 percent of GDP—almost double the 2016 deficit of 3.1 percent—as surpluses in trade in services and in net transfers failed to compensate for rising imports and a higher primary income deficit. The high CAD in Montenegro, 18.9 percent of GDP in 2017, is a threat to external sustainability, having been pushed up from 18.1 percent in 2016 by the rise of construction-related imports. CADs widened slightly in Bosnia and Herzegovina (by 0.8 percent), driven mainly by higher trade deficits. In contrast, it is estimated that a lower trade deficit and higher remittances are responsible for the narrowing of CADs in Albania (by 0.7 pp of GDP), Kosovo (by 3.2pp of GDP), and FYR Macedonia (by 1.4pp of GDP).

Goods and services exports grew briskly in several countries, but imports grew even faster (Figure 7.2). In 2017, heightened demand from the EU benefited Western Balkan exporters, and prices going up additionally benefited commodity exporters Albania, Bosnia and Herzegovina, Kosovo, FYR Macedonia, and Montenegro. Nonetheless, rising imports of intermediate goods, infrastructure, energy, and consumption goods worsened most trade deficits. Higher imports were driven by rising domestic demand as currencies firmed up in several countries (see Section 5). In Albania, mineral exports and tourism receipts pumped up goods and services exports; higher exports compensated for higher imports for investments in the energy sector and higher electricity imports as drought depressed

Figure 7.1. CADs in the region widened in some countries in 2017.

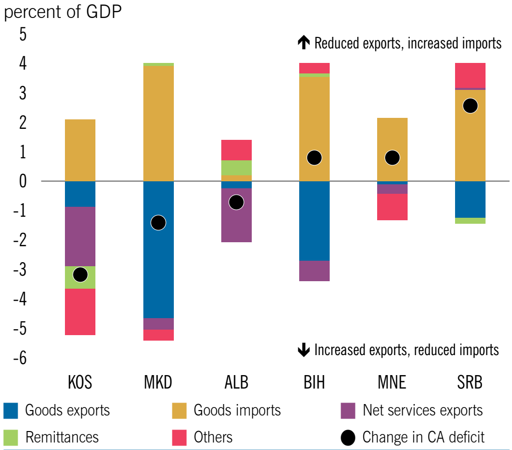
Current account balance, percent of GDP



Source: Central banks and national statistical offices; World Bank estimates.

Figure 7.2. Goods Imports mainly drove the change in CADs.

Contribution to changes in current account deficit, 2017e, percent of GDP



Source: Central banks and national statistical offices; World Bank estimates.
Note: "Others" mainly refers to repatriation of profits.

electricity production. Although Bosnia and Herzegovina's exports benefited from improved external demand, higher imports for infrastructure and stable remittances resulted in a higher trade deficit. Kosovo experienced a surge in exports of goods (23 percent) and services (18 percent), which combined with higher remittance inflows offset the rise in investment- and consumption-related imports. In Montenegro, the trade deficit widened as solid exports of services (mostly tourism) and commodities were not enough to offset the rise in construction-related imports for both the Bar-Boljare highway and tourism investments. In FYR Macedonia and Serbia there was a surge in energy imports (largely oil) and imports of intermediate goods related to FDI. Nevertheless, in FYR Macedonia growth in exports (supported by both FDI and traditional goods-related exports) overperformed imports, narrowing the trade deficit. Meanwhile, Serbia's trade deficit was worsened by high growth of imports.

Because a common feature of Western Balkan economies is the relatively high import content of exports, as exports go up, so do imports of intermediate goods. This is particularly true for Bosnia and Herzegovina, FYR Macedonia, and Serbia, where most exports come from the FDI sector. Exports from foreign firms have helped to both diversify and increase the sophistication of the export basket. Creating backward linkages between FDI-funded and local firms would help reduce the import content of exports and thus improve trade balances (see Box 7.1).

Box 7.1. Current account sustainability in the Western Balkans

While there is no absolute definition of current account sustainability, policymakers recognize that a persistent current account deficit (CAD) could affect the macroeconomic stability necessary for EU accession. A country has a positive CAD when the value of the goods and services it imports exceeds the value of those it exports. Because the CAD represents the difference between national savings and investment, it needs to be externally financed. In general, a country's current account deficit (CAD) can be sustained if the ratio of foreign debt to GDP is not increasing and foreign investors are willing to finance it, though other factors can have some effect.

A stationary intertemporal ratio of CAD to GDP is a good indicator of sustainability. With econometric analysis it is possible to find the long-run steady state for a country's CAD. Countries with a CAD that may be high can be projected to experience a narrowing in the deficit toward its their long-term equilibrium CAD, while those countries below equilibrium level might experience a widening of their external deficits.

While actual CADs vary, in all Western Balkan countries except FYR Macedonia they are above 5 percent of GDP, the generalized threshold for a sustainable external balance. The CAD long-run steady state for the region is high at 9.4 percent. In the medium term, as Western Balkan countries grow and improve their economic institutions, their long-run CAD steady state should trend down. Reducing CADs is also important in terms of the criteria for EU accession. In terms of policy, a high but sustainable CAD based on imports of machinery and equipment for investments to boost future exports can promote growth. But a high CAD due to rising imports for consumption goods may exacerbate vulnerabilities.

Source: World Bank calculations based on national accounts data.

Figure 7.3. Total FDI inflows to the region were generally steady in 2017…

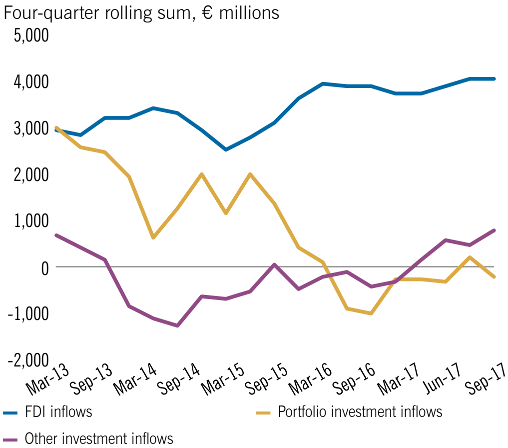
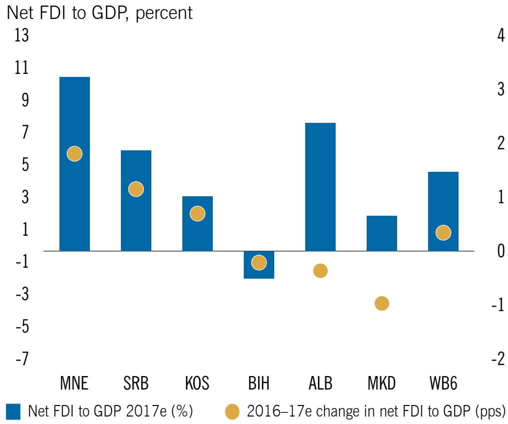


Figure 7.4. …but net FDI inflows fell in FYR Macedonia.



Source: Central banks and national statistical offices; World Bank estimates.

Steady FDI inflows helped finance CADs. Total FDI inflows to the region were relatively steady in 2017 (Figure 7.3), supported by remittance inflows. In Montenegro, net FDI inflows went up 1.8 pp, to 11.2 percent of GDP as tourism and real estate investments resumed, but only financed 60 percent of the CAD. In Albania, net FDI inflows were associated with large investment projects, and in Kosovo diaspora investments in real estate were supported by the highest remittances in the region, 11.2 percent of GDP. In Serbia, FDI inflows increased and were higher than the CAD. In FYR Macedonia, although net FDI inflows declined, they continue to fully finance the CAD; but in Bosnia and Herzegovina, where FDI is significantly less than in other countries, they finance only about 30 percent of it. Although the Western Balkans have enjoyed substantial support to growth from FDI inflows, investment remains lower than recommended for stable long-term growth (see Section 8).

Sources of external financing for the Western Balkans need to be closely monitored to prevent pushing up external debt. Though growing exports and FDI inflows are positive for Western Balkan external positions, there are risks associated with sustained, and in some countries relatively high, CADs. Currently, CADs are mainly financed by FDI. If rising imports continue to widen external deficits, pressures on official foreign currency reserves and external debt would intensify. In 2017, however, all Western Balkan countries had foreign currency reserves of more than 5 months of imports.

8. A positive but somewhat clouded growth outlook

In the medium term real GDP growth in the Western Balkans is projected to recover, reaching 3.2 percent in 2018 and 3.4 percent in 2019. A slight slowdown in Albania and Montenegro is being more than counteracted by faster growth in other countries in the region (Table 8.1). FYR Macedonia's economy is projected to gain momentum in 2018 and grow at 2.3 percent, from zero in 2017, as investment and consumption recover after resolution of the political crisis. In Serbia, a recovery in investment is projected to support growth of 3 percent in 2018 and 3.5 percent in 2019. Kosovo is projected to grow at 4.8 percent in 2018–19, led by higher capital spending and investment. Growth in Bosnia and Herzegovina is also expected to pick up, supported by more investment in energy, construction, and tourism. On the other hand, growth in Albania and Montenegro is expected to moderate in during 2018–19 as large FDI projects wind down and the much-needed fiscal consolidation advances in Montenegro.

The growth outlook assumes favorable external conditions: an investment-supported economic recovery in the EU, higher growth in global trade flows, and favorable financing conditions with relatively low interest rates, even if there is further normalization of monetary policy in advanced economies. With a projected modest increase in prices, commodity exporters will get an additional growth boost, which should further build domestic demand. In general, growth relies on higher exports in Albania, FYR Macedonia, and Bosnia and Herzegovina and investment in Kosovo, FYR Macedonia, and Serbia, tied to growth in the EU. While consumption is currently a major driver of growth throughout the region, its contribution is expected to strengthen even further in Albania, Bosnia and Herzegovina, Montenegro, and Serbia. As a result, risks could rise as growing demand for imports leads to higher external imbalances and subdues growth. Albania, Kosovo, Montenegro, and Serbia will also rely on more public investment to support baseline growth, thus highlighting the importance of creating fiscal space for public investment, improving project management capacity, and exploring options for additional investment, such as PPPs.

Table 8.1. With growth likely to recover, the outlook is positive

Percent

	2016	2017e	2018f	2019f
Albania	3.4	3.8	3.6	3.5
Bosnia and Herzegovina	3.1	3.0	3.2	3.4
Kosovo	4.1	4.4	4.8	4.8
Macedonia, FYR	2.9	0.0	2.3	2.7
Montenegro	2.9	4.3	2.8	2.5
Serbia	2.8	1.9	3.0	3.5
WB6	**3.1**	**2.4**	**3.2**	**3.5**

Source: Central banks and national statistics offices; World Bank estimates and projections.

Externally, the expected recovery in EU growth is a major impetus for growth in the Western Balkans. But should the fears of trade wars gain ground, there could be a decline in confidence that would affect medium-term growth. EU growth is projected to remain strong in 2018 (though somewhat constrained by the unwinding of the monetary stimulus and below-target inflation), supported by higher investments and consumption driven by improved labor market conditions. Yet trade protectionism and rising geopolitical tensions could disrupt progress. Imports to the EU are projected to moderate in the medium term with a slowing in trade growth and domestic demand. The proposed U.S. introduction of tariffs on imports of steel and aluminum would have negative impacts, both direct and indirect, on the outlook for the Western Balkans. For instance, the EU exports about US$6 billion of steel to the U.S. While estimates suggest that the new tariffs would depress U.S. demand for steel by not more than 10 percent, lower margins and volumes might have some impact on Western Balkan countries. In 2017, in Bosnia and Herzegovina steel constituted 4 percent of total exports, and Montenegro exported steel and aluminum valued at €89 million, equivalent to 24 percent of its exports.

Furthermore, both weather-related shocks and country-specific vulnerabilities—such as low potential growth—could disrupt regional growth forecasts. Growth in 2017 was damaged by Serbia's weather vulnerability,

Box 8.1. Climate change and the Western Balkans

The Western Balkans region suffers inordinately from natural disasters. Since 1990, 100 disasters there have affected more than 3.8 million people and caused more than US$ 3.5 billion in direct damages. In May 2014 alone, unprecedented rainfall in Bosnia and Herzegovina affected about 1 million people, 25 percent of the population, and the resulting heavy flooding caused estimated damages and losses equivalent to nearly 15 percent of the country's GDP. In Serbia at the same time, damage and losses were estimated at 4.7 percent of GDP. In terms of impact on GDP growth, natural disasters in Serbia are more severe and happen more often, underscoring the importance of adaptation to climate change. Agriculture makes this very clear: because of climate-change-related disasters, since 2000 agriculture has made a negative contribution to GDP growth 10 years out of 17.

Figure B8.1.1. Impact of natural disasters

Response of exports to a 1 percentage point shock to growth in a corresponding region, percent increase in exports, 1990–2017

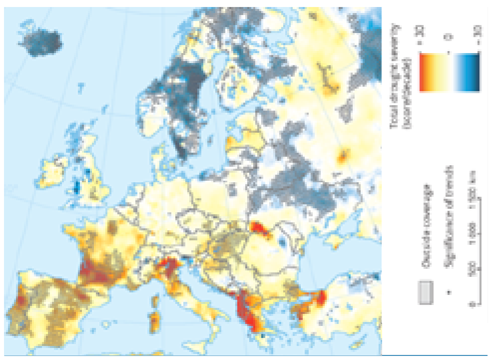
	Natural Disaster	Total Deaths	Total Persons Affected	Direct Damage (US$ million)
Albania	25	52	962,326	24.7
FYR Macedonia	23	68	1,281,548	409.2
Bosnia and Herzegovina	23	46	1,414,155	821.6
Montenegro	6	1	12,586	--
Serbia	23	96	210,499	2,280.5
Region Total	100	263	3,881,341	3,536

Source: EM-DAT: The Emergency Events Database - Université Catholique de Louvain (UCL) - CRED, Belgium.

Note: Natural disasters include droughts; earthquakes; extreme temperatures; floods; landslides; storms and wildfires. Kosovo is not included in the database.

Figure B8.1.2. Trends in severity of droughts

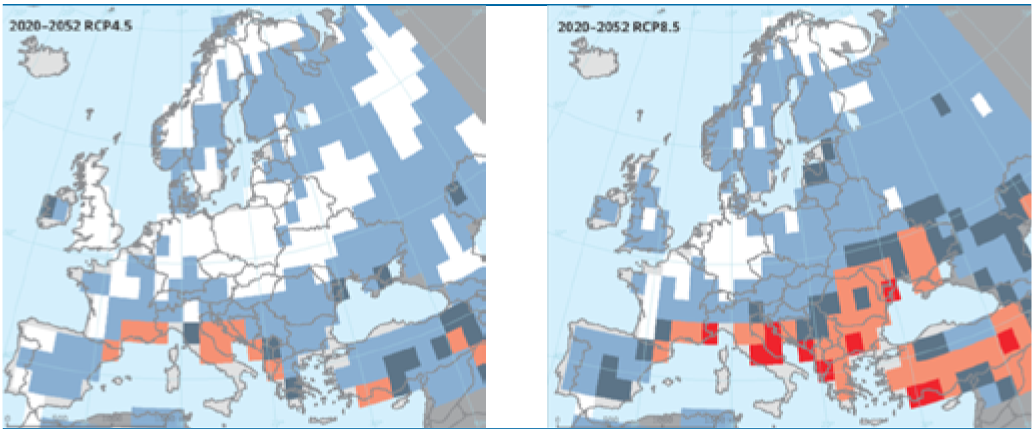
Response of GDP to a 1 percent shock to the corresponding region's GDP, percent increase in GDP



Source: Meteorological and hydrological droughts; European Environment Agency 2016.

