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No.15 | Spring 2019

Reform Momentum Needed



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Western Balkans
Regular Economic Report No.15

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

The team was led by Marco Antonio Hernandez and Marc Tobias Schiffbauer (Task Team Leaders). This issue's core team included World Bank staff working on the Western Balkan countries (with additional contributions to specific sections): Bojan Shimbov, Sandra Hlivnjak (External section), Edith Kikoni (Fiscal section), Johanna Jaeger, Christoph Ungerer (Financial sector section), Sanja Madžarević-Šujster, Gonzalo Reyes (Labor section), Asli Senkal (Growth section), Lazar Šestović, Milan Lakicević (Outlook section), and Hilda Shijaku (Monetary section). Additional contributions were made by: Stefanie Brodmann, Trang Van Nguyen, Ana Maria Oviedo, Monica Robayo, and Cesar A. Cancho (Labor section and Spotlight#2); Gunhild Berg, Alena Kantarovich, Blerta Qerimi, Ruvejda Aliefendic, Keler Gjika, and Alper Oguz (Financial sector section); Elwyn Davies, Graciela Miralles, Tania Begazo, Leandro Zipitria, and Tilsa Ore (Growth section and Spotlight#1); David Gould (Outlook section); David Duarte and Lorena Meco (Fiscal section).

The Special Focus Section "Human Capital in the Western Balkans: A Missing Link to Growth and Inclusion" was led by Jamele Rigolini, with contributions from Bojana Naceva, Boryana Gotcheva, Cem Mete, Dorothee Chen, Flora Kelmendi, Harry Patrinos, Ian Forde, Katia Herrera, Marijana Jasarevic, Mirey Ovadiya, Stefanie Brodmann, Tania Dmytraczenko, Marc Tobias Schiffbauer, and Marco Antonio Hernandez.

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The dissemination of the report and external and media relations are managed by an External Communications team comprised of Lundrim Aliu, Anita Božinovska, Paul A. Clare, Ana Gjokutaj, Jasmina Hadžić, Carl P. Hanlon, Vesna Kostić, John Mackedon, Mirjana Popović, Kym Louise Smithies, and Sanja Tanić.

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

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Washington DC 20433
Telephone: 202-473-1000
Internet: www.worldbank.org

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Reform Momentum Needed

1. Overview

The Western Balkans economies are projected to continue to expand in 2019–20, but this stable outlook is vulnerable to risks. In 2018 economic growth in the Western Balkans reached 3.8 percent, supported by increased public spending, and in Albania and North Macedonia also by a rise in net exports. Growth is projected to average 3.7 percent for 2019–20, faster than the EU and similar to the average for Central and Eastern Europe (CEE). Growth will differ by country, accelerating in Bosnia and Herzegovina, Kosovo, and North Macedonia while decelerating in Albania, Montenegro, and Serbia. Factors common to all countries are the recent fiscal stimuli and favorable external conditions that pushed growth in 2018, beyond its potential in some of them. The waning effects of these factors challenges the medium-term growth outlook in the region. Moreover, there is growing public discontent in several countries which could lead to higher political uncertainty and a slower pace of structural reforms. In North Macedonia, by contrast, the resolution in early 2019 of the decades-long dispute with Greece over the country's name is an opportunity to advance reforms, accelerate EU accession, and become more integrated in global markets. Western Balkan countries are also confronted with growing external risks from slower-than-projected growth in the EU, geopolitical and trade disputes, and a possible tightening of financing conditions in international capital markets. Against this backdrop, there is an opportunity to advance reforms to mitigate risks and the demands for greater economic opportunities.

Despite stronger growth in 2018, the pace of job creation slowed, reflecting limited private sector dynamism. In 2018, 96,000 jobs were created in the Western Balkans (mostly in industry and services), down considerably from 171,200 jobs created during 2017. The slower labor market response reflects to some extent the temporary effects of the fiscal stimuli that pushed growth but did not encourage private sector job creation. Unemployment fell in 2018 but remains high, particularly for women and the youth; in some countries the fall in unemployment stemmed from increased labor inactivity and emigration rather than new jobs. Labor market distortions at the country level remain evident in regional and gender disparities. Reducing disincentives to employment and labor force participation, such as the high burden of taxes on low-wage earners, is critical to spur job creation and growth.

Ensuring that firms can readily enter, compete on equal terms, and efficiently exit the market would support business development and attract private investment in the Western Balkans. In recent years, inflows of foreign direct investment (FDI) have helped transform industries and increase exports; but FDI is still low as a share of GDP and its growth is slow. Regulatory barriers make it difficult for existing firms to expand, become more productive, or exit the market, and for new firms to emerge and succeed, or fail fast and cheap. High-growth firms—that grow on average by at least 20 percent for three consecutive years—create the most jobs in the Western Balkans, but there are few of these firms: in 2016

only 1 in 33 formal sector firms in North Macedonia and, in 2017, only 1 in 20 in Serbia had average growth of at least 20 percent for three consecutive years. Other small transition economies in Europe, such as Latvia, Lithuania, and Estonia, as well as other emerging markets have much larger shares of high-growth firms. Reinforcing the public institutions that ensure no one benefits from special treatment would encourage entrepreneurs to enter the market and innovate, expanding the pool of younger, more productive firms that grow and create jobs (Spotlight #1).

Because public spending is dominated by large public wage bills and untargeted social programs, the efficiency of fiscal policy needs to improve. Countries that have been committed to fiscal consolidation such as Albania and Serbia are seeing their debt go down, and it is critical to safeguard these gains. But public and publicly guaranteed debt remains high in most countries, and rose in Montenegro, North Macedonia, and Kosovo in 2018. Fiscal risks related to pensions, municipal finances, and state-owned enterprises are also on the rise. Improving the efficiency and equity of public spending as well as strengthening revenue mobilization remain priorities for fiscal policy to reduce the high debt levels, create fiscal buffers to mitigate risks, and improve the delivery of public services in the Western Balkans.

Harnessing the opportunity to build reform momentum at a time of a stable outlook is essential for strengthening the foundations for future growth. This edition of the Western Balkans Regular Economic Report discusses selected reform areas that will help boost productivity for faster and sustained growth and jobs, namely (1) competition policy;

(2) labor taxation; (3) the distributional impact of personal income taxation; (4) financial sector diversification; (5) export sophistication; and (6) economic connectivity. Advancing reforms in these and other areas would allow Western Balkan countries to seize the opportunities that EU accession can bring, and to be able to compete on an equal footing with EU peers.