Box 8.1 continued

Figure B8.1.3. Projected heat wave frequency, 2020–52, RCP 4.5 and 8.5 scenarios



Source: European Environment Agency, 2015.
Note: Orange areas might face 3-6 heatwaves over the projection period, red areas could have 6-12. The RCP 4.5 scenario assumes that greenhouse gas emissions peak around 2040, then decline; the RCP 8.5 scenario assumes that emissions continue to increase.

Flood risk is especially worrisome. For a once-in-100-years flood, potential GDP losses are estimated at 6 percent in Albania to 18 percent in FYR Macedonia. With climate change and continued urbanization and concentration of assets in vulnerable areas, the risk is expected to double or quadruple by 2080. Moreover, more intense short rainfall events will exacerbate flash flooding and urban flooding across the region, especially where urban storm water systems are already under pressure. Similarly, areas where landslides have occurred are likely to experience increases in slope instability after intense rain.

Wildfire potential is already high in all Western Balkans countries and higher temperatures and greater unpredictability of rainfall will add to the number of days with extreme wildfire potential. Drought frequency and severity are both expected to worsen. The whole region will be affected, but it is expected that droughts will be most severe in Albania, FYR Macedonia, Montenegro, and southern Bosnia and Herzegovina.

Sources: World Bank. 2017. Europe and Central Asia - Country risk profiles for floods and earthquakes (English). Washington, D.C.: World Bank Group. http://documents.worldbank.org/curated/en/958801481798204368/Europe-and-Central-Asia-Country-risk-profiles-for-floods-and-earthquakes; www.thinkhazard.org with data from CSIRO, Australia; Meteorological and hydrological droughts; European Environment Agency, 2016, https://www.eea.europa.eu/data-and-maps/indicators/river-flow-drought-2/assessment.

which could rise even further with climate change (Box 8.1). In addition, in the absence of productivity gains there is a risk that growth in the Western Balkan countries may slow down even if global growth trends up. Also, with interest rates low and financial markets volatile, the possibility of a sudden adjustment cannot be ruled out; inflation expectations are edging up as labor markets in developed countries tighten, and the U.S. dollar could appreciate as monetary easing is withdrawn in the EU, raising risk to countries with a high share of US$-denominated debt, like Serbia and Montenegro.

Domestically, political uncertainty may cloud the growth outlook if upcoming elections in several countries lead to a slower pace of structural reforms. Notably, the risk of fiscal loosening is compounded by the increasing reliance on consumption: Serbia has announced yet another increase in public wages and pensions, Kosovo continues to provide untargeted social programs with unplanned costs, high spending on pensions in FYR Macedonia leaves little for public investment, and while Montenegro has started an ambitious consolidation program it will take time to reap its benefits. Downside risks to growth, challenges generated by fiscal consolidation, high rates of unemployment and inactivity, and exposure to natural disasters can only heighten vulnerability. Volatile domestic policy has previously affected growth in the Western Balkans (Box 8.2).

Box 8.2. Unpredictable domestic policy can cause growth volatility

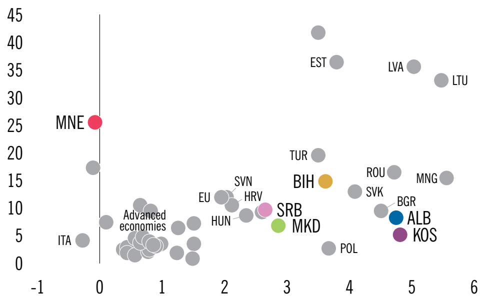
High volatility can undermine long-term growth due to higher uncertainty. Since the 2008 global financial crisis, both globally and in the Western Balkans the dynamics of output volatility has changed. Contrary to previous crises, as the recession originated in the US and spread to other advanced economies, situations in the advanced economies and the EU-28 became more volatile as it combined with narrowing fiscal space and limited exchange rate flexibility.

Between 2009 and 2016 growth in the Western Balkans, except Montenegro, was much less volatile than was the EU-28 average due to underdevelopment of the financial systems and low integration with external financial markets. Yet, as the region gradually becomes more integrated financially, it is important to build strong policy and institutional framework to guard against such external shocks.

Unlike in the EU, in the Western Balkans, the main cause of growth volatility is country-level shocks, once volatility of growth is decomposed by whether it stems from global shocks, country-specific shocks, or the interaction of country-specific and sector-specific shocks in agriculture, industry and services. The covariance between country-specific and sector-specific shocks reflects the interaction of policies and volatility. For example, in some countries fiscal or monetary policy innovations might be correlated with the shocks to particular sectors. Except in Albania, FYR Macedonia, and Bosnia and Herzegovina in 2001–08, and more recently Kosovo, policies have seen very little success in reducing volatility. If policies are such that they reduce volatility, the latter term is negative; this also reflects that macroeconomic policies are countercyclical and mitigate the effect of economic cycles arising from volatility in different sectors.

Figure B8.2.1. Volatility and growth, 2001–16

Variance of growth of GDP per capita at factor cost in constant US dollars



The largest source of variation in the Western Balkans are country-specific sectoral shocks because of inadequate aggregate domestic policies. This suggests that improvements in macroeconomic policy and political stability would promote growth. Incomplete financial development is also a factor, because shocks can amplify the negative consequences of volatility and lead to acute uncertainty and binding financial constraints. Empirical evidence suggests that increasing financial depth, higher

Box 8.2 continued

educational attainment, higher manufacturing output as a share of GDP, and higher exchange rate flexibility help reduce volatility.

Figure B8.2.2. Before the crisis domestic shocks spurred volatility.

Decomposition of volatility of GDP per capita growth, 2001–2008

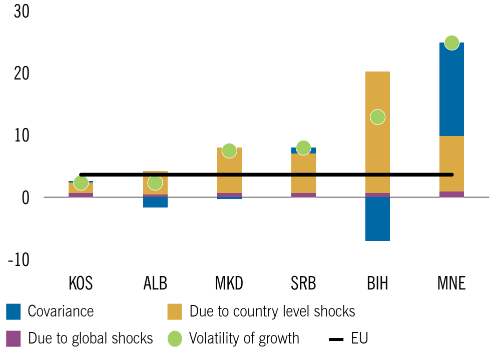
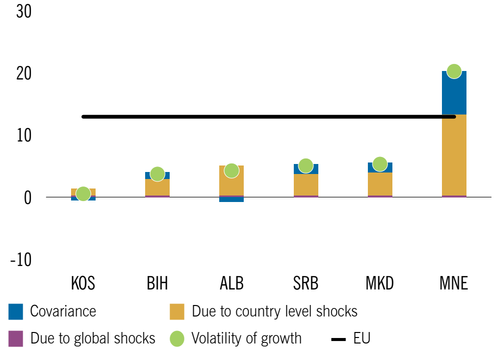


Figure B8.2.3. After the crisis volatility fell, but with no help from policy, except in Kosovo and Albania.

Decomposition of volatility of GDP per capita growth between 2009–2008



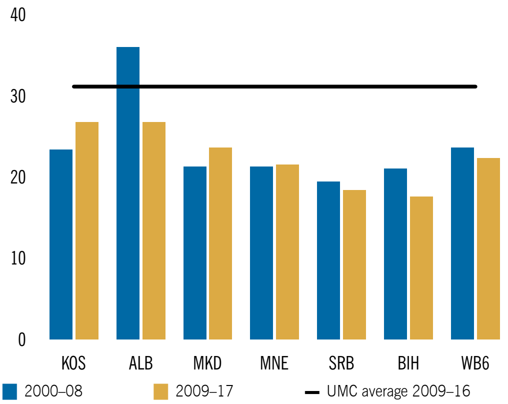
As the region's economies grow and become more integrated both regionally and globally, structural reforms and stronger institutions continue to be vital to mitigate both internal and external shocks. While countries with fixed exchange rates have few monetary policy options to cope with shocks, others have little fiscal space for countercyclical fiscal policy. It is now ever more important to build resilience to shocks by improving social outcomes like educational attainment, increasing financial depth, improving institutional development, and creating fiscal space to enact countercyclical fiscal policy.

Sources: World Bank estimates based on data from World Development Indicators, and Koren, M and S Tenreyro, "Volatility and Development," The Quarterly Journal of Economics, February 2007, Vol. 122, No. 1: 243-287.

Risks to the growth outlook can be mitigated by increasing fiscal space for growth-enhancing reforms and investments. The current fiscal consolidations in Albania, Serbia, and Bosnia and Herzegovina, as well as the recent adjustment in Montenegro, have reduced fiscal risks and improved confidence. However, more profound and long-lasting reforms are needed to ensure that policy reversals do not jeopardize growth and confidence outcomes. Tax reforms to mobilize revenues and create the fiscal space to fund development priorities should be accompanied by rationalization of spending. Fiscal rules, medium-term expenditure frameworks, and close monitoring of fiscal risks and contingent liabilities can foster institutional credibility and help restore fiscal space. Reforms to support growth include broadening the tax base, eliminating loopholes and excessive tax exemptions, and reinforcing tax administration and collection. To be prepared for shocks, countries in the Western Balkans need fiscal space in which to maneuver; the space is currently tightly bound by untargeted recurrent spending. Rationalizing spending must be emphasized, especially as

Figure 8.1. Investment rates are low.

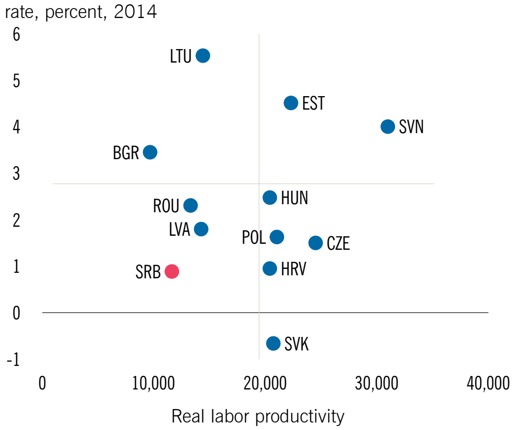
Gross capital formation, percent of GDP



Source: World Development Indicators.
Note: UMC = upper middle income countries.

Figure 8.2. Productivity is low and stagnant.

Real labor productivity in constant 2010 euro and its growth rate, percent, 2014



Source: Eurostat, Serbia's Structural Business Surveys 2009 to 2014, and World Bank staff calculations.
Note: Lower left quadrant denotes the lowest productivity and productivity growth among countries depicted. Among the Western Balkans countries, comparable data are available only for Serbia. Real labor productivity is measured as value added (at factor cost) per person employed. Real values are euro 2010-adjusted. Compound annual growth rate is based on growth between 2009 and 2014 for each country.

several countries in the region prepare for elections. Reforms could enhance the quality of public spending.

But because the highest risk to the outlook is a low-growth trap, it is important to advance structural reforms to promote private sector development and reduce barriers to labor force participation. With high structural unemployment, low investment, low education outcomes that explains the inadequacy of human capital, and stagnating productivity growth, potential output in the Western Balkans is low. Investment rates are below the 25 percent of GDP recommended by the Growth Commission for sustainable long-term growth, even though countries with similar incomes have on average surpassed that (Figure 8.2).[6] Real labor productivity has been low and stagnating (Figure 8.2). Political concerns—such as coalition politics and repeated election cycles, which intensify the political cycle, so that even dominant elites are risk-averse—have been slowing essential structural reforms, which are the only engine that can increase growth potential. The cost of inaction on reforms is enormous; an outsized public sector encourages capture of state assets and income streams. Finalizing this part of the transition from a planned to a market economy would lower fiscal pressures, reduce crowding-out, and promote market competition. Policies to lift physical and human capital, encourage labor force participation, and improved market institutions will help raise growth potential and reduce inequality.

Low productivity, which is holding back the region's growth potential, is a consequence of years of under-investment, inadequate institutions, and a difficult business environment. In all Western Balkan countries,

6 Commission on Growth and Development. 2008. "The Growth Report: Strategies for Sustained Growth and Inclusive Development." World Bank: Washington, DC.

the private sector is the main contributor to economic output; yet in several countries the state is still dominant in important industries, and the privatization agenda is still extensive. Small and medium-sized enterprises dominate the private sector and account on average for about two-thirds of value added. An econometric analysis of barriers to productivity and growth highlights the importance of numerous factors and qualities.[7] For instance, extreme corporate indebtedness and market concentration are two variables that help explain poor productivity, as does the low level of youth inclusion. Complementary evidence comes from a major survey of firm owners and senior managers, which reveals the difficulties caused by competitors operating informally. Small businesses in particular find this obstacle, as well as corruption, highly problematic. Other constraints cited frequently were cumbersome tax administration, difficulties in accessing a reliable supply of electricity, and limited access to financing.

7 Sanfey, P. and J. Milatovic (2018) The Western Balkans in transition: diagnosing the constraints on the path to a sustainable market economy. EBRD. http://www.ebrd.com/documents/eapa/western-balkans-summit-2018-diagnostic-paper.pdf. See also Vostroknutova, E; TV Nguyen. 2017. Western Balkans - Revving up the engines of growth and prosperity. Washington, D.C.: World Bank Group. http://documents.worldbank.org/curated/en/643211511855017188/Overview.

Country Notes

Albania

- *Economic growth is estimated to have reached 3.8 percent in 2017, supporting job creation and helping to reduce poverty.*
- *Growth is expected to moderate to 3.6 percent in 2018 as two large foreign direct investment (FDI) energy projects wind down.*
- *Although public debt declined in 2017, the pace of fiscal consolidation slowed.*
- *Continued efforts to consolidate public finances, improve the efficiency of spending, reduce debt and contingent liabilities, and introduce structural reforms in the energy, financial, and judiciary sectors are critical to foster confidence and drive sustainable growth.*

Recent Economic Developments

Albania's real GDP grew by 3.8 percent in 2017, up from 3.4 percent in 2016, mainly driven by private investment and consumption. Investment dynamics were mainly related to two large energy projects financed by foreign direct investment (FDI), the Trans Adriatic Pipeline and the Devoll hydropower plant. A sustained recovery in employment, wages, and household credit heightened private consumption. Growing public wage bill caused a small positive contribution to growth from public consumption. Tourism exports and recovering commodity exports more than compensated for a surge in investment-related imports of machinery and equipment and in drought-related energy imports.

Growth stimulated job creation. Employment grew by 3.3 percent in 2017, following its impressive expansion of 6.5 percent in 2016. Labor force participation increased to 58.3 percent, 0.8 percentage points higher than in 2016. Besides improved employment prospects, the increase in labor force participation may reflect the government's anti-informality campaign, which features more tax audits and higher penalties for noncompliance. In 2017 the unemployment rate declined by 1.5 pp to average 13.7 percent. Real wages for formal jobs started to pick up in 2017 in such industries as construction, energy, and tourism.