This report features a special focus section on human capital development. The region has achieved notable progress in expanding access to basic education and health and setting up social protection systems to protect the vulnerable. This Focus Section explores how Western Balkan societies can be better prepared to take advantage of the opportunities offered by rapid technological changes, mitigate risks, and create dynamic growing economies where young people can thrive and realize their aspirations. Unaddressed, the region's human capital challenges will severely limit the region's prospects for growth and poverty reduction. For instance, too little investment in early childhood development translates into poor performance in primary and secondary education in some countries. In school, students in some countries do not acquire the skills they need to function effectively as labor markets become ever more competitive. Poor-quality technical and university education makes the transition from school to work difficult; many graduates who suffer years of unemployment cannot build work experience. Social assistance programs also do not give vulnerable households the support they need to prepare them for the labor market. Inefficient health systems are unable to address the rise of noncommunicable diseases, and individual out-of-pocket spending on health is high. In general, countries in the region must act boldly to build human capital.

Figure 1.1. Economic growth in the Western Balkans picked up in 2018 and the outlook for 2019–20 is stable.

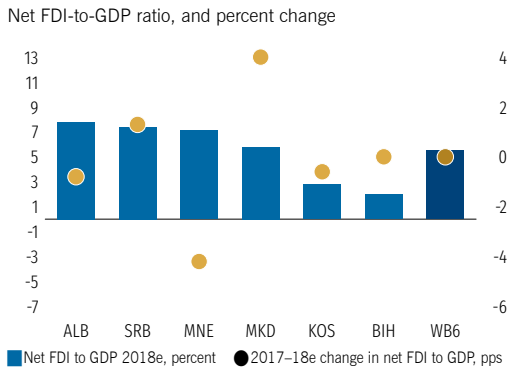
Growth rates, 2017–20f, percent

	2017	2018e	2019f	2020f
Albania	3.8	4.2	3.8	3.6
Bosnia and Herzegovina	3.2	3.0	3.4	3.9
Kosovo	4.2	4.2	4.4	4.5
North Macedonia	0.2	2.7	2.9	3.2
Montenegro	4.7	4.4	2.9	2.4
Serbia	2.0	4.2	3.5	4.0
Western Balkans	2.6	3.8	3.5	3.8
EU28	2.6	2.1	1.8	1.7
Central and Eastern Europe	4.9	4.3	3.6	3.2

Source: For the Western Balkans: World Bank estimates based on data from national authorities. For EU28 and Central and Eastern Europe: European Commission Winter Economic Outlook.

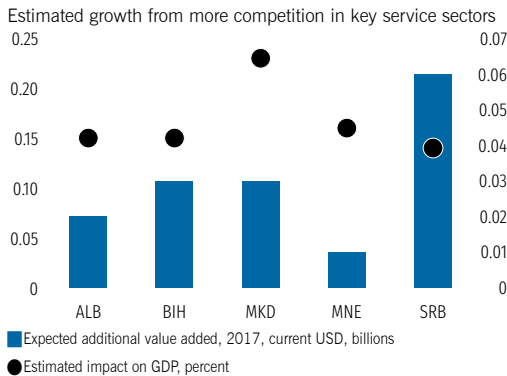
Notes: Growth in the Western Balkans is a weighted average by population. EU28 comprises the 28 EU members countries. Central and Eastern Europe comprises Bulgaria, Croatia, Czech Republic, Hungary, Poland, and Romania.

Figure 1.3. ...and in low, and slow-growing foreign investment inflows.



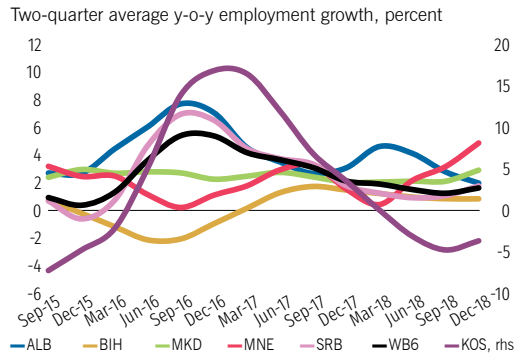
Source: National authorities and World Bank estimates.

Figure 1.5. Advancing reforms to ensure that private sector firms can compete on equal terms will boost productivity and sustain higher growth rates.



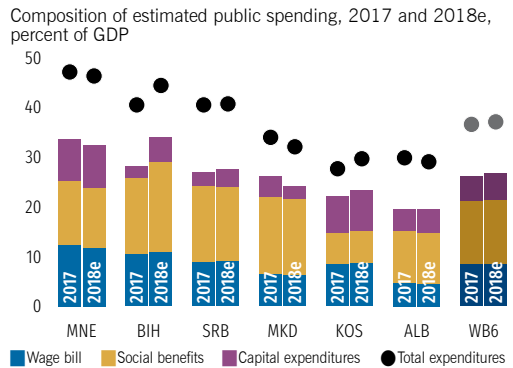
Source: World Bank estimates (see text for details).

Figure 1.2. But limited private sector dynamism is reflected in slow job creation...



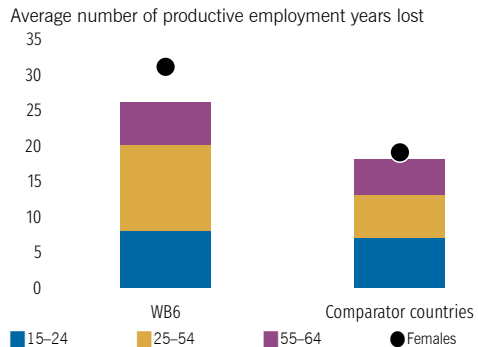
Source: National authorities and World Bank estimates.

Figure 1.4. With public spending dominated by wages and untargeted social programs, fiscal policy needs reform.



Source: National authorities and World Bank estimates.

Figure 1.6. Investing more efficiently in human capital would allow Western Balkan countries to expand their economic potential and ensure that growth is inclusive.



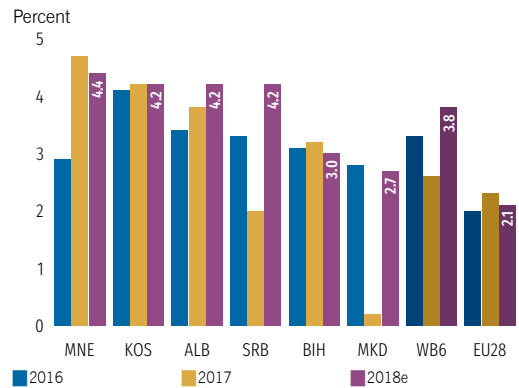
Source: World Bank estimates (see text for details).