Prudent fiscal policy helped to bring down public debt, but the pace of fiscal consolidation slowed in 2017. The 2017 deficit is estimated to have been 2 percent of GDP, slightly above the 1.8 percent in 2016. Tax revenue gains of 0.4 percent of GDP, largely building on increased economic activity and the recovery of commodity prices, were counterbalanced by a reduction in grants and other non-tax revenues. On the spending side, under-execution of public investments and operations and maintenance and lower interest expenditures partially compensated for the drought-related emergency support the electricity sector needed. Although commitment controls were enforced, because of continuing unfunded commitments in the medium-term budget, poor contingency planning related to court fees, and delays in value-added tax (VAT) refunds, in 2017 the stock of central government arrears reached about 0.9 percent of GDP. However, the fiscal rule banning overspending in election years was respected. Overall, fiscal policy helped to bring down public debt from 72.4 percent of GDP in 2016 to an estimated 71 percent in 2017.

Bank of Albania (BoA) policy continues to be accommodative. Although average inflation picked up to 2 percent in 2017, it stayed below the BoA's 3 percent target, which gave no reason to change the policy rate, at 1.25 percent since May 2016. Despite a weather-related spike in food prices, underlying price pressures have continued to be minimal, helped by appreciation of the national currency relative to the euro of 1.7 percent. The BoA has announced that it will not increase the policy rate before the end of 2018.

Credit growth supported the economy, and progress on resolving nonperforming loans (NPLs) reinforced bank balance sheets. The banking sector remains profitable and well-capitalized; the capital adequacy ratio was 16.6 percent in the first three quarters of 2017, well above the regulatory minimum of 12 percent. The restructuring of the NPLs of large borrowers and mandatory write-offs led to a sizable decline in the NPL ratio to 13.2 percent of total loans by yearend. Low interest rates, the progress in dealing with NPLs, and economic growth stimulated an increase in extension of private sector credit by 13.5 percent, supporting both households and private businesses.

The current account deficit (CAD) narrowed in 2017, reaching 6.9 percent of GDP. Exports of commodities, tourism and manufacturing-related services pushed up total exports by 44.9 percent. The financing needs were largely covered by continued significant FDI inflows. The CAD is expected to narrow again this year, driven by growing services exports and slowing FDI- related imports.

Foreign exchange reserves have been stable for the past two years, covering 6½ months of imports of goods and services.

Outlook and Risks

Growth is projected to moderate to 3.6 percent in 2018 as two large FDI projects in the energy sector are completed, and then to average 3.5 percent in the next two years. As the demand stimulus from the FDI projects diminishes and economic activity returns to close to potential, growth is expected to moderate. Increasingly, growth will rely on private consumption, supported by better labor market conditions and higher net exports in response to heightened demand from the EU and to domestic structural transformation. Although to a lesser extent than in the past three years, investment will continue to support growth as public investment strives to reduce infrastructure gaps and as structural reforms and improvements in the business climate encourage private investment.

Sustained fiscal consolidation efforts and structural reforms are expected to gradually reduce the fiscal deficit. Deficit is projected to fall to 1.5 percent of GDP by 2020 and the debt-to-GDP ratio to 60 percent of GDP by 2022. The government's medium-term plan calls for fiscal consolidation to continue until 2021—bringing down, in particular, expenditures on personnel, operations and maintenance, social outlays, and local governments. Revenues are expected to rise after the value-based property tax is introduced in the second quarter of 2018. While the government is planning sustained capital spending of 5 percent of GDP over the medium term, it has also announced that sizable investments are to be financed through public-private partnerships (PPPs), to be contracted starting in 2018.[1]

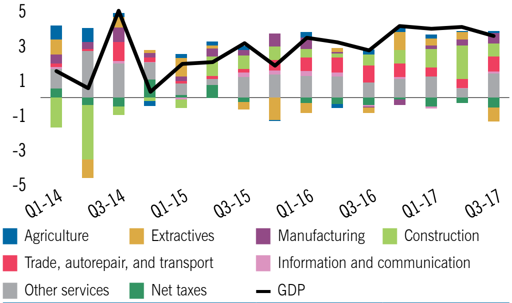
Poverty (US$5.5/day, 2011 PPP) is estimated to have eased from 33.9 percent in 2016 to 32.8 percent in 2017 and is projected to decline yet again, to 31.3 percent, in 2018. Unemployment will remain persistently high if the government does not address both the skills mismatch between workers and business needs and labor market institutional arrangements, especially the relatively high minimum wage, which is acting as a disincentive for hiring low-skilled and young people.

Economic prospects are vulnerable to several risks. With public debt still high, the government needs to fully realize its fiscal consolidation plans and further tighten tax compliance if it is to preserve the macrofiscal stability that is the foundation for Albania's current growth. In particular, the government needs to toughen its management of PPPs to minimize their fiscal risks and to ensure that each investment is cost-effective. Harnessing growth will require improving the business climate through legal, land, financial, and energy reform and upgrading the skills of the labor force. Lower than expected growth in trading partners and higher global interest rates are also a serious concern for Albania's growth and its public finances.

1 Capital spending is expected to finance infrastructure, reforms in the water sector and the judiciary, and higher defense spending.

Growth slowed in the third quarter of 2017 as extractives and energy production ebbed. Construction and services generated most of the growth in output.

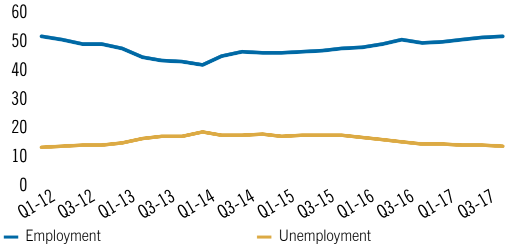
Contributions to growth



Sources: Country authorities; World Bank staff estimates.

As growth created jobs, unemployment declined and employment increased.

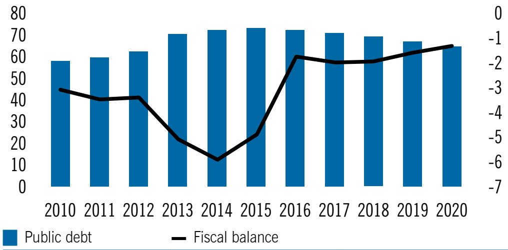
Employment and unemployment, in percent



Sources: Country authorities.

At 0.2 percent of GDP energy subsidies led to a larger than expected deficit in 2017, but public and publicly guaranteed debt declined.

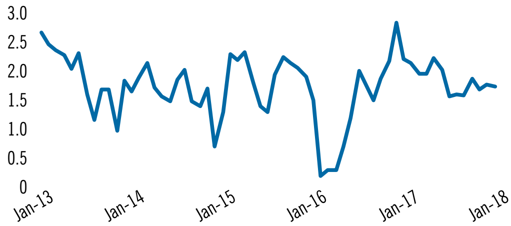
Public debt, percent of GDP   Fiscal balance, percent of GDP



Sources: Country authorities; World Bank staff estimates and projections.

Inflation remained within the 3 ±1 percent target band as monetary policy was again accommodative.

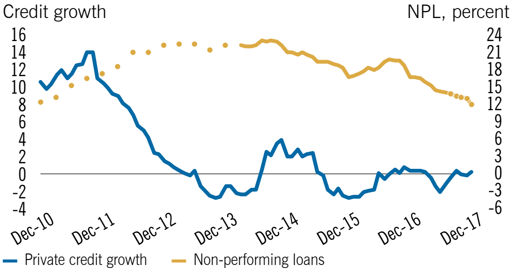
Annual inflation, percent



Sources: Country authorities.

Outstanding credit remained largely unchanged by write-offs of nonperforming loans, because of the flow of new credit issued.

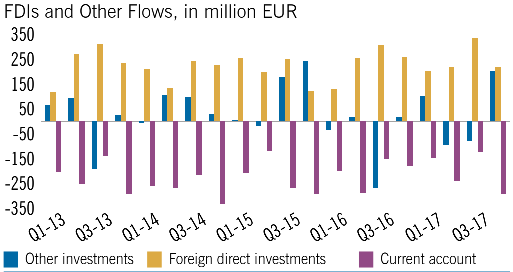
Credit growth   NPL, percent



Sources: Country authorities; World Bank staff calculations.

Sustained FDI to the energy sector financed the current account deficit.

FDIs and Other Flows, in million EUR



Sources: Country authorities.

ALBANIA	2014	2015	2016	2017[e]	2018[f]	2019[f]	2020[f]
Real GDP growth (percent)	1.8	2.2	3.4	3.8	3.6	3.5	3.5
Composition (percentage points):							
Consumption	4.5	-0.9	0.1	1.3	2.0	1.9	2.4
Investment	-0.9	0.7	1.4	2.1	1.1	1.0	0.6
Net exports	-1.8	2.4	1.9	0.4	0.5	0.6	0.5
Exports	0.9	0.5	6.5	4.1	3.7	3.8	3.8
Imports (-)	2.7	-1.9	4.6	3.7	3.2	3.2	3.3
Consumer price inflation (percent, period average)	1.6	1.9	1.3	2.0	2.1	2.3	2.8
Public revenues (percent of GDP)	26.3	26.6	27.6	27.6	28.1	28.1	28.1
Public expenditures (percent of GDP)	32.3	31.5	29.4	29.6	30.1	29.7	29.4
Of which:							
Wage bill (percent of GDP)	5.1	5.1	4.6	4.7	4.8	4.7	4.5
Social benefits (percent of GDP)	9.9	9.9	10.4	10.4	10.3	10.4	10.3
Capital expenditures (percent of GDP)	4.3	4.4	4.0	4.4	5.2	5.0	4.9
Fiscal balance (percent of GDP)	-6.0	-4.9	-1.8	-2.0	-2.0	-1.6	-1.3
Primary fiscal balance (percent of GDP)	-3.1	-2.2	0.7	0.6	0.5	1.0	1.5
Public debt (percent of GDP)	66.1	69.1	68.7	67.8	65.5	62.7	61.7
Public and publicly guaranteed debt (percent of GDP)	72.0	73.1	72.4	71.0	69.0	66.6	64.7
Of which: External (percent of GDP)	29.6	34.2	32.7	33.7	36.7	35.8	35.8
Goods exports (percent of GDP)	9.3	7.5	6.6	6.9	7.3	7.4	7.5
Goods imports (percent of GDP)	31.6	30.0	30.9	31.1	30.7	30.5	30.3
Net services exports (percent of GDP)	3.2	5.1	7.4	9.3	7.9	8.3	8.6
Trade balance (percent of GDP)	-19.1	-17.4	-16.9	-15.0	-15.5	-14.8	-14.2
Remittance inflows (percent of GDP)	7.2	7.5	7.2	6.7	7.2	7.1	6.9
Current account balance (percent of GDP)	-10.8	-8.6	-7.6	-6.9	-7.1	-6.9	-6.7
Foreign direct investment inflows (percent of GDP)	8.1	8.0	8.7	8.3	8.5	7.0	6.5
External debt (percent of GDP)	69.6	73.6	72.4	70.4	73.0	70.4	68.7
Real private credit growth (percent, period average)	-1.4	-1.8	-2.1	-2.3	n.a.	n.a.	n.a.
Nonperforming loans (percent of gross loans, end of period)	22.4	18.2	18.3	13.2	n.a.	n.a.	n.a.
Unemployment rate (percent, period average)	17.5	17.1	15.2	13.8	n.a.	n.a.	n.a.
Youth unemployment rate (percent, period average)	32.5	33.2	29.0	25.9	n.a.	n.a.	n.a.
Labor force participation rate (percent, period average)	53.7	55.7	57.5	58.3	n.a.	n.a.	n.a.
GDP per capita, PPP (current international $)	10,645	10,926	11,276	11,693	12,114	12,526	12,964
Poverty rate at US$5/day, PPP (percent of population)	35.9	35.4	33.9	32.8	31.3	29.6	27.2

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

Bosnia and Herzegovina

- *With economic growth estimated at 3 percent in 2017, Bosnia and Herzegovina (BiH) has kept growth stable for the last three years. The trend is expected to continue in 2018 and pick up in the medium term as structural reforms take effect and there is increased investment in infrastructure.*
- *Although the economy has been expanding steadily, job creation has not kept up; unemployment remains high, particularly among youth.*
- *As a result of the planned push in public investments, the fiscal stance could deteriorate over the medium term if reforms to reduce the high public wage bill and improve tax collection are delayed.*
- *As general elections approach, reforms may slow, clouding the outlook.*

Recent Economic Developments

Growth reached an estimated 3 percent in 2017. Domestic demand continues to drive growth: consumption added 3 percentage points (pp), investment 0.8 pp, and imports 5.1 pp. Improved external demand has helped push up exports, but a surge in imports is offsetting that momentum. Negative net exports are estimated to have subtracted 0.8 pp from growth. Exports expanded in intermediate goods and energy (65 percent of total export growth), and growth in imports was driven by the same two categories plus capital goods—together these explain 86 percent of import growth.

Although unemployment continues to be high, some improvements in the labor market are evident. Unemployment did fall from 25.4 percent in 2016 to 20.5 percent, driven by a fall in the activity rate and a slight rise in employment.[2] Ultimately, employment stood at 33.9 percent, which is still quite low, even in the Western Balkans. Most of the expansion in employment originated in agriculture and the services sector; industrial employment went down in absolute terms. However, long-term unemployment, while still high at 82 percent, decreased by nearly 3.4 pp. The modesty of the gains in employment over the last three years, however, highlights the need to continue addressing structural rigidities if BiH is to achieve tangible progress in job creation.

Inflation began in 2017. After almost two years of deflation, prices started to pick up as global oil prices recovered and some inflation was imported. By December 2017 the consumer price index had risen by 1.2 percent year-on-year (y-o-y). The biggest drivers of the increase were transport, tobacco, and rental housing. In contrast, prices dropped noticeably on alcohol, clothing, and telecommunication services. Because growth in nominal salaries was similar, the effect on real incomes was neutral.

In 2017 the fiscal balance remained in surplus. The latest consolidated data estimate a surplus of 2.1 percent of GDP, up from

2 According to the 2017 Labor Force Survey.

0.3 percent in 2016.[3] In 2017, revenues rose due to more effective collection of indirect taxes, and spending declined—a demonstration of the continued government restraints on current spending. At the same time, capital spending did not increase because there were project delays. Total public debt in 2017 was 36.4 percent of GDP (external public debt was 30.9 percent) and consisted primarily of concessional debt to international financial institutions.

The banking sector continued to be liquid and well-capitalized during 2017, and the same is expected for 2018. Nevertheless, the sector is still dealing with the aftershocks of the global financial crisis, that had weakened asset quality and profitability in the financial sector. The system-wide NPL ratio, although trending down, remained high at 10.8 percent in the third quarter of 2017, reflecting still lax credit practices and weak debt recovery mechanisms which hamper banks' efforts to work out NPLs. Profitability has been improving, with return on equity at 11.7 percent in the third quarter of 2017. Although the capital adequacy ratio has remained relatively stable recently (at 15.7 percent by end-2017) and capital buffers are above the regulatory minimum of 12 percent, individual bank ratios vary widely.