2. Growth in the Western Balkans accelerated in 2018

In 2018 growth accelerated in the region, reaching 3.8 percent, despite slower growth in its main market, the EU area (Figure 2.1). Serbia, the largest economy in the region, grew by 4.2 percent, significantly higher than the previously projected 3.5 percent when the Fall 2018 edition of this report was published. The strong growth was driven by consumption and investment, in part due to a temporary stimulus from an increase in public sector wages and pensions, and a recovery of the energy sector after a drop in production in 2017. In Kosovo and Albania, growth reached an estimated 4.2 percent. In Kosovo, it was driven by a rise in public infrastructure investment and by a consumption rebound due to higher public wages, remittances, and consumer lending. In Albania, a rise in energy production due to exceptionally favorable hydrological conditions explained half of total GDP growth, which was further supported by growth in tourism services and household consumption driven by higher employment and wages. In Bosnia and Herzegovina, growth slowed marginally to 3 percent from last year's 3.2 percent, with domestic demand as the dominant driver of growth. In North Macedonia, the economy recovered from the political crisis with consumption growth driven by rising employment, wages, and household lending and higher net exports pushing up growth to 2.7 percent (2.5 percentage points (pp) higher than last year's). Growth in Montenegro was a solid 4.4 percent,¹ 0.6 pp higher than projected earlier, as private investment in tourism and

energy surged and the construction of the Bar-Boljare highway accelerated.

Figure 2.1. Growth accelerated in 2018.



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

Higher growth has been supported by consumption (Figure 2.2). Consumption growth has been driven by an increase in public sector wages or social benefits including pensions in Serbia, Kosovo, and Bosnia and Herzegovina. Higher consumer lending also supported consumption in Albania, Kosovo, Montenegro, North Macedonia, and Serbia as did employment in Albania, Montenegro, and North Macedonia. However, while a rise in untargeted social benefits may have spurred consumption in some countries, it raises concerns about the sustainability and efficiency of public spending (see Section 4).

Private and public investments were another important driver of growth, especially in Kosovo, Montenegro, and Serbia. In Montenegro, private investments in tourism and energy and the construction of the Bar-Boljare highway fueled investment growth, which contributed an estimated 5.8 pp to GDP

1 Following the closing date for data collection for this report the Statistical Offices of Montenegro and Serbia issued new GDP estimates for 2018 (see the country notes for more details).

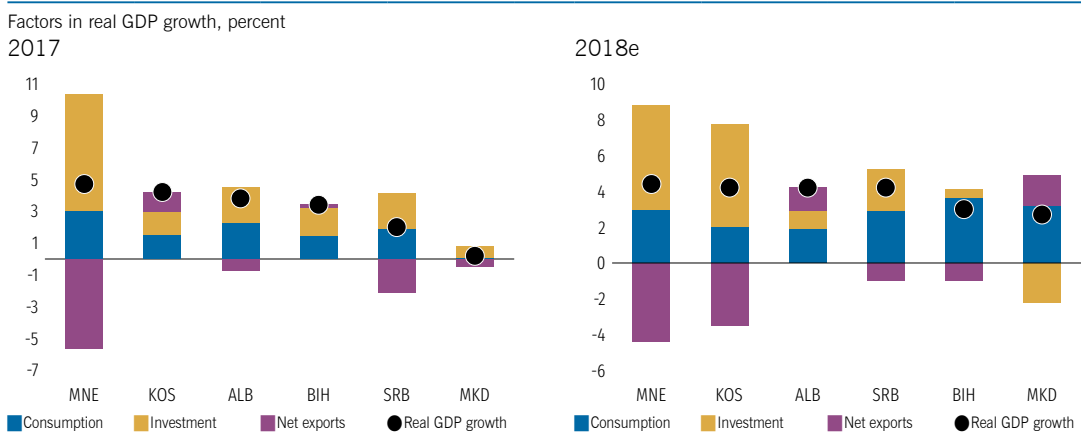
growth in 2018. In Albania, higher public investment compensated for the deceleration of FDI-driven investment in energy, with total investment contributing 1 pp to GDP growth.² In Kosovo, total investment contributed 5.7 pp to GDP growth, driven by higher public spending on infrastructure financed by privatization proceedings and private investment, including FDI in real estate. Total investment was stable in Serbia, contributing 2.3 pp to growth, based on both higher private and public investment. By contrast, the contribution of investment to growth was limited in Bosnia and Herzegovina (0.5 pp) due to project delays, and negative in North Macedonia (-2.2 pp) due to a combination of project delays and lower public investment.

Except for Albania and North Macedonia, the contribution of net exports in the region was negative. Net exports contributed 1.3 pp to GDP growth in Albania, thanks to a weather-related spike in exports of hydroelectric power, a strong tourism season, and a slowdown in imports as import-intensive FDI projects were phased out. In North Macedonia, net

exports added 1.7 pp, largely the product of FDI-related exports. Net exports cut 1 pp from GDP growth in Bosnia and Herzegovina and subtracted 3.5 pp from GDP growth in Kosovo, because a halt in nickel production outweighed the effect of an increase in tourism-related exports.

Tourism, retail, and transport services as well as energy production were the main drivers of growth in the region, reflecting higher public spending and external factors. A record tourism season in Montenegro boosted service exports and investment; tourism also supported growth in Albania, Kosovo, and Serbia. Retail trade, the rebound of construction, and transport—in part driven by public spending—further contributed to growth, especially in Montenegro and North Macedonia. In addition, exceptional events such as favorable weather conditions in Albania and the near completion of the of underwater electricity transmission cable between Montenegro and Italy boosted energy production in these two Western Balkan countries.

Figure 2.2. Higher public spending supported consumption and investment growth in 2018.



Source: National statistical office data; World Bank estimates.