The current account deficit (CAD) increased slightly in 2017 as both imports and exports began to pick up. The CAD is estimated to have widened from 5.1 percent in 2016 to 5.8 percent, mainly because of the imports needed for public investment projects. The services surplus from transport, travel, construction, and remittances, which was almost unchanged, was enough to finance a significant part of the trade deficit. The rest was financed by the capital account mainly through other investment and FDI. Net FDI inflows went up by an estimated 0.2 pp of GDP, which financed about 30 percent of the CAD.

3 See IMF Country Report No 18/39.

Outlook and Risks

Economic growth is projected to build to about 4 percent by 2020, with consumption still the main driver, followed by public investment. As the BiH reform agenda advances, a moderate rise in exports is expected, but heavy demand for imports for infrastructure projects will outpace export growth. Remittances are likely to stay steady and will support a gradual pickup in consumption, which will continue to be a major driver of growth. Investments will support job creation in energy, construction, and tourism. Real GDP is therefore projected to grow gradually from 3 percent in 2017 to 3.2 percent in 2018 and up to 4 percent in 2020.

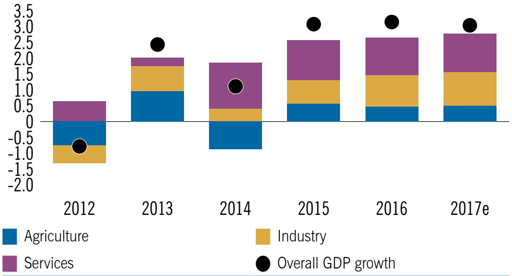
Stronger capital spending in 2018 is expected to push the fiscal surplus below that of 2017. As construction of highways and railways proceeds, recurrent expenditures are expected to continue their downward trend as a result of the commitment of the authorities to reduce the wage bill. In 2018, the public debt-to-GDP ratio is expected to move slightly below 36 percent. Further accumulation of arrears would represent a fiscal risk.

Prudent, efficient, and effective fiscal policy that addresses persistent unemployment and continues to safeguard the banking sector will remain central to the BiH reform agenda. Although deficits continue to be moderate, the tax burden is high and public spending is inefficient, as evidenced by poorly targeted benefits. Fiscal consolidation and provision of an effective safety net will not be effective if structural rigidities in spending are not addressed—especially the high public wage bill. Without continued structural reforms, it will be difficult to address rigidities in public employment, pensions, and debt.

There are notable risks, both domestic and external. The main domestic risk is a challenging political environment that makes serious reforms difficult in infrastructure, telecommunications, energy sector, and transport. Political factors also worsen the risks to the economic outlook. Despite some delays, however, BiH has submitted a detailed Questionnaire to the European Commission, a major step to becoming a candidate country. Slower growth in the EU and rising inflation in both developed countries and in interest rates represent an external risk to BiH's economic outlook.

Annual GDP growth stabilized at 3 percent, supported by the services sector.

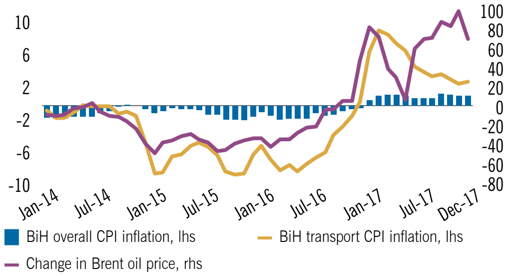
Contributions to growth, percentage points of GDP



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

2017 marked the start of moderate inflation.

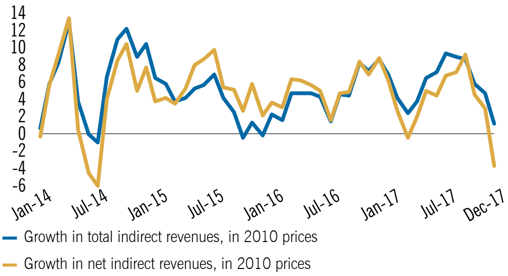
Percent y-o-y Euro



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

Collection of indirect gross tax revenues slowed at yearend.

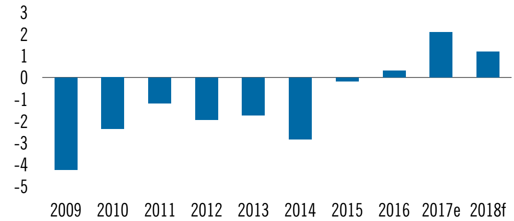
Real 3 months moving average, percent y-o-y



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

The fiscal balance is expected to remain in surplus.

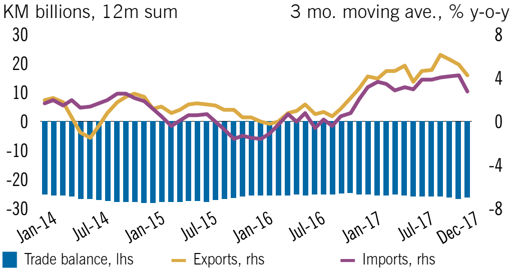
General government fiscal balance, percent of GDP



Source: Fiscal authorities; World Bank staff estimates.

The deficit in the goods trade has begun to widen.

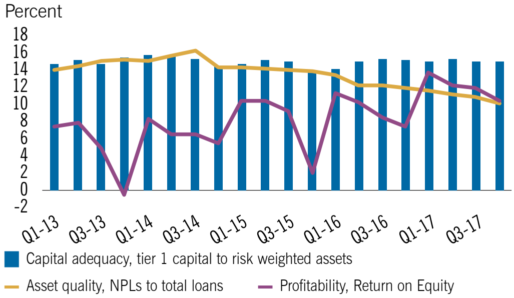
KM billions, 12m sum 3 mo. moving ave., % y-o-y



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

Because commercial banks still have too many nonperforming loans, deleveraging is still a risk.

Percent



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

BOSNIA AND HERZEGOVINA	**2014**	**2015**	**2016**	**2017[e]**	**2018[f]**	**2019[f]**	**2020[f]**
Real GDP growth (percent)	1.1	3.0	3.1	3.0	3.2	3.4	4.0
Composition (percentage points):							
Consumption	n.a.	n.a.	1.7	3.0	3.6	4.0	3.4
Investment	n.a.	n.a.	0.7	0.8	0.6	1.3	1.1
Net exports	n.a.	n.a.	0.8	-0.8	-1.0	-1.9	-0.5
Exports	n.a.	n.a.	1.4	4.2	3.4	1.8	1.4
Imports (-)	n.a.	n.a.	0.6	5.1	4.4	3.7	1.9
Consumer price inflation (percent, period average)	-0.9	-1.0	-1.1	1.2	1.4	1.4	1.4
Public revenues (percent of GDP)	43.4	43.2	42.7	43.5	43.9	43.9	43.8
Public expenditures (percent of GDP)	46.3	43.4	42.3	41.4	42.6	43.7	43.8
Of which:							
Wage bill (percent of GDP)	12.0	11.7	11.2	10.8	10.6	10.4	10.3
Social benefits (percent of GDP)	15.4	14.8	14.2	13.7	13.7	13.6	13.4
Capital expenditures (percent of GDP)	5.3	3.6	3.8	3.9	5.5	6.8	7.6
Fiscal balance (percent of GDP)	-2.9	-0.2	0.3	2.1	1.2	0.2	0.0
Primary fiscal balance (percent of GDP)	-2.1	0.6	1.3	3.0	2.2	1.2	0.7
Public debt (percent of GDP)	41.6	41.9	40.5	36.4	35.1	34.0	33.2
Public and publicly guaranteed debt (percent of GDP)	42.1	42.5	41.3	38.0	36.7	35.6	34.8
Of which: External (percent of GDP)	34.3	35.0	34.3	30.9	29.8	29.0	28.4
Goods exports (percent of GDP)	25.1	25.2	25.7	28.5	31.2	33.9	34.6
Goods imports (percent of GDP)	53.9	50.3	49.3	52.8	55.7	59.0	59.9
Net services exports (percent of GDP)	6.1	6.4	6.4	7.1	7.4	7.7	7.8
Trade balance (percent of GDP)	-22.7	-18.8	-17.1	-17.3	-17.1	-17.4	-17.5
Remittance inflows (percent of GDP)	8.5	8.3	8.2	8.0	7.9	7.9	7.9
Current account balance (percent of GDP)	-7.4	-5.7	-5.1	-5.8	-6.2	-6.4	-6.5
Foreign direct investment inflows (percent of GDP)	-2.9	-1.7	-1.6	-1.8	-1.8	-1.8	-1.8
External debt (percent of GDP)	76.3	72.2	71.0	70.9	69.3	68.8	68.8
Real private credit growth (percent, period average)	4.1	2.3	4.2	4.9	n.a.	n.a.	n.a.
Non-performing loans (percent of gross loans, end of period)	14.0	13.7	11.8	10.8	n.a.	n.a.	n.a.
Unemployment rate (percent, period average)	27.5	27.7	25.4	20.5	n.a.	n.a.	n.a.
Youth unemployment rate (percent, period average)	62.9	62.2	54.5	n.a.	n.a.	n.a.	n.a.
Labor force participation rate (percent, period average)	43.7	44.1	43.0	n.a.	n.a.	n.a.	n.a.
GDP per capita, PPP (current international $)	10,089	10,537	10,908	11,404	11,409	11,922	12,458
Poverty rate at US$5/day, PPP (percent of population)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Sources: Country authorities, World Bank estimates and projections.
Notes: Non-performing loans show year-to-date actuals.

Kosovo

- *The economy grew by an estimated 4.4 percent in 2017, up from 4.1 percent in 2016, driven mainly by investment and exports.*
- *In 2017, the fiscal deficit was low at 1.4 percent of GDP due to good revenue performance and under-execution of the capital budget.*
- *Strong growth supported job creation in 2017; the labor market participation rate went up by 3.3 pp and employment by 1.3 pp.*
- *The outlook projects average growth of 4.8 percent for 2018-20, but major risks lie in political dynamics and incomplete execution of the investment program.*

Recent Developments

Growth reached an estimated 4.4 percent in 2017, up from 4.1 percent, driven mainly by increased public and private investment and a recovery in exports. Exports, building on higher prices for base metals and higher production and higher services exports, added 3.6 percentage points (pp) to growth. In 2017, net exports contributed 1.1 pp, reversing the three-year negative trend. Private investment was encouraged by better financing options, a more attractive business environment, and more FDI inflows; and public investments contributed 3 pp to growth, up from 2.1 pp.[4] Despite increases in disposable income, consumption contributed just 0.4 pp.[5] Expansion in services (construction, trade, financial, and transport) added 2.6 pp to growth, up from 1.4 pp, despite contractions in real estate and public administration. Agriculture contributed only 0.4 pp, and industry 0.7 pp, up from 0.3pp in 2016.

In 2017 higher growth again fostered job creation. Labor force participation increased by 3.8 pp, and employment grew by 1.7 pp, although unemployment also increased (by 3.3 pp), reaching 30.4 percent because employment did not grow fast enough to offset the expansion of the labor force.[6] Youth unemployment dropped to 51.6 percent (by 1.3 pp y-o-y). Over 70 percent of those unemployed have been job-hunting for over a year, and employment is still only 29.7 percent. Employment did go up in information, manufacturing, wholesale and retail trade, communications, and administrative activities and support services; public employment declined.

The fiscal deficit registered 1.4 percent in 2017. Higher growth helped increase revenues by 5.3 percent y-o-y. Indirect tax revenues grew by 6.1 percent (VAT 8.1 percent) and nontax revenues by 5.6 percent. Direct tax revenues grew by only 2.5 percent, as corporate income tax collection declined by 7 percent. Spending grew by 5.7 percent, distributed equally to

4 Kosovo improved its *Doing Business 2018* ranking from 60 to 40 by simplifying procedures for registering employees, improving access to credit, and enacting a new corporate bankruptcy structure.

5 2017 GDP figures are estimates, based on official data through the third quarter, and may be revised.

6 Labor market data are only available for the first three quarters of 2017. All numbers are averages for Q1–Q3 2017 over the same period 2016.

current and capital spending, on higher social transfers and spending on goods and services. Social transfers went up 11.9 percent because actual payments far exceeded the budget for the war veterans scheme and changes in the law were not passed to cap the spending at 0.7 percent of GDP. The reasons goods and services spending also grew by 10.7 percent were early elections and government expansion.[7] Poor project execution led to fewer charges on the capital budget. Public and publicly guaranteed debt reached 16.5 percent of GDP by yearend and is likely to exceed 30 percent by 2025.

Investment and consumption were fueled by credit growth. At yearend just 3.1 percent of loans were nonperforming. Better market conditions and lower interest rates spurred growth in private credit to 11.5 percent. Corporate loans grew by 10.9 percent y-o-y, mostly to the service sector, wholesale and trade, construction, and other services, followed by manufacturing.

Prices for fuel, food products, tobacco, alcohol, and household items pushed average inflation to 1.5 percent in 2017. That, however, passed in January 2018 turning into deflation of 0.2 percent (driven by communication, clothing, and household and recreation activities) and zero percent in February.

Higher exports lowered the CAD from 8.2 percent of GDP in 2016 to about 5.1 percent. Exports of goods went up by 23.1 percent due to higher growth in trading partners, higher global prices of base metals, and more production. Exports of services grew by 17.7 percent, mainly because solid growth in tourism by the diaspora.

Net FDI went up by 29 percent in 2017 as growth built in the Euro Area. Remittances and FDI covered the domestic savings shortfall and supported private investment in construction, financial intermediation, and real estate.

Outlook

Economic growth in Kosovo is projected to speed to 4.8 percent in the medium term, propelled by higher capital spending. The government is preparing several railway and regional road projects, to be financed by IFIs. The enhanced business climate, higher FDI, and optimism in the EU are expected to encourage private investment.[8] Higher wages, social spending, remittances, and credit to households should lead household consumption to add 2.3 pp to growth. Exports are likely to benefit from robust growth in the EU and higher base metal prices, but net exports are expected to subtract 0.9 pp from growth because of higher imports for public investments.

In 2018, higher growth is expected to stimulate job creation in services, construction and manufacturing. However, if more people enter the labor market, unemployment might also rise.

The 2018 fiscal deficit is expected to be 2.2 percent. Collection of more revenue is projected to be offset by higher current and capital spending on IFI-financed projects,

7 The government created in September 2017 has two more ministries, which add to overall current costs.

8 The Euro Area forecasts have improved by 0.6 pp since June 2017 (Global Economic Prospects, January 2017).

higher bills for wages, goods, and services, and higher subsidies and transfers for veteran benefits and a targeted social assistance. The deficit of 1.6 percent of GDP, and additional allocations to IFI-financed projects and for privatization, in accordance with the investment clause are projected, in line with the fiscal rule.