2 Specifically, investments in the Trans Adriatic Pipeline and the Devoll Hydropower PowerPlant are phasing out.

Overall, growth in the Western Balkans was higher in 2018 but it was also fragile as it benefited from fiscal stimuli and favorable external conditions. On the one hand, the weather helped boost energy production in Albania and agriculture production in Serbia. But weather conditions can change rapidly, and the experience of previous years shows that growth in the Western Balkans is highly vulnerable to weather shocks as evidenced, for example, by the devastating effects that floods, droughts, and harsh winters have had on production. On the other hand, fiscal stimulus supported growth in some countries, through higher public investment, public wages, and untargeted social benefits. Public investment can support long-term growth, but it needs to be accompanied by greater efficiency and efficacy of public spending. Meanwhile, the effects of public wages and untargeted social benefits on growth are temporary and costly, and they can hinder fiscal sustainability. Furthermore, robust growth in tourism is a welcome sign, but is partly driven by economic developments in other regions such as the EU.

Western Balkan countries need to raise their long-term growth potential to sustain faster growth. The pattern of growth in the region raises concerns about its sustainability, and thus the need to build reform momentum to raise growth potential. The one-off factors noted above pushed growth in 2018 beyond its potential, especially in Albania, Kosovo, Montenegro, and Serbia. As further discussed in Section 8, growth is projected to revert to its long-term potential in the coming years as temporary fiscal stimuli phase out and external conditions become less favorable. Higher potential growth will require macroeconomic sustainability, and advancing reforms to strengthen governance, the business environment, skills, and resilience to climate change and natural hazards. For example, Box 2.1 and Spotlight #1 on “Competitive Markets” highlight the need to reinforce policies and public institutions that promote market competition to boost productivity in the region.

Box 2.1. High-Growth Firms in the Western Balkans: Startups Wanted!

Challenges to firm productivity and job creation in the Western Balkans are rooted in a policy environment that favors a few dominant market players over startups.

In the Western Balkans high-growth firms create most jobs. The OECD and Eurostat define high-growth firms as those that (1) grew by at least 20 percent annually for three consecutive years (measured by firm turnover, deflated using the producer price index), (2) have at least 10 workers, and (3) are at least 4 years old. In 2015–16 these firms created 56 percent of net new jobs in North Macedonia, 61 percent in Serbia, and 42 percent in Albania (Figure S1.1). In faster-growing or more developed countries, high-growth firms are even stronger job creators (World Bank, 2015 and 2018). For example, in 2015/16 in Croatia they created all the new jobs.

But there are only few of them in the region. High-growth firms are relatively rare in the Western Balkans—only 1 in 50 formal sector firms in North Macedonia in 2014 and 1 in 33 in 2016 (Figure S1.2); in Serbia, the number was 1 in 25 in 2015 and 1 in 20 firms in 2017, and in Albania, 11 percent

Box 2.1 continued

in 2013 and 17 percent in 2016.³ Other Eastern European countries are doing substantially better: In Latvia in 2015, almost 50 percent of firms were high-growth firms, in Estonia about 33 percent, and in Lithuania, the Czech Republic, and Hungary, about 25 percent. Moreover, in 2018 in emerging markets about 20 percent of firms were high-growth (World Bank 2018).

Figure B2.1. High-growth firms create over 50 percent in Albania, Serbia, and North Macedonia...

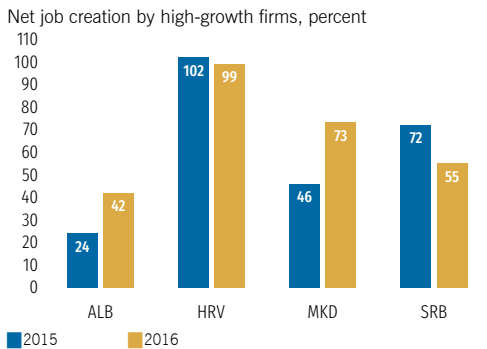
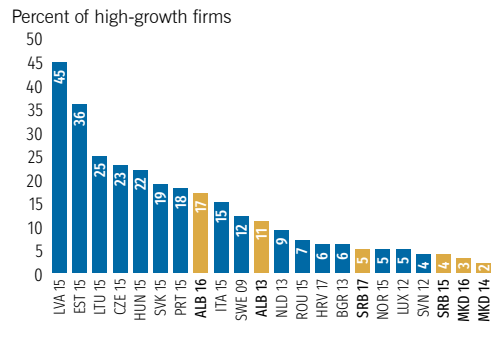


Figure B2.2. ...but there are not many high-growth firms.



Source: Registry and SBS data in the region, including firms with more than 10 employees; for other countries, OECD Business Demographics; World Bank calculations.

Note: High-growth firms are at least 4 years old, with 10 or more workers, with growth of at least 20 percent a year for three consecutive years.

In all three countries in the region, high-growth firms engage in a variety of activities and are not more common in high-tech industries. This is consistent with World Bank findings (2015, 2018). In Albania, they are a bit more common in manufacturing, construction, wholesale and retail, transport, and food and accommodation and less common in ICT and media. In Serbia and North Macedonia, they are more likely to emerge in manufacturing, construction, transport, and ICT.

But unlike in most other regions, high-growth firms in the Western Balkans are not necessarily younger or more productive. They tend to be 10–12 years old, about the average for all firms in Albania, North Macedonia, and Serbia. In most other emerging economies, high-growth firms are younger (World Bank 2015, 2018). Moreover, also unlike comparators (World Bank 2015, 2018), high-growth firms in the region are not necessarily more productive, as measured by turnover or value added per worker.

Startups wanted! It thus appears that in the region the dynamics that produce high-growth firms and thus jobs are distorted. More firms entering—and leaving—would enlarge the pool of younger firms, which have been found more likely to become high-growth firms. Since these firms create most jobs, removing barriers to market entry can boost private sector job growth. Similarly, removing constraints that discourage firms from innovating or prevent a more effective allocation of capital and labor across firms, would unleash productivity growth and thus the number of high-growth firms and new jobs. In contrast, the firm dynamics in the Western Balkans point to the existence of barriers to firm entry and productivity growth that hold back job creation and appear to be rooted in a policy environment that insulates a few dominant market players from competition.

³ In Albania, the recent anti-informality campaign which encouraged formalizing employment likely contributed to the higher share of high-growth firms.