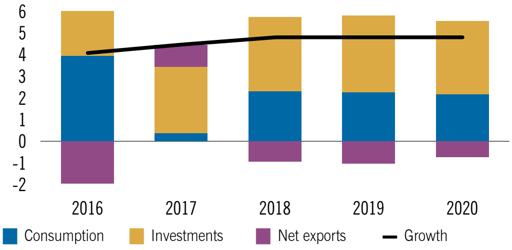
In 2018 the CAD is expected to hold at about 6 percent of GDP. Heightened demand for investment goods is expected to widen it, but growing FDI and remittances should finance larger shares.

Though positive, Kosovo's outlook is vulnerable to risks related to both domestic politics and weaker growth in Europe than projected. The government holds only 61 of 120 seats in parliament and the investment clause requires that a two-thirds majority ratify IFI financing. Any delay in reforms, for example to cap war veteran benefits or to prevent rises in untargeted social benefits and unfunded early retirement schemes, can jeopardize fiscal sustainability. Project delays can also raise costs. Political risks might heighten around creation of the Association of Serb Majority Municipalities, and creation of Kosovo Armed Forces. The expansion of public investment 2018–20 may suffer from capacity constraints; lower than expected growth in the Euro Area might reduce remittance and FDI, and lower base metal prices might expand the CAD.

To counterbalance the risks, priority reforms should by preserving fiscal stability, shifting resources to tradable sectors, increasing productivity, engaging and employing youth and women, addressing corruption, improving environmental sustainability, and addressing infrastructure constraints.

Investment and net exports were the main reason behind accelerating growth in 2017.

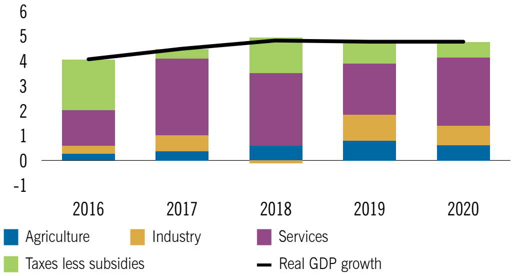
Growth contributions, percent



Source: Statistics Agency of Kosovo; World Bank staff estimates and projections.

Services were the main engine of growth in 2017.

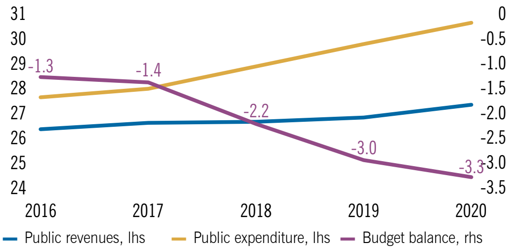
Growth contributions, percent



Source: Statistics Agency of Kosovo; World Bank staff estimates and projections.

Despite fiscal pressures, the overall budget balance (RHS) is expected to stay within the fiscal rule limits in 2018.

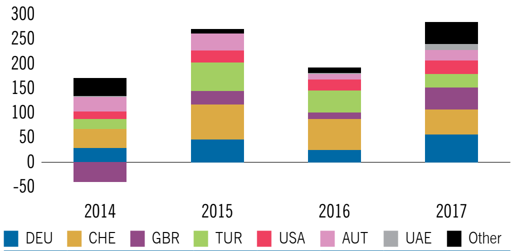
Percent of GDP



Source: Ministry of Finance; World Bank staff calculations.

Germany, Switzerland, and UK continue to be main origin of FDI inflows to Kosovo.

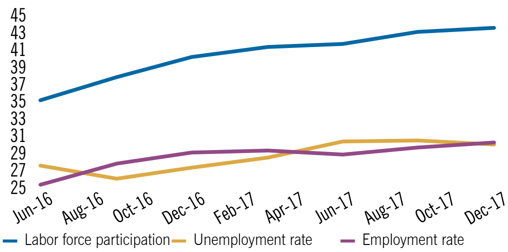
Million euros, nominal



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

Employment growth was positive but at a declining trend.

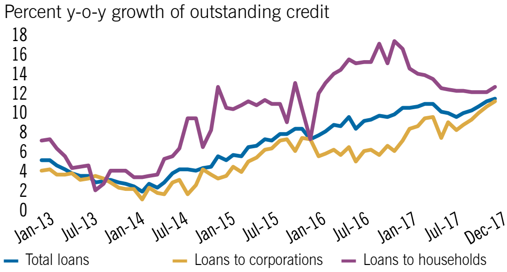
Percent



Source: Statistics Agency of Kosovo.

Credit growth continues to spur private investment.

Percent y-o-y growth of outstanding credit



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

KOSOVO	2014	2015	2016	2017[e]	2018[f]	2019[f]	2020[f]
Real GDP growth (percent)	1.2	4.1	4.1	4.4	4.8	4.8	4.8
Composition (percentage points):							
Consumption	5.5	2.5	3.9	0.4	2.3	2.2	2.2
Investment	-1.3	3.0	2.1	3.0	3.4	3.5	3.3
Net exports	-2.9	-1.4	-1.9	1.1	-0.9	-1.0	-0.7
Exports	1.4	0.4	1.6	3.6	2.2	2.2	2.1
Imports (-)	4.3	1.8	3.5	2.6	3.1	3.2	2.9
Consumer price inflation (percent, period) average)	0.4	-0.5	0.3	1.5	1.7	1.7	1.9
Public revenues (percent of GDP)	24.0	25.1	26.3	26.6	26.6	26.8	27.4
Public expenditures (percent of GDP)	26.3	26.8	27.6	28.0	28.8	29.8	30.7
Of which:							
Wage bill (percent of GDP)	8.7	9.0	9.0	8.7	8.7	8.6	8.5
Social benefits (percent of GDP)	4.9	5.3	5.9	6.3	6.5	6.5	6.5
Capital expenditures (percent of GDP)	7.4	7.0	7.2	7.4	8.3	9.4	10.5
Fiscal balance (percent of GDP)	-2.4	-1.8	-1.3	-1.4	-2.2	-3.0	-3.3
Primary fiscal balance (percent of GDP)	-2.1	-1.5	-1.0	-1.1	-1.9	-2.6	-2.9
Public debt (percent of GDP)	10.4	12.7	14.1	15.8	16.6	18.6	20.9
Public and publicly guaranteed debt (percent of GDP)	10.6	12.8	14.4	16.5	17.4	19.3	20.9
Of which: External (percent of GDP)	5.8	6.2	6.2	6.6	6.4	6.5	6.6
Goods exports (percent of GDP)	5.8	5.6	5.1	6.0	6.2	6.4	6.6
Goods imports (percent of GDP)	42.8	41.9	42.8	44.9	45.4	46.1	46.4
Net services exports (percent of GDP)	8.3	7.9	10.1	12.1	12.9	13.5	14.3
Trade balance (percent of GDP)	-28.7	-28.5	-27.6	-26.8	-26.3	-26.2	-25.6
Remittance inflows (percent of GDP)	9.9	10.5	10.5	11.2	11.4	11.8	12.1
Current account balance (percent of GDP)	-6.9	-8.6	-8.2	-5.1	-6.0	-7.0	-7.5
Foreign direct investment inflows (percent of GDP)	2.2	4.7	2.9	3.6	4.0	4.7	5.3
External debt (percent of GDP)	31.2	33.3	33.1	34.4	35.5	35.8	35.7
Real private credit growth (percent, period average)	3.2	7.9	8.7	8.8	n.a.	n.a.	n.a.
Nonperforming loans (percent of gross loans, end of period)	8.5	6.5	4.9	3.1	n.a.	n.a.	n.a.
Unemployment rate (percent, period average)	35.3	32.9	27.5	30.4	n.a.	n.a.	n.a.
Youth unemployment rate (percent, period average)	61.0	57.7	52.4	n.a.	n.a.	n.a.	n.a.
Labor force participation rate (percent, period average)	41.6	37.6	38.7	n.a.	n.a.	n.a.	n.a.
GDP per capita (current US$)	4,055	3,745	3,699	3,902	4,075	4,393	4,575
Poverty rate at US$5/day, PPP (percent of population)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Sources: Country authorities, World Bank estimates and projections.

FYR Macedonia

- *Stagnant economic growth in 2017 reflects the lasting effect of a prolonged political crisis. Growth is projected to rebound to 2.3 percent in 2018, driven by consumption and recovering investment.*
- *Labor market performance improved as unemployment fell to a historic minimum of 22.4 percent. Although higher than in most Western Balkan countries, employment and labor force participation rates are low by EU standards.*
- *The fiscal deficit was unchanged from 2016, with higher spending offsetting improved tax collection.*
- *Well-designed fiscal reform program and structural reforms enhancing the investment climate, human capital, and public-sector efficiency will boost investor confidence and the potential of the economy to grow in the medium term.*

Recent Economic Developments

The political turmoil of 2015–17 slowed growth in 2017 to zero. Real GDP growth dropped from 2.9 percent in 2016 to zero. The slowdown was mainly because investment fell by 4.5 percent. The inauguration of a new government in June 2017 resolved the political stalemate, as evidenced by more optimistic business expectations for future production. Private consumption was the only contributor to growth in 2017, supported by higher employment and wages. Net exports contributed negatively to growth (–0.7 pp); solid growth in exports, propelled by the recovery in the Euro Area, was not enough to compensate for rising imports for energy, FDI-related projects, and iron and steel. At the sector level, both construction and manufacturing had negative growth in 2017, with construction falling by almost 14 percent y-o-y in real terms because both private and public construction activity stalled. Mining, supported by rising metal prices; wholesale and retail trade, buoyed by social transfers; and agriculture, where harvests were favorable, were the only sectors that contributed positively to growth.

Despite slower growth, the labor market improved. Employment grew by 2.4 percent y-o-y in 2017, partly helped by subsidies in the first half of the year that facilitated creation of more than 5,000 jobs (the policy was discontinued by the new authorities). However, the employment rate is still low at 44.1 percent, which means that more than half of working-age Macedonians are either unemployed or are not looking for work. Most of the jobs created were in wholesale and retail trade, transport and storage and manufacturing—the sectors most linked to the FDI projects, which benefit from tax exemptions and other government support. Construction jobs grew far less than in previous years in line with developments in the sector. The unemployment rate fell to a historical low, 22.4 percent in 2017, but 81 percent of that is long-term. Youth unemployment declined by 1.5 pp to reach 46.7 percent in 2017. Real net wages rose slightly, by 1.2 percent y-o-y, with inflation low throughout the year.

Revenue gains in 2017 were offset by higher spending on social transfers and subsidies, so that there was no change in the fiscal deficit. Revenues increased by 6.1 percent y-o-y thanks to solid revenue performance of the VAT and higher contributions. Expenditures went up by 6 percent y-o-y, with current spending increasing by 4.9 percent as more was spent on health, pensions, and subsidies. Meanwhile, spending on goods and services eased. Once again capital spending was under-executed (17 pp below the budgeted amount) reflecting a slowdown in project implementation. As in 2016, the fiscal deficit for 2017 was 2.7 percent of GDP.

Public and publicly guaranteed (PPG) debt declined from 48.5 percent in 2016 to 46.7 percent in 2017. The decline is largely due to the decision to finance the fiscal deficit and debt repayments by drawing down accumulated deposits. Domestic general government debt rose from 14.6 percent of GDP in 2016 to 15.9 percent, but was offset by lower external debt, mostly because debt disbursements for the construction of two highways slowed.

Inflation remained low in 2017 at 1.4 percent y-o-y, though prices rose for food and beverages, energy (including oil), clothing and footwear, and communications. Core inflation for 2017 was 2.9 percent y-o-y.

Monetary policy remained accommodative. In 2017, the Central Bank, in three consecutive steps, lowered the key interest rate by 75 bps, back to the 3.25 percent that prevailed before the tightening in May 2016. The bank also effectively stimulated the denarization of loans and deposits: the share of loans in foreign currency fell to 19 percent of total loans, compared to 21 percent a year earlier. Given subdued price developments, sluggish corporate lending activity, and a negative output gap, current monetary policy is well aligned with economic fundamentals.

Credit growth increased in 2017 but was mainly targeted to households. Household credit grew by 9.2 percent y-o-y. At 2.6 percent, corporate lending was subdued throughout 2017, though it turned negative in September before rebounding slightly by year-end. The survey of credit activity suggests the possibility of lower credit requirements and higher credit demand from companies in 2018. In addition, the 2017 loan-to-deposit ratio of 88 percent should allow banks to expand their lending. Non-performing loans (NPLs) stood at 6.3 percent, slightly lower than 6.4 percent at end-2016. This dynamic was entirely driven by lower household NPLs (given the rise in total loans, i.e., the denominator), while corporate NPLs increased slightly and stood at 9.9 percent.

In 2017, the current account deficit (CAD) narrowed to 1.3 percent of GDP. Solid export performance of FDIs, iron and steel, furniture, and tobacco helped to narrow the goods and services deficit from 15 percent of GDP in 2016 to 13.9 percent. Net private transfer inflows went up slightly, from 15.3 percent of GDP in 2016 to 15.8 percent—enough to cover the entire goods and services trade deficit. The deficit in the primary income balance widened from 3.9 percent of GDP in 2016 to 4.2 percent as foreign investors repatriated profits during the political turmoil. FDI dropped from 3.2 percent of GDP in 2016 to 2.3 percent. At the end of 2017 FYR Macedonia had foreign reserves equal to 4.4 months of import, and were further replenished in January 2018 as the government issued a 7-year €500 million

Eurobond at 2.75 percent that fully covers government borrowing requirements for 2018.

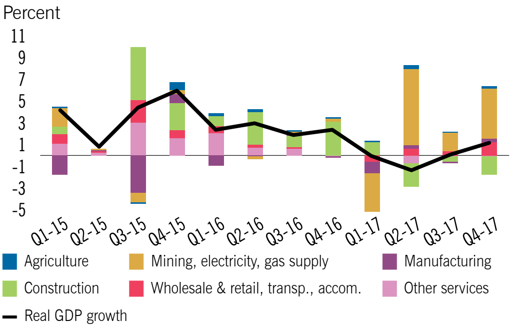
Outlook and Risks

The economic outlook is positive, and growth is expected to average 2.7 percent for 2018–20. Spurred by recovering investments, improved political climate and the end of technical difficulties that interrupted the construction of two highways, construction is expected to recover. Manufacturing is also expected to grow, a process that began in late 2017, propelled by higher demand from the EU. Private consumption is projected to rise supported by higher wages, employment, and rising credit to households, but also, as the new authorities indicated, a rise in social transfers.

With the political crisis resolved, the main risks are related to fiscal vulnerabilities. With one of the lowest revenue-to-GDP ratio in Europe and Western Balkans, a growing deficit in the pension system, higher interest payments, and accumulating arrears are risks to fiscal sustainability. Tightening of the global financial markets would add to the current pressures.

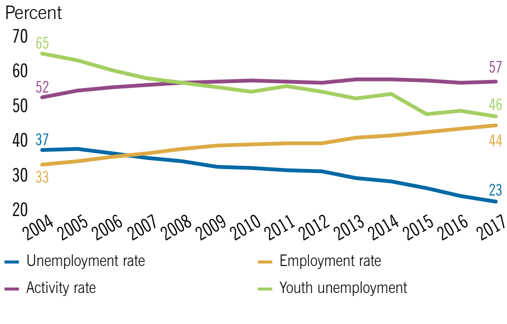
A credible fiscal reform program directed to making public spending more efficient and broadening the tax base would help stabilize public debt, rebuild fiscal buffers against shocks, and increase investor confidence. The fiscal deficit is expected to decline gradually to 2.3 percent by 2020 as the government launches reforms to build up tax collection, tighten spending controls, and make social spending more efficient. In the baseline scenario of gradual consolidation, the PPG debt-to-GDP ratio is expected to rise to 57.4 percent by 2020, which underscores the need for strong and frontloaded reforms to stabilize debt in the medium term. Structural reforms enhancing the investment climate, human capital, and public-sector efficiency will also help to boost investor confidence and the potential of the economy to grow in the medium term.

Political turmoil suppressed growth in 2017, but…



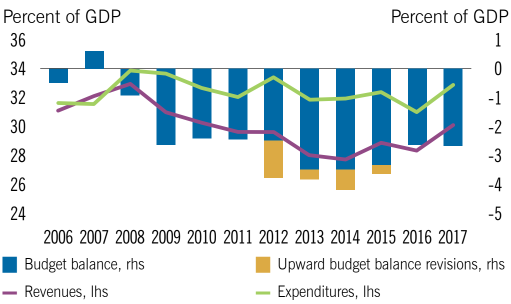
Source: State Statistics Office; World Bank staff calculations.

…unemployment declined despite the slowdown.



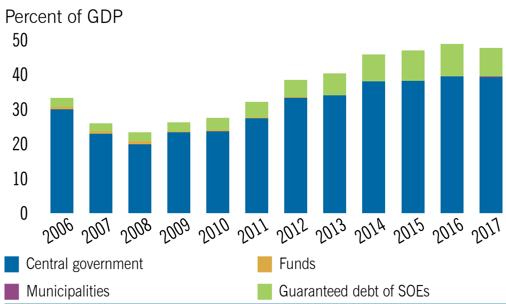
Source: State Statistics Office; World Bank staff estimates.

Fiscal deficit remained unchanged, while…



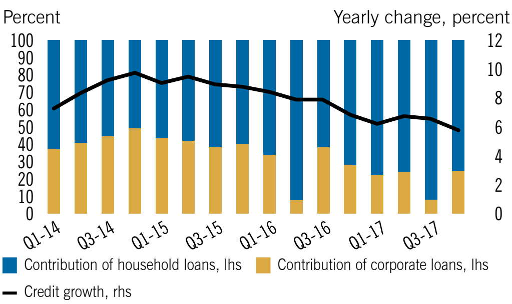
Source: Ministry of Finance; World Bank staff estimates.

…public debt fell given the drawdown of government deposits.



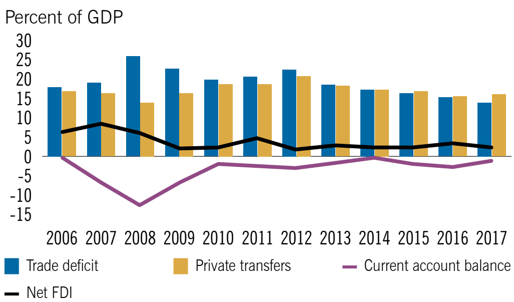
Source: Ministry of Finance; World Bank staff estimates.

Despite continued credit expansion, lending to businesses declined.



Source: National Bank; World Bank staff calculations.

External deficit narrowed, but FDI inflows declined.



Source: National Bank; World Bank staff calculations.

FYR MACEDONIA	2014	2015	2016	2017[e]	2018[f]	2019[f]	2020[f]
Real GDP growth (percent)	3.6	3.9	2.9	0.0	2.3	2.7	3.0
Composition (percentage points)							
Consumption	1.9	3.0	3.8	1.8	1.9	1.6	1.6
Investment	3.1	1.1	-1.7	-1.1	0.2	0.7	1.0
Net exports	-1.3	-0.2	0.8	-0.7	0.2	0.4	0.4
Exports	7.3	3.4	7.1	5.0	3.2	3.9	4.0
Imports	8.7	3.6	6.3	5.7	3.0	3.5	3.6
Consumer price inflation (percent, period average)	-0.3	-0.3	-0.2	1.4	1.6	2.0	2.0
Public revenues (percent of GDP)	29.7	31.0	30.3	31.1	31.4	31.6	31.7
Public expenditures (percent of GDP)	33.9	34.4	33.0	33.8	34.1	34.1	34.0
Of which:							
Wage bill (percent of GDP)	7.0	7.0	7.0	6.9	6.8	6.8	6.8
Social transfers (percent of GDP)	14.9	14.8	14.9	15.8	16.0	16.0	16.0
Capital expenditures (percent of GDP)	4.3	4.2	3.8	4.0	4.1	4.4	4.4
Fiscal balance (percent of GDP)	-4.2	-3.4	-2.7	-2.7	-2.7	-2.5	-2.3
Primary fiscal balance (percent of GDP)	-3.2	-2.3	-1.5	-1.4	-1.2	-0.9	-0.5
Public debt (percent of GDP)	38.0	38.1	39.5	39.3	43.0	45.4	42.1
Public and publicly guaranteed debt (percent of GDP)	45.7	46.6	48.5	46.7	53.5	58.5	57.4
Of which: External (percent of GDP)	31.8	31.4	33.7	31.6	34.8	37.0	34.2
Goods exports (percent of GDP)	32.5	33.6	35.7	40.4	41.3	42.8	43.2
Goods imports (percent of GDP)	54.2	53.7	54.3	58.2	58.7	58.7	57.5
Net services exports (percent of GDP)	4.5	3.8	3.6	4.0	4.1	4.3	4.4
Trade balance (percent of GDP)	-17.2	-16.2	-15.0	-13.9	-13.3	-11.6	-9.9
Remittances inflows (percent of GDP)	1.9	1.8	1.6	1.5	1.5	1.5	1.4
Current account balance (percent of GDP)	-0.5	-2.0	-2.7	-1.3	-2.5	-2.5	-2.6
Foreign direct investment inflows (percent of GDP)	2.3	2.2	3.3	2.3	2.6	2.9	3.1
External debt (percent of GDP)	70.0	66.9	64.7	73.5	77.8	78.6	79.4
Real private credit growth (percent, period average)	8.5	9.4	7.8	4.2	n.a.	n.a.	n.a.
Nonperforming loans (percent of gross loans, end of period)	11.1	10.6	6.4	6.3	n.a.	n.a.	n.a.
Unemployment rate (percent, period average)	28.0	26.1	23.7	22.4	20.4	19.4	18.0
Youth unemployment rate (percent, period average)	53.1	47.3	48.2	46.7	n.a.	n.a.	n.a.
Labor force participation rate (percent, period average)	57.3	57.0	56.5	56.8	n.a.	n.a.	n.a.
GDP per capita, PPP (current international $)	12,938	13,330	13,583	13,678	13,993	14,371	14,802
Poverty rate at US$5/day, PPP (percent of population)	24.8	23.2	21.9	21.0	20.6	20.5	20.2

Sources: Country authorities, World Bank estimates and projections.

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

Montenegro

- *Economic growth accelerated to 4.3 percent in 2017, led by investment in highway construction and a record-setting tourism season. Growth is projected to moderate to 2.8 percent in 2018 as the needed fiscal consolidation advances.*
- *Job creation continued to improve in 2017 for the fifth year of steady growth; administrative unemployment remained high because of considerable informality and high labor imports. Labor market participation did increase slightly, particularly among men.*
- *Tax increases led the fiscal consolidation process, but the deficit and public debt remain high.*
- *A better credit outlook is easing access to capital markets.*

Recent Economic Developments

Montenegro's economy grew n estimated 4.3 percent in 2017. Growth was underpinned by household consumption and investment. Investment, in fact, contributed most to growth, 5 percentage points (pp), as construction of the Bar-Boljare highway and residential construction accelerated. Supported by employment and wage growth, consumption also grew, adding 3.7 pp to GDP growth. However, net exports continued to subtract from growth, though in 2017 the drag from net exports was not so severe as in previous years due to a record tourism season, a pickup in exports of metal goods in response to higher EU demand, but more importantly from a lower imports growth.

Given higher growth, more jobs were created in 2017. Employment increased by 2.3 percent in the year, although it dropped during the last quarter by 0.1 percent y-o-y. This was the first such decline since late 2013. The decline came in agriculture, mining, retail, and real estate. The administrative unemployment rate increased from 19.4 percent in 2016 to 21.7 percent. Note, however, that the survey-based unemployment rate shows a decline from 17.7 percent in 2016 to 16.1 percent in 2017. This apparent disconnect is due to the fact that a third of jobs are informal. The survey-based employment rate grew to 45.9 percent, while labor force participation also grew, though more slowly, and solely due to higher participation by men. Female participation has not improved for the last three years.

Already high external imbalances worsened in 2017. The current account deficit (CAD) widened to 18.9 percent of GDP. Imports of goods increased by 11.7 percent, led by the high import-dependence of investments in infrastructure and tourism. Given the rise in EU demand, exports, led by metals and mineral ore sales, surged by 13.9 percent. The largest contribution to CAD moderation came from exports of services, mostly tourism, which went up by close to 8 percent, and to surpluses in the income accounts due to less withdrawal of dividends. However, the widening of the trade deficit by more than 2 pp could not be offset by the growing surpluses in services accounts. Net FDI inflows increased to 11.2 percent of GDP, financing two-thirds of the CAD.

After a decline in 2016, external debt again rose in 2017 and remains the highest in the Western Balkans. It appears that in 2016 the external debt- to-GDP ratio had declined from its 2014 peak of 163.3 percent of GDP to 160.9 percent. However, in 2017 it regressed to an estimated 162 percent. Two-thirds of external debt is with the private sector, and two-fifths is intracompany debt to subsidiaries.

After deflation of 0.3 percent in 2016, inflation warmed up in 2017. Overall, consumer prices increased by 2.4 percent. Although a rise in excises on tobacco and alcohol drove those prices up, by year-end prices had moderated, helped by reductions in those of oil and food, and rentals. Due to the increase in the VAT rate and excises on alcohol and tobacco, inflation picked up by 2.6 percent y-o-y in January 2018. Alcohol and tobacco prices are now 30 percent higher than a year ago.

Credit growth increased, as did the profitability of the banking sector. Overall credits grew by 11.8 percent y-o-y in 2017, while credits to the private non-financial sector grew by 6.5 percent y-oy driven by household lending. Corporate lending remained subdued (2.4 percent increase y-o-y). Deposits also grew, by 13.8 percent, because of both a good tourist season and a rise of 1.5 percent in wages after the summer. With lending growing, nonperforming loans declined, to below 8 percent, helped by amended legislation for voluntary financial restructuring. Return on assets and equity increased in 2017, along with the capital adequacy ratio, which reached 16.8 percent.

In 2017 work began on much-needed fiscal consolidation. The government adopted a series of reforms amounting to a consolidation of more than 3 pp of GDP, to stabilize public debt over the medium term. These measures have already brought the deficit down by over 1 pp of GDP compared to an earlier fiscal scenario. Included in the fiscal reform package are abolition of mothers' benefits, reduction in the wages of officials, and increases in excises and VAT. By December, tax revenues had increased by over 9 percent y-o-y, led by collection of more VAT and excise revenue. However, a trebled capital budget pushed up spending by close to 12 percent. On the other hand, wage reduction and abolition of mothers' benefits started yielding benefits in the second half of 2017 in terms of a deceleration of growth in the wage bill and social transfers. Ultimately, the general government deficit increased from 3.1 percent of GDP in 2016 to 5.4 percent. Public debt, including guarantees, broadened from 71.4 percent of GDP in 2016 to 74 percent by the end of 2017.

The initial fiscal reforms resulted in more positive market sentiment, with the credit rating outlook improving to stable. This has allowed easier access to capital markets for regular refinancing of liabilities coming due from 2018 through 2021. The budget revision for 2018 raised the deficit to 3.2 percent because it launched repurchase of shares in the electricity company.

Outlook and Risks

The economic outlook is positive but not without risk. The economy is projected to grow on average by 2.5 percent in 2018–20, driven by public investments and personal consumption. In 2018, fiscal consolidation is projected to lead to moderation of growth in the short term. From 2019, with completion of the Bar-Boljare highway, growth will slow unless there are productivity gains and new private sector investments that would stimulate currently low potential growth.

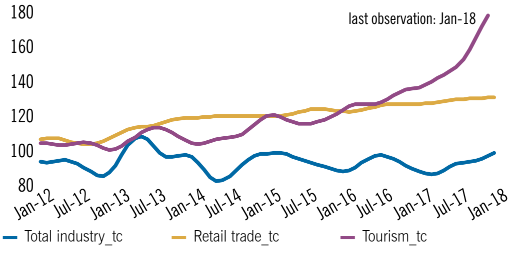
External imbalances are still high, exacerbating already high external vulnerability. Because economic growth tends to be import-dependent, they are likely to remain. Enhancing policy predictability and accelerating the pace of structural reforms will be necessary if external imbalances are to moderate. Reducing unemployment, especially for youth, mitigating the short-term poverty and social impacts of fiscal consolidation, and facilitating access to employment need to become policy priorities.

Achieving the fiscal goal of reaching balance by 2019 is important to reduce country risks. One goal of the Government Economic Reform Program for 2018–20 is to reach a balanced budget by 2019 and generate a surplus thereafter; another goal is to bring public debt below 60 percent by 2020. Balancing the budget by 2019 will require credible spending consolidation in the wage bill, social transfers, and operational costs. While tax policy changes are expected to reduce the deficit by 1 pp, fiscal consolidation efforts need to be deepened to put the public deficit and debt on a sustainable trajectory so as to secure orderly refinancing of liabilities coming due in 2019–21.

The government has announced reforms in procurement, the labor market, the business environment, transport regulation, and education. Digital connectivity is also high on the agenda. The EU accession negotiations are a critical part of the government reform program; 30 chapters have been opened so far and three have been provisionally closed.

Growth has increased…

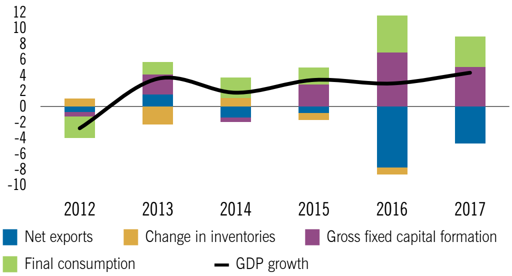
High-frequency data, trend-cycle, 2012–18, index, 2011=100



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

…led by consumption and investments.

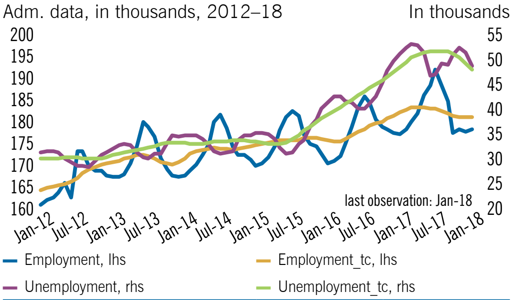
Contribution to growth, percent



Source: MONSTAT; World Bank staff estimates.