Box 2.1 continued

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3. Fewer jobs were created in 2018 despite strong growth

Although employment grew, job creation slowed in most of the Western Balkans.⁴

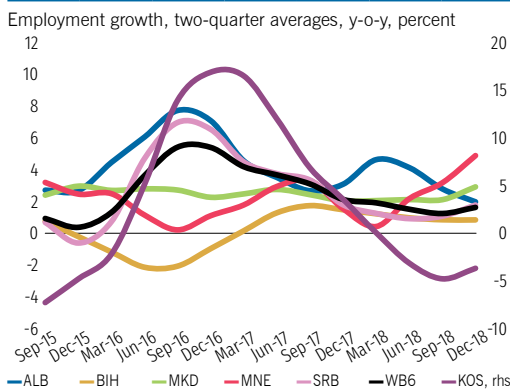
While employment rose in all countries except Kosovo, the annual rate of job growth was only 1.6 percent in 2018. By September employment growth in the region was only 1.5 percent y-o-y—the lowest rate since December 2015—but it started to pick up in the last quarter of 2018 (Figure 3.1). About 96,000 jobs had been created, a little more than half of the 2017 achievement. Employment growth in 2018 slowed in all countries except Montenegro (3.6 percent) and North Macedonia (2.5 percent); job growth was led by construction, tourism, services, and the public sector in Montenegro, and by services and manufacturing in North Macedonia. The employment rate in Montenegro reached a historical high of 47.5 percent in 2018. Albania has the highest employment rate in the region at 52.1 percent and saw the largest increase in the

rate of 1.8 percentage points in 2018, despite the deceleration in job creation in comparison to the previous year. Overall, if Western Balkan countries are to achieve the average employment rate of middle-income countries worldwide (about 62 percent), the region would need to create 2.8 million additional jobs. And to achieve the average employment rate of the EU28, the region would need to create 3.7 million additional jobs. In comparison, the Western Balkans region created only 755,000 additional jobs over the past 4 years.

The labor market remained difficult in Kosovo and to a lesser extent in Bosnia and Herzegovina.

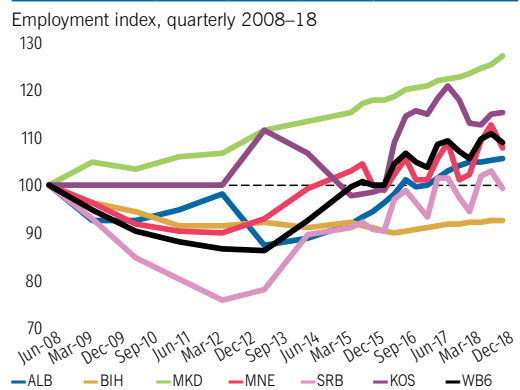
In Kosovo, employment contracted, by a deep 3.4 percent in 2018, mostly because employment in the manufacturing and construction slackened. The employment rate had fallen from 29.8 in 2017 to 28.8 percent; with male employment low at 45 percent and

Figure 3.1. Employment responded feebly to growth...



Source: National statistics offices and World Bank estimates.

Figure 3.2. ...and in Bosnia and Herzegovina it is still below the pre-crisis level.



⁴ Labor Force Survey (LFS) data for the 15+ age group are used throughout the document, unless specifically referred to administrative data. For Kosovo, data refer to the age group 15–64.

female employment dismal at 12 percent. Employment in Bosnia and Herzegovina grew by 0.9 percent in 2018, with the rate for the year rising slightly to 34.3 percent, second lowest in the Western Balkans (Figure 3.2).

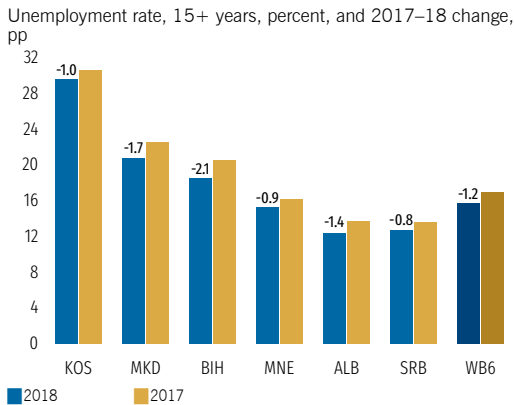
In 2018 employment rates in both Serbia and North Macedonia reached historical peaks, but in Serbia employment growth was less intense. At 47.6 percent, the employment rate in Serbia hit a new high, having grown by 0.9 percentage points. Serbia's 38,300 new jobs in 2018 account for 40 percent of all new jobs created in the Western Balkans. Employment growth in Serbia—of 1.4 percent in 2018—was particularly pronounced in the formal private sector; informal employment, mostly in agriculture, contributed 20.4 percent of new jobs, while employment in the public sector narrowed by 1.1 percent. In North Macedonia, employment increased by 2.5 percent, pushing up the employment rate by 1 pp to 45.1 percent.

Most jobs created were in industry and services, while employment in agriculture continued to decline. In Albania, employment in industry went up by 3.9 percent in 2018 and in services by 2.5 percent; public sector employment also rose, by 4.3 percent. In Bosnia and Herzegovina, manufacturing and wholesale trade accounted for more than 70 percent of the employment increase according to the administrative data. Of the 18,000 new jobs created in Bosnia and Herzegovina, about 72 percent were in manufacturing and trade, 11 percent in tourism, and 10 percent in the public sector, especially education and health. In North Macedonia, most new jobs were in manufacturing, transport and storage, and professional services (mainly call centers). The gains in manufacturing and professional services were in FDI companies, which still benefit

from tax exemptions and public subsidies on employment. In Montenegro, construction and tourism were significant contributors to employment growth. In Kosovo, employment in industry fell, but it rose in trade, information and communication technology (ICT), and the public sector.

Unemployment rates declined in all Western Balkan countries in 2018 (Figure 3.3). In 2018, 1.15 million people in the region were unemployed—95,800 or 7.7 percent less than a year ago. Unemployment declined most in Bosnia and Herzegovina (13 percent) to a historical low of 18.4 percent. But the decline in Bosnia and Herzegovina and Kosovo was primarily driven by higher inactivity and likely emigration, reducing labor force participation. In contrast, inactivity declined substantially in Albania and Serbia. Albania (12.3 percent), Serbia (12.7 percent), Montenegro (15.2 percent), and North Macedonia (20.7 percent) reached historically low unemployment rates in 2018. The lowest unemployment rate in the region is in Albania while it is the highest in Kosovo at 29.5 percent.

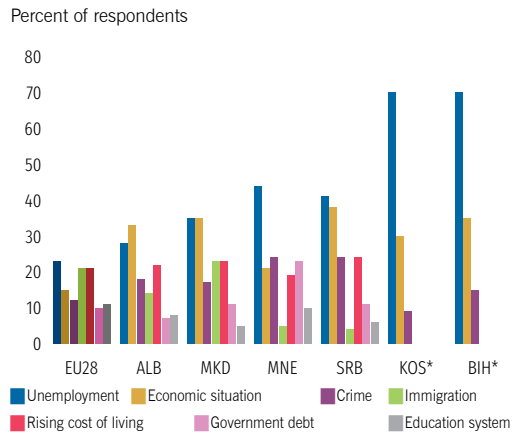
Throughout the Western Balkans unemployment continues to be a major concern of citizens (Figure 3.4). About 70 percent of respondents in Kosovo and Bosnia and Herzegovina cited unemployment as their top concern—more than triple the EU share. In the other Western Balkan countries, more than 33 percent of respondents still cite unemployment as the major concern, although edged out in Albania by the prevailing economic situation; however, these are smaller percentages than in the 2017 survey. A lack of adequate jobs is considered the biggest obstacle for securing employment in Albania (66 percent) and Kosovo (48 percent); in neighboring

Figure 3.3. Unemployment declined in all Western Balkans countries...

Source: National statistics offices and World Bank estimates.

economies the biggest obstacle is thought to be not knowing the right people.⁵ In Serbia, about 25 percent of respondents believe that inability to get a job is related to age discrimination. Yet, 42 percent of the Western Balkans population would still prefer working for a public employer. Public jobs are considered more secure and better paid, with better working conditions. The highest preference for public jobs is in Kosovo (62 percent) and the lowest in Serbia (37 percent). About 39 percent of respondents have considered moving abroad for work—far fewer than a year ago.

Youth unemployment dropped to 37 percent—about 2 pp below the 2017 rate. In the Western Balkans, about 280,600 people between 15–24 years old—a contingent at a highly productive age—are without jobs. The lowest youth unemployment rates were in Albania (23.1 percent) and in Serbia and Montenegro (about 30 percent in both). Robust economic growth and a variety of occupational and training programs have helped reduce youth

Figure 3.4. ...but is still the most serious concern of Western Balkan citizens.

Source: Eurobarometer, Autumn 2018. *For Bosnia and Herzegovina and Kosovo: Balkan Barometer 2018, a public opinion survey by the Regional Cooperation Council, www.rcc.int.

unemployment in Montenegro from 32 percent a year before. Bosnia and Herzegovina has seen the largest drop in youth unemployment—by close to 7 pp to 38.8 percent—but this is likely to be due to rising inactivity or emigration. Youth unemployment is still very high in Kosovo at 55.3 percent and in North Macedonia at 45.4 percent. In fact, in Kosovo youth unemployment has even gone up as more young people entered the labor market and the pace of job creation slowed. Despite improvements, the labor market situation of young people in the Western Balkan countries still features high inactivity, persistently high unemployment, high share of informal employment, significant skills mismatches and continued emigration (Box 3.1). Since 2012, when about 50 percent of young people were unemployed, the rate fell to 37 percent in 2018, but that is still more than double the EU average. More than half of the young people are long-term unemployed (without a job for more than a year), which erodes skills, reduces motivation to seek employment, and raises the possibility of leaving the local labor market

⁵ Balkan Barometer 2018, www.rcc.int.

altogether (see the Focus Section on Human Capital in the Western Balkans).

Through 2018 the regional average labor force participation rate improved slightly, but participation declined in Bosnia and Herzegovina and Kosovo. In 2018, labor force participation in the region averaged 51.6 percent—up 0.1 pp from the year before, with the largest gains in Montenegro by 1.3 pp and Albania by 1.1 pp. Labor force participation

reached 59.4 percent in Albania—a record for the region. Employment dynamics encouraged job searching despite a decrease of the working-age population over the past four years. While in Serbia the labor force participation rate increased slightly (up by 0.5 pp), in Bosnia and Herzegovina and Kosovo because the working-age population was declining, so did labor force participation. The lowest ratio of working-age population participating in the labor force is 40.9 in Kosovo and 42.1 percent in Bosnia

Box 3.1. Youth Employment in the Western Balkans.

In the Western Balkans participation of young people in the labor force is low by European standards and stagnant. In June 2018, youth participation averaged 30.5 percent in general and only 22.5 percent for young women. In Kosovo only 12.5 percent of young women were active, probably because of family responsibilities, lack of child and elder care facilities, and too little education. For young people, the transition from school to work often takes two years (World Bank 2016).

Table B3.1.1. Labor Market Characteristics, Western Balkans Youth, June 2018, Percent.

	WB6	ALB	BIH	KOS	MNE	MKD	SRB	AUT	BGR	HRV	HUN
Employment rate (% of the age group)	20.0	25.6	19.7	9.7	27.4	17.0	21.5	50.1	20.6	25.2	28.7
Unemployment rate (% of labor force)	34.6	27.3	38.8	54.9	23.9	47.6	27.5	9.1	15.2	21.1	9.5
Long-term unemployment share (% of total unemployment)	54.6	52.7	68.7	47.2	43.4	62.1	47.4	15.7	48.1	28.8	26.4
Temporary employment share (% of total employment)	49.9	26.0	42.1	83.0	77.0	41.6	55.4	31.9	8.8	58.3	15.2
Part-time employment share (% of total employment)	12.8	19.1	8.3	4.3	12.4	5.0	14.2	24.0	6.8	9.6	7.5
NEET rate (% of the age group)	22.3	25.9	24.3	25.9	16.7	24.9	17.2	6.5	15.3	15.4	11.0

Source: World Bank's Western Balkans Labor Market Trends 2019, based on data provided by national statistics offices and Eurostat.

Moreover, youth employment is mostly based on temporary contracts. In June 2018, the employment rate for people aged 15–24 years (Table B3.1.1) was 20 percent, compared with 35 percent in the EU. Only 13 percent of young women and 23 percent of young men had jobs. In Kosovo, just 5 percent of young women were employed. Regionally, about 50 percent of the young people working were on temporary contracts, with a range of 80 percent in Kosovo and Montenegro, but only about 25 percent in Albania. Although the rates are declining, almost 20 percent of young workers had informal jobs in Albania, and almost 33.3 percent in North Macedonia and Serbia (Djurić 2016; Marjanović 2016).