Labor market as improved…

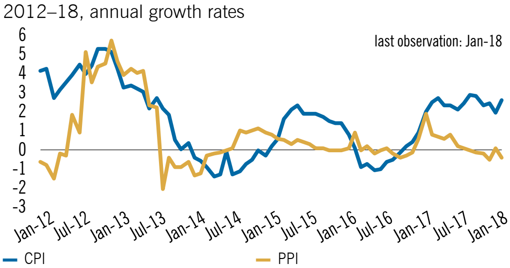
Adm. data, in thousands, 2012–18 In thousands



Source: MONSTAT; World Bank staff calculations.

…while inflationary pressures have moderated.

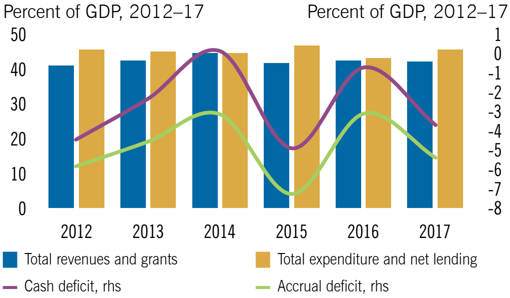
2012–18, annual growth rates



Source: MONSTAT.

Public finances remain fragile…

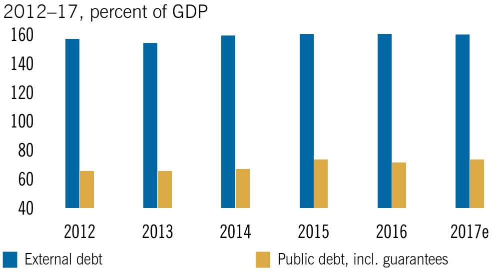
Percent of GDP, 2012–17 Percent of GDP, 2012–17



Source: MOF; MONSTAT; World Bank staff calculations.
Note: 2017 data show central government only.

…because external and public debt are high.

2012–17, percent of GDP



Source: MoF, CBCG; MONSTAT; World Bank staff estimates.

MONTENEGRO	2014	2015	2016	2017e	2018f	2019f	2020f
Real GDP growth (percent)	1.8	3.4	2.9	4.3	2.8	2.5	2.1
Compositioin (percentage points):							
Consumption	2.6	2.2	4.5	3.7	1.1	2.4	3.3
Investment	0.5	1.9	6.1	5.0	3.1	0.6	-1.1
Net exports	-1.3	-0.7	-7.6	-4.5	-1.4	-0.5	-0.1
Exports	-0.3	2.2	2.4	1.7	1.7	2.2	2.6
Imports (-)	1.0	2.9	10.0	6.1	3.1	2.7	2.6
Consumer price inflation (percent, period average)	-0.7	1.5	-0.3	2.4	3.1	2.1	1.6
Public revenues (percent of GDP)	44.6	41.5	42.5	42.0	44.1	43.2	42.6
Public expenditures (percent of GDP)	47.7	48.8	45.6	47.4	47.3	43.7	40.4
Of which:							
Wage bill (percent of GDP)	13.3	13.1	12.9	12.4	11.1	10.7	10.6
Social benefits (percent of GDP)	14.3	13.3	14.1	12.7	12.3	11.8	11.5
Capital expenditures (percent of GDP)	5.8	9.0	4.3	8.3	10.9	8.9	5.7
Fiscal balance (percent of GDP)	-3.1	-7.3	-3.1	-5.4	-3.1	-0.6	2.2
Primary fiscal balance (percent of GDP)	-0.9	-4.9	-1.0	-3.0	-0.8	1.8	4.6
Public debt (percent of GDP)	59.9	66.2	64.4	66.3	70.9	68.5	63.6
Public and publicly guaranteed debt (percent of GDP)	67.1	73.7	71.4	74.0	78.2	75.4	70.3
Of which: External (percent of GDP)	47.9	55.7	52.8	54.5	66.1	59.8	53.7
Goods exports (percent of GDP)	10.3	8.9	8.7	8.9	9.1	9.5	9.9
Goods imports (percent of GDP)	50.1	48.9	50.6	52.8	53.0	53.4	53.9
Net services exports (percent of GDP)	20.0	21.6	19.4	19.7	20.0	20.8	21.7
Trade and services balance (percent of GDP)	-19.8	-18.5	-22.5	-24.2	-23.9	-23.1	-22.3
Remittance inflows (percent of GDP)	4.3	4.1	3.8	3.8	3.8	3.6	3.5
Current account balance (percent of GDP)	-15.2	-13.2	-18.1	-18.9	-18.5	-17.9	-17.3
Foreign direct investment inflows (percent of GDP)	10.2	16.9	9.4	11.2	11.3	10.8	9.3
External debt (percent of GDP)	163.3	162.2	160.9	162.0	161.4	153.6	149.7
Real private credit growth (percent, period average)	-1.6	0.0	4.0	3.6	n.a.	n.a.	n.a.
Nonperforming loans (percent of gross loans, end of period)	15.9	12.5	10.3	7.2	n.a.	n.a.	n.a.
Unemployment rate (percent, period average)	18.0	17.6	17.7	16.1	15.8	15.5	15.0
Youth unemployment rate (percent, period average)	36.3	38.5	36.1	32.0	n.a.	n.a.	n.a.
Labor force participation rate (percent, period average)	52.7	53.7	54.5	54.7	n.a.	n.a.	n.a.
GDP per capita, PPP (current international $)	15,410	16,050	16,195	16,389	16,586	16,785	16,986
Poverty rate at US$5/day, PPP (percent of population)	4.8	4.6	4.2	4.4	4.8	4.6	4.4

Sources: Country authorities, World Bank estimates and projections.
Notes: Nonperforming loans show year-to-date actuals.

Serbia

- *Economic growth slowed to an estimated 1.9 percent in 2017, mainly because of bad weather.*
- *However, employment increased by about 3 percent in 2017, driven by more formal employment in services and manufacturing.*
- *Continuing fiscal consolidation and lower than planned public investment led to a budget surplus of 1.2 percent of GDP that reduced public debt.*
- *To enhance growth, reform priorities are to reduce the government stakes in the real and financial sectors and restructure state energy and transport utilities.*
- *In 2018, growth is expected to reach 3 percent as domestic demand picks up. The main concerns now are the sustainability of fiscal consolidation, the recent expansion of the external deficit, and the implications for external debt.*

Recent Economic Developments

Economic growth in 2017 is estimated at 1.9 percent; services and manufacturing are recovering but a cold winter caused significant problems. The yearend economic recovery was not enough to push growth above 2 percent. Fast growth of imports was offset by an only modest increase in exports. Imports increased mainly because of a significant increase in import of oil; metals, as steel mill activity picked up; food, because of the drought; and coil, due to first-quarter problems in the electricity company (EPS). A contributing factor was the dinar's appreciation against the euro. On the supply side, the recovery in services and industrial output was not enough to compensate for the decline in agricultural production. Services recovered in 2017, with growth in trade, transport, and tourism, and contributed about 1.2 percentage points (pp) to overall GDP growth; also recovering, industry contributed about 0.9 pp. Due to a harsh winter and summer drought, agricultural output declined by nearly 10 percent, dragging down GDP growth by about 1 pp. Construction recovered in the second half, bringing up the value of completed works by 10.1 percent in real terms.

Despite the effect of weather on agricultural activity, compared to 2016, employment increased by about 3 percent in 2017.[9] The average 2017 employment rate reached a record high of 46.7 percent, led by services, which created 33,000 new jobs (a quarter of them in wholesale and retail trade), spurred by higher consumption and fast-growing services exports. Manufacturing created another 23,700 jobs (a 6 percent increase in employment in this sector). Also, the number of registered entrepreneurs went up by 5.9 percent. Unemployment fell to 14.7 percent in December 2017, compared to 15.3 percent in 2016. Average wages rose by 3.9 percent in nominal terms in 2017 (y-o-y) and by 0.9 percent in real terms. Average private sector wages recovered by 4.5 percent

9 The increase is confirmed by data from the Labor Force Survey (LFS), which captures the informal sector, and by data from the Central Registry of Social Insurance, which captures formal employment only. Also, this was reflected in higher collection of social security contributions.

in nominal terms in 2017, compared to 2.6 percent growth in the public sector.[10]

The budget scored a surplus of 1.2 percent of GDP in 2017, powered by strong revenue collection, spending controls, and under-execution of public investment. Revenues were up 7.1 percent (y-o-y in nominal terms); spending rose only 1.3 percent. Revenue gains came from higher proceeds from the VAT on imports (by 1.2 percent of GDP), corporate income tax (CIT), and social contributions. CIT collections drew on good performance of the real sector in 2016; collection of social contributions tracked the rise in formal employment. While total public spending went up slightly (in nominal terms), there were major savings on interest payments and activated guarantees that together saved the government about 0.5 percent of GDP compared to 2016. Savings from activated guarantees respond to stricter policies for providing financial support to utility companies and state-owned enterprises (SOEs). The savings could have been higher, but spending on goods and services went up by about 0.4 percent of GDP. Despite recent consolidation, current spending still represents 90 percent of all spending. The fiscal surplus and a favorable dollar/euro exchange rate have helped to reduce public debt as a share of GDP from 73 percent in 2016, to estimated 62.4 percent for 2017.[11]

Slower growth and appreciation of the dinar helped lower inflation, but credit to the private sector increased only marginally. Inflation peaked at 4 percent in April 2017, and then fell to 3 percent in December. After keeping its policy rate at 4 percent for 13 months, the central bank lowered it to 3.75 percent in September, 3.5 percent in October, and in March 2018 to 3.25 percent. Through December the dinar had appreciated in nominal terms by 4 percent against the euro, but remained broadly stable in nominal terms throughout the first quarter of 2018. Nominal growth of private sector credit was sluggish, hitting 3.6 percent by yearend; loans to households were up by 7.8 percent, to private enterprises down by 2.1 percent, and to the government down 1.2 percent (all y-o-y, in nominal terms). Having hit 17 percent at the end of 2016, gross nonperforming loans (NPLs) fell back to 9.5 percent in December 2017 as banks more aggressively wrote off or sold bad loans. Despite recent improvements in regulation of the banking sector (introduction of the IFRS 9; new regulations governing risk management in banks, and further operationalization of Basel III standards) there are risks stemming from a large share of state-owned banks in the banking sector. The number of state-owned banks is a challenge and their NPLs are higher than those of other banks.

The current account deficit (CAD) rose markedly, from 3.1 percent of GDP in 2016 to 5.7 percent in 2017. Surpluses in trade in services and in net-transfers could not compensate for the 27.8 percent rise in the widening goods trade deficit and a 27.1 percent deficit in primary income (transactions related to compensation of nonresident employees; interest payments; and transfers in the net income of businesses). Within the primary income balance, income transfers by foreign companies were up 33.7 percent, but interest payments went down 9 percent (in euro terms). Remittances grew robustly, by 10.1 percent, to reach 5.9 percent of GDP. The net FDI increase

10 Averages wage level for 2017, compared to 2016.
11 Total public debt includes nonguaranteed debt of local governments.

of 27.1 percent (or 1.1 percent of GDP)[12] was more than enough to finance the CAD.

Outlook and Risks

After disappointing growth in 2017, the Serbian economy is expected to recover over the medium term, increasingly driven by consumption rather than exports. Exports are projected to grow by 7 percent in real terms, but announced increases in public wages and expected increases in employment generally should push up consumption. However, it is not clear how much will spill over to imports and worsen the CAD. Public investment is expected to rise, but it is critical to increase private investment.

The medium-term growth projections depend crucially on timely structural reforms and progress with EU accession. It is thus vital that Serbia deal with its unsustainable SOEs. The government has a stake in more than 600 companies, several of which together have cost the government 1 percent of GDP in financial support.[13] Finalizing this part of the transition from a planned to a market economy would lower fiscal pressures, reduce crowding-out, and heighten competition. Speeding up the restructuring of the state-owned utilities, most of which are in the energy sector, would both bring significant savings and also ensure a more reliable electricity supply, which is crucial for growth. Meanwhile, acceleration of the EU accession process could send a favorable signal to investors to consider entering Serbia's market. Investment in connective infrastructure, an EU priority, would also benefit Serbian exporters.

Risks are mainly associated with Serbia's external position. The widening of the CAD in 2017 has begun to affect official foreign currency reserves, which now cover only 135 percent of the money supply, down from 156 percent in 2016, and 5.3 months of imports of goods and services, down from 6.2 months in 2016. A higher CAD will push up external debt, perhaps nullifying recent efforts to reduce it.

Another important risk is fiscal loosening. The IMF program expired in February 2018 and the government's medium-term fiscal plan is not yet clear.[14] Recent increases in public sector wages, substantial subsidies to SOEs, and delays in reforming the public wage system are major threats to fiscal stability.

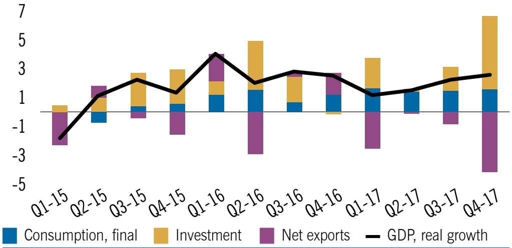
12 If flow of equity alone is considered, the increase was significantly smaller, about 3.4 percent, in euro terms.

13 While overall subsidies from the general government sector reached 2.5 percent of GDP in 2017.

14 Discussions between the government and the IMF about a new program started in March 2018.

The economy slowed as imports increased…

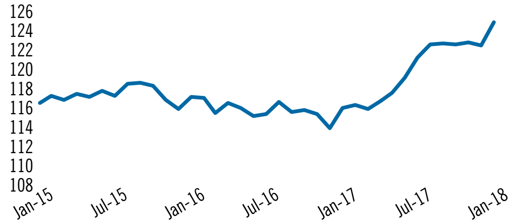
Contribution to GDP growth in percentage points



Source: Statistics Office of Serbia; World Bank staff calculations.

…in part related to the appreciation of the dinar…

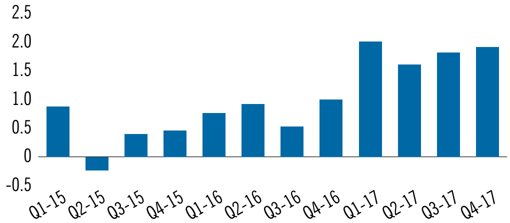
Percent, REER, 2005 = 100



Source: National Bank of Serbia.

…and because consumption rose

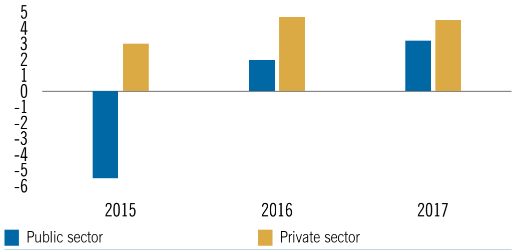
Private consumption, change in real terms



Source: Statistics Office of Serbia.