Box 3.1 continued

Above-average unemployment rates for the highly educated suggest skills mismatches. According to regional Survey Towards Employability and Productivity (STEP) surveys for firms trying to recruit, lack of skills and experience are the major problem. Skill gaps cover both technical job-specific skills and broad socio-emotional and basic cognitive skills. The skills gap is higher for labor market entrants than for the current workforce; apparently the education system is not adequately preparing youth for the jobs available. Unemployment was higher for young men in Albania, Montenegro, and North Macedonia, and for young women in Bosnia and Herzegovina, Kosovo, and Serbia. The options of emigration and family support may have raised reservation wages and thus youth unemployment durations and inactivity rates.

Youth inactivity is high. The rates of young people neither in employment nor in education and training (NEET) were substantially higher in Western Balkan countries than elsewhere in Europe. Despite a decline, in June 2018 the NEET rate in the region still averaged 22.3 percent, placing many young people at risk of poverty and social exclusion. Young people detached from jobs or education for long periods may find it difficult to penetrate the labor market. Due to degraded skills, they also earn about 20 percent less when they do find work, and the earnings deficit can persist for a long period.

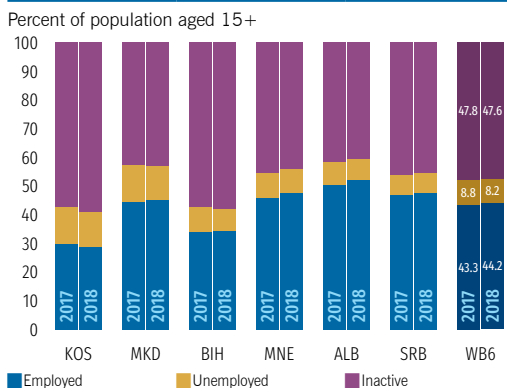
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 Djurić. 2016. Labour market transitions of young women and men in Montenegro,” Work4Youth Publication Series No. 34. Geneva: International Labour Organization.
 Marjanović. 2016. “Labour market transitions of young women and men in the Republic of Serbia,” Work4Youth Publication Series No. 36. Geneva: International Labour Organization.

and Herzegovina. Both countries have seen a rise in their inactive population (Figure 3.5 and Figure 3.6).

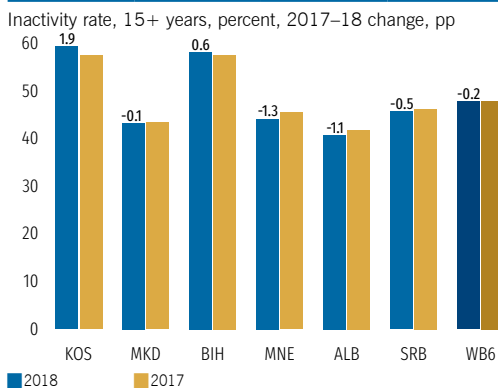
Participation rates improved because more women entered the labor market (Figure 3.7). The largest increase was in Albania and Serbia. Although Albanian women’s participation in the

Figure 3.5. More people seem to be seeking and finding jobs, but the progress is slow.



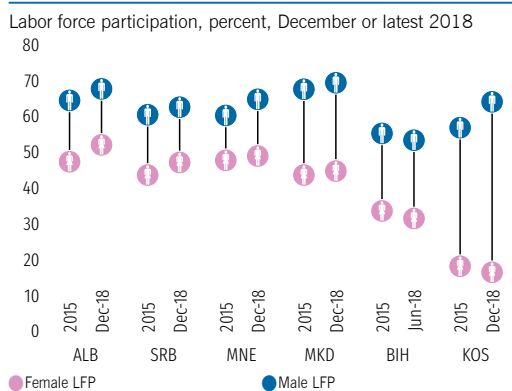
Source: National statistics offices and World Bank estimates.

Figure 3.6. In some countries inactivity is not only high but increased.



labor force grew less than men's during 2018's economic expansion, the female participation rate of 51 percent in Albania is the highest in the region. The rates in Serbia and Montenegro are also above the regional median of 45.8 percent, and in Serbia, the gender gap of 15.4 pp is the narrowest. The female to male participation gap declined by 2 pp from last year's to 23 percentage points, although it is still at 43 pp in Kosovo. One factor explaining the low participation rates is the relatively high labor tax wedges in the Western Balkans, which discourage low wage earners from actively seeking jobs (see Spotlight #2 on Labor Taxation).

Figure 3.7. The female–male labor participation gap narrowed to 23 percentage points.



Source: National statistics offices and World Bank estimates.

Employment, wage growth, and low inflation further reduced poverty in the Western Balkans. In 2018, the average poverty rate for Albania, Montenegro, North Macedonia, and Serbia dropped by about 1 pp y-o-y, producing a regional poverty rate estimated at 21.6 percent.⁶ In other words, about 114,000 people escaped poverty in the past year. In Albania, rising wages in the private sector indicate strong growth

of about 13 percent y-o-y in real terms. The average wage in Serbia went up by 4.2 percent in real terms. Led by wage growth in mining, ICT, tourism, manufacturing, and the public sector, real wage growth in North Macedonia was 4.4 percent in 2018, compared to 1.2 percent in 2017. The mandatory minimum wage increase continued to put pressure on labor-intensive industries, which sought temporary government support to deal with higher labor cost pressures. The low-earning labor-intensive sectors saw a nominal increase in wages of over 10 percent y-o-y, compared to negative labor productivity over the past several years. Further wage increases might erode the competitiveness of low-value-added industries. In Bosnia and Herzegovina, real wages rose by 3 percent y-o-y in November 2018, with the highest increase in construction. In Montenegro, real wages declined during 2018 as fiscal consolidation affected salaries in public administration and manufacturing salaries fell. A rise in the minimum wage is being discussed in Montenegro. If the minimum wage is to remain an instrument of labor market policy, to avoid a surge in informal employment, and to maintain cost competitiveness, minimum wage policy should be informed by assessments of labor productivity in the sectors where it mostly applies.

⁶ Poverty figures reflect the upper-middle-income-country standardized benchmark of living on less than US\$5 a day in 2011 PPP terms.