…thanks to higher salaries across the economy

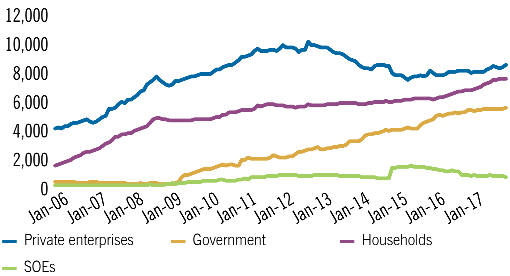
Wages, annual change in percent



Source: Ministry of Finance; World Bank staff calculations.

…and increased lending to households.

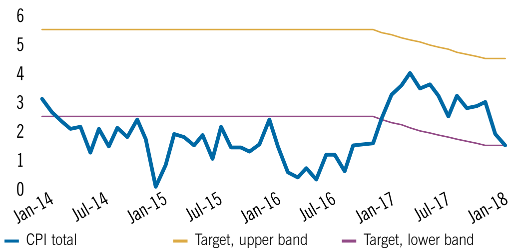
In euro million



Source: National Bank of Serbia.

However, inflation remains within the target band.

Percent



Source: National Bank of Serbia; SORS.

SERBIA	2014	2015	2016	2017e	2018f	2019f	2020f
Real GDP growth (percent)	-1.8	0.8	2.8	1.9	3.0	3.5	4.0
Composition (percentage points):							
Consumption	-1.1	0.1	1.1	1.5	2.4	2.6	3.7
Investment	0.0	1.6	1.5	2.3	1.1	1.1	1.2
Net exports	-0.7	-0.9	0.2	-1.9	-0.5	-0.2	-0.9
Exports	2.3	4.5	5.8	5.2	3.6	4.3	4.4
Imports (-)	3.0	5.4	5.6	7.1	4.1	4.6	5.4
Consumer price inflation (percent, period average)	2.1	1.4	1.1	3.2	3.0	3.0	3.0
Public revenues (percent of GDP)	39.7	40.4	41.7	42.7	40.9	41.0	40.7
Public expenditures (percent of GDP)	46.3	44.0	43.0	41.5	41.5	41.5	41.2
Of which:							
Wage bill (percent of GDP)	9.9	8.8	8.3	8.1	8.3	8.2	8.1
Social benefits (percent of GDP)	17.8	17.6	16.8	16.1	15.7	15.7	15.7
Capital expenditures (percent of GDP)	2.5	2.8	3.3	3.0	3.6	3.8	3.8
Fiscal balance (percent of GDP)	-6.6	-3.6	-1.3	1.2	-0.6	-0.5	-0.5
Primary fiscal balance (percent of GDP)	-3.7	-0.5	1.8	3.8	1.9	2.1	2.0
Public debt (percent of GDP)	64.2	68.8	67.8	57.6	56.0	54.3	52.0
Public and publicly guaranteed debt (percent of GDP)	71.9	75.9	73.0	62.4	60.1	57.6	55.5
Of which: External (percent of GDP)	41.5	45.2	45.9	38.0	37.0	37.0	36.0
Goods exports (percent of GDP)	31.9	33.9	37.0	38.3	41.3	43.3	43.3
Goods imports (percent of GDP)	44.3	45.8	46.0	49.1	50.9	52.9	52.9
Net services exports (percent of GDP)	1.4	2.2	2.6	2.6	3.1	3.5	3.5
Trade balance (percent of GDP)	-10.9	-9.8	-6.4	-8.2	-6.6	-6.1	-6.1
Remittance inflows (percent of GDP)	5.8	6.4	5.6	5.8	5.7	5.5	5.5
Current account balance (percent of GDP)	-6.0	-4.7	-3.1	-5.7	-4.2	-4.1	-3.9
Foreign direct investment inflows (percent of GDP)	3.7	5.4	5.5	6.6	5.2	5.3	5.2
External debt (percent of GDP)	77.1	78.3	76.5	73.4	70.1	67.0	65.0
Real private credit growth (percent, period average)	-3.8	-1.2	5.0	1.9	n.a.	n.a.	n.a.
Non-performing loans (percent of gross loans, end of period)	21.5	21.6	17.0	12.2	n.a.	n.a.	n.a.
Unemployment rate (percent, period average)	19.2	17.7	15.3	13.5	13.0	12.5	11.5
Youth unemployment rate (percent, period average)	47.0	42.9	35.0	32.0	n.a.	n.a.	n.a.
Labor force participation rate (percent, period average)	51.9	51.6	53.3	54.0	n.a.	n.a.	n.a.
GDP per capita, PPP (current international $)	13,398	13,454	13,773	14,412	15,164	16,063	17,049
Poverty rate at US$5/day, PPP (percent of population)	24.1	24.0	23.1	22.4	21.7	20.9	19.7

Sources: Country authorities, World Bank estimates and projections.
Notes: Non-performing loans show year-to-date actuals.

Key Economic Indicators

	2013	2014	2015	2016	2017e	2018f	2019f	2020f
Real GDP growth (percent)								
Albania	1.0	1.8	2.2	3.4	3.8	3.6	3.5	3.5
Bosnia and Herzegovina	2.4	1.1	3.0	3.1	3.0	3.2	3.4	4.0
Kosovo	3.4	1.2	4.1	4.1	4.4	4.8	4.8	4.8
Macedonia, FYR	2.9	3.6	3.9	2.9	0.0	2.3	2.7	3.0
Montenegro	3.5	1.8	3.4	2.9	4.3	2.8	2.5	2.1
Serbia	2.6	-1.8	0.8	2.8	1.9	3.0	3.5	4.0
WB6	*2.5*	*0.3*	*2.2*	*3.1*	*2.4*	*3.2*	*3.5*	*3.8*
Consumer price inflation (percent, period average)								
Albania	1.9	1.6	1.9	1.3	2.0	2.1	2.3	2.8
Bosnia and Herzegovina	-0.1	-0.9	-1.0	-1.1	1.2	1.4	1.4	1.4
Kosovo	1.8	0.4	-0.5	0.3	1.5	1.7	1.7	1.9
Macedonia, FYR	2.8	-0.3	-0.3	-0.2	1.4	1.6	2.0	2.0
Montenegro	2.2	-0.7	1.5	-0.3	2.4	3.1	2.1	1.6
Serbia	7.9	2.1	1.4	1.1	3.2	3.0	3.0	3.0
WB6	*4.3*	*0.9*	*0.7*	*0.5*	*2.3*	*2.3*	*2.4*	*2.4*
Public expenditures (percent of GDP)								
Albania	29.2	32.3	31.5	29.4	29.6	30.1	29.7	29.4
Bosnia and Herzegovina	45.0	46.3	43.4	42.3	41.4	42.6	43.7	43.8
Kosovo	27.8	26.3	26.8	27.6	28.0	28.8	29.8	30.7
Macedonia, FYR	34.1	33.9	34.4	33.0	33.8	34.1	34.1	34.0
Montenegro	46.9	47.7	48.8	45.6	47.4	47.3	43.7	40.4
Serbia	43.5	46.3	44.0	43.0	41.5	41.5	41.5	41.2
WB6	*37.7*	*38.8*	*38.2*	*36.8*	*36.9*	*37.4*	*37.1*	*36.6*
Public revenues (percent of GDP)								
Albania	24.2	26.3	26.6	27.6	27.6	28.1	28.1	28.1
Bosnia and Herzegovina	43.2	43.4	43.2	42.7	43.5	43.9	43.9	43.8
Kosovo	24.6	24.0	25.1	26.3	26.6	26.6	26.8	27.4
Macedonia, FYR	30.1	29.7	31.0	30.3	31.1	31.4	31.6	31.7
Montenegro	42.3	44.6	41.5	42.5	42.0	44.1	43.2	42.6
Serbia	37.9	39.7	40.4	41.7	42.7	40.9	41.0	40.7
WB6	*33.7*	*34.6*	*34.6*	*35.2*	*35.6*	*35.9*	*35.8*	*35.7*

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

	2013	2014	2015	2016	2017[e]	2018[f]	2019[f]	2020[f]
Fiscal balance (percent of GDP)								
Albania	-5.1	-6.0	-4.9	-1.8	-2.0	-2.0	-1.6	-1.3
Bosnia and Herzegovina	-1.8	-2.9	-0.2	0.3	2.1	1.2	0.2	0.0
Kosovo	-3.1	-2.4	-1.8	-1.3	-1.4	-2.2	-3.0	-3.3
Macedonia, FYR	-4.0	-4.2	-3.4	-2.7	-2.7	-2.7	-2.5	-2.3
Montenegro	-4.6	-3.1	-7.3	-3.1	-5.4	-3.1	-0.6	2.2
Serbia	-5.6	-6.6	-3.6	-1.3	1.2	-0.6	-0.5	-0.5
WB6	*-4.0*	*-4.2*	*-3.5*	*-1.6*	*-1.4*	*-1.6*	*-1.3*	*-0.9*
Public debt (percent of GDP)								
Albania	61.7	66.1	69.1	68.7	67.8	65.5	62.7	61.7
Bosnia and Herzegovina	37.6	41.6	41.9	40.5	36.4	35.1	34.0	33.2
Kosovo	9.0	10.4	12.7	14.1	15.8	16.6	18.6	20.9
Macedonia, FYR	34.0	38.0	38.1	39.5	39.3	43.0	45.4	42.1
Montenegro	57.5	59.9	66.2	64.4	66.3	70.9	68.5	63.6
Serbia	52.6	64.2	68.8	67.8	57.6	56.0	54.3	52.0
WB6	*42.1*	*46.7*	*49.5*	*49.2*	*47.2*	*47.8*	*47.2*	*45.6*
Public and publicly guaranteed debt (percent of GDP)								
Albania	70.4	72.0	73.1	72.4	71.0	69.0	66.6	64.7
Bosnia and Herzegovina	39.1	42.1	42.5	41.3	38.0	36.7	35.6	34.8
Kosovo	9.0	10.6	12.8	14.4	16.5	17.4	19.3	20.9
Macedonia, FYR	40.2	45.7	46.6	48.4	47.5	53.5	58.5	57.4
Montenegro	66.0	67.1	73.7	71.4	74.0	78.2	75.4	70.3
Serbia	60.9	71.9	75.9	73.0	62.4	60.1	57.6	55.5
WB6	*47.6*	*51.6*	*54.1*	*53.5*	*51.6*	*52.5*	*52.2*	*50.6*
Goods exports (percent of GDP)								
Albania	11.1	9.3	7.5	6.6	6.9	7.3	7.4	7.5
Bosnia and Herzegovina	24.8	25.1	25.2	25.7	28.5	31.2	33.9	34.6
Kosovo	5.5	5.8	5.6	5.1	6.0	6.2	6.4	6.6
Macedonia, FYR	29.1	32.5	33.6	35.7	40.4	41.3	42.8	43.2
Montenegro	11.8	10.3	8.9	8.7	8.9	9.1	9.5	9.9
Serbia	30.7	31.9	33.9	37.0	38.3	41.3	43.3	43.3
WB6	*24.0*	*24.7*	*25.3*	*26.8*	*28.5*	*30.4*	*32.0*	*32.2*

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

	2013	2014	2015	2016	2017e	2018f	2019f	2020f
Trade balance (percent of GDP)								
Albania	-18.0	-19.1	-17.4	-16.9	-15.0	-15.5	-14.8	-14.2
Bosnia and Herzegovina	-20.5	-22.7	-18.8	-17.1	-17.3	-17.1	-17.4	-17.5
Kosovo	-27.7	-28.7	-28.5	-27.6	-26.8	-26.3	-26.2	-25.6
Macedonia, FYR	-18.3	-17.2	-16.2	-15.0	-13.9	-13.3	-11.6	-9.9
Montenegro	-20.1	-19.8	-18.5	-22.5	-24.2	-23.9	-23.1	-22.3
Serbia	-11.2	-10.9	-9.8	-6.4	-8.2	-6.6	-6.1	-6.1
WB6	*-16.3*	*-16.7*	*-15.1*	*-13.3*	*-13.7*	*-12.9*	*-12.3*	*-12.0*
Current account balance (percent of GDP)								
Albania	-9.3	-10.8	-8.6	-7.6	-6.9	-7.1	-6.9	-6.7
Bosnia and Herzegovina	-5.3	-7.4	-5.7	-5.1	-5.8	-6.2	-6.4	-6.5
Kosovo	-3.4	-6.9	-8.6	-8.2	-5.1	-6.0	-7.0	-7.5
Macedonia, FYR	-1.6	-0.5	-2.0	-2.7	-1.3	-2.5	-2.5	-2.6
Montenegro	-14.5	-15.2	-13.2	-18.1	-18.9	-18.5	-17.9	-17.3
Serbia	-6.1	-6.0	-4.7	-3.1	-5.7	-4.2	-4.1	-3.9
WB6	*-6.0*	*-6.7*	*-5.8*	*-5.1*	*-5.9*	*-5.5*	*-5.5*	*-5.5*
External debt (percent of GDP)								
Albania	66.1	69.6	73.6	72.4	70.4	73.0	70.4	68.7
Bosnia and Herzegovina	72.9	76.3	72.2	71.0	70.9	69.3	68.8	68.8
Kosovo	30.2	31.2	33.3	33.1	34.4	35.5	35.8	35.7
Macedonia, FYR	64.0	70.0	66.9	64.7	73.5	77.8	78.6	79.4
Montenegro	156.3	163.3	162.2	160.9	162.0	161.4	153.6	149.7
Serbia	74.8	77.1	78.3	76.5	73.4	70.1	67.0	65.0
WB6	*77.4*	*81.2*	*81.1*	*79.8*	*80.8*	*81.2*	*79.0*	*77.9*
Unemployment rate (period average, percent)								
Albania	15.9	17.5	17.1	15.2	13.8	n.a.	n.a.	n.a.
Bosnia and Herzegovina	27.5	27.5	27.7	25.4	20.5	n.a.	n.a.	n.a.
Kosovo	30.0	35.3	32.9	27.5	30.4	n.a.	n.a.	n.a.
Macedonia, FYR	29.0	28.0	26.1	23.7	22.4	20.4	19.4	18.0
Montenegro	19.5	18.0	17.6	17.7	16.1	15.8	15.5	15.0
Serbia	22.1	19.2	17.7	15.3	13.5	13.0	12.5	11.5
WB6	*24.0*	*24.3*	*23.2*	*20.8*	*19.4*	*16.4*	*15.8*	*14.8*

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

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Semejstvo (Family)
by Nehat Beqiri

Born in Tetovo, Macedonia in 1967, Nehat Beqiri achieved his masters in painting in 2001, at the Faculty of Fine Arts, University of Pristina, under the mentorship of Professor Muslim Mulliqi. A member of the Artists' Association of Macedonia, Nehat is currently Associate Professor at Tetova State University (Macedonia) as well as at International University-Novi Pazar (Srbija). Besides painting, Nehat dwells in sculpture, design, conceptual art. His awards is evidence of his participation in hundreds of collective and sole exhibitions, both private and public collections, in Macedonia, Kosovo, Turkey, France, Albania, Croatia, and Bulgaria.

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