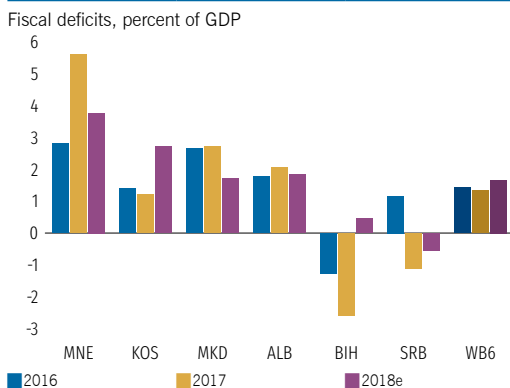
4. Safeguarding the fiscal adjustment made in recent years is critical

While fiscal deficits remain relatively low in all Western Balkan countries other than Montenegro, the deficit increased in 2018 in some countries due to higher capital spending. The average unweighted fiscal deficit in the region went up from 1.3 percent of GDP in 2017 to 1.7 percent in 2018 as deficits widened in Bosnia and Herzegovina and Kosovo (Figure 4.1). In Bosnia and Herzegovina, the fiscal position is estimated to have returned to deficit, owing largely to an expansion in veterans' benefits in the Federation, wage increases in Republika Srpska, and higher investment in infrastructure. In Kosovo, the widening deficit is attributed to more current spending on social transfers and goods and services and higher capital spending on infrastructure. In contrast, Montenegro, North Macedonia, and Albania narrowed their deficits. Montenegro achieved a consolidation of 1.8 pp after a series of fiscal consolidation reforms, among them the abolition of mothers' benefits, a reduction in

public sector wages, and securing more revenue from raising excise duties and value-added tax (VAT) rates. In contrast, the deficit reduction of 0.9 pp in North Macedonia was mainly due to under-execution of capital spending, while current spending grew by 6 percent. In Albania, continued robust spending on capital infrastructure was offset by restraint in spending on wages and social benefits, which reduced the deficit slightly. Still benefiting from the fiscal adjustment of recent years, public finances in Serbia remained in surplus, though slightly lower than last year's because public sector salaries and pensions went up and infrastructure capital spending, which has been weak in recent years, was more vigorous.

With revenues generally holding steady, the regional average revenue-to-GDP ratio was 35.3 percent in 2018. Policy reforms and efforts to improve revenue collection in 2018 raised the ratios in Montenegro (by 1.1 pp of

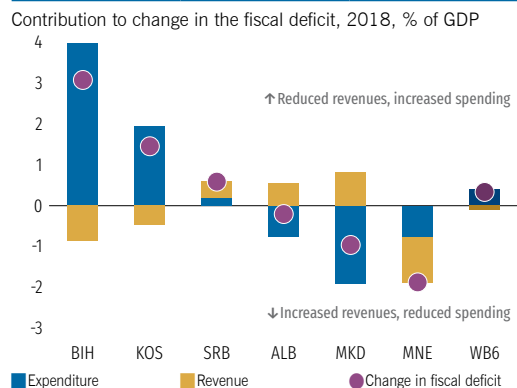
Figure 4.1. Fiscal consolidation reduced the deficit in Montenegro while Bosnia's budget returns to deficit.



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

Notes: Data for North Macedonia presented in this section excludes finances of the Roads Agency which were taken off-budget in 2013. Unless otherwise specified, the regional average is calculated as the non-weighted average.

Figure 4.2. Spending restraint contributed to fiscal outcomes in Albania, North Macedonia and Montenegro.



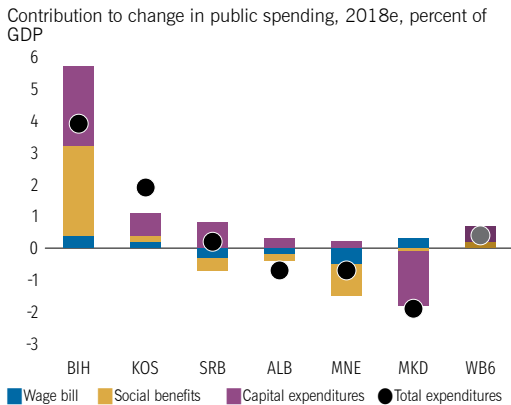
GDP) and Bosnia and Herzegovina (0.9 pp). As value added tax (VAT) receipts surged, aggregate revenue in Montenegro was boosted by the tax reforms adopted in 2017. In Bosnia and Herzegovina, higher excise taxes on oil and oil derivatives, introduction of a road tax, and a tax on liquid gas brought in more revenue. Livelier economic activity contributed to the revenue gains in Kosovo (0.5 pp). Nominal revenues increased in Albania, Serbia, and North Macedonia, but at a slower pace than economic growth, causing a decline in the revenue-to-GDP ratio (see Figure 4.2). In Albania, the estimated revenue fall of 0.5 percent of GDP in 2018 results from VAT revenues that were lower than expected, partly because they were offset by VAT refund arrears being cleared. For similar reasons, net VAT receipts as a share of GDP fell. In North Macedonia, even though the revenue-to-GDP ratio fell, the collection of corporate income tax (CIT) and social security contributions exceeded expectations, supported by employment and wage growth. In Serbia, a solid rise in social security contributions and personal income tax (PIT)—reflecting the growth in formal employment—was countered by minimal growth in corporate and indirect tax receipts.

Capital investment and higher public wages and social benefits have pushed up total spending in the region (Figure 4.3). The largest increases in capital spending were in Bosnia and Herzegovina (2.5 pp), Serbia (0.8 pp), and Kosovo (0.7 pp). In Bosnia and Herzegovina resumption of the capital investment plan is estimated to have produced robust growth in capital spending in 2018⁷; which combined with higher public sector wages and social transfers boosted overall

spending from 40.4 percent of GDP in 2017 to 44.3 percent in 2018. In Serbia, improved economic and financing conditions have attracted higher capital investment from both foreign and domestic sources. This has been supported by better capital budget execution, mainly because backlogs have been reduced and oversight is now more effective. In Kosovo, spending on capital investment has gone up but also untargeted social protection expenditures (pensions and benefits to war veterans) have been rising fast. Elsewhere in the region, total spending as a percentage of GDP contracted, though the reasons varied. Public spending in Montenegro grew by 5.5 percent in nominal terms but the spending-to-GDP ratio declined by 0.8 pp thanks to higher GDP growth and a reduction in social benefits and nominal public sector wages. In North Macedonia, political uncertainty before the referendum and the decision to scrutinize the existing portfolio of construction projects contributed to exceptionally low capital spending in 2018. In Albania, the authorities have prioritized capital spending—which strengthened to 4.7 percent of GDP—and accelerated the use of public-private partnerships (PPPs) to address public infrastructure gaps.

PPPs can raise the efficiency of public spending and reduce the strain of large infrastructure projects on scarce public finances, but they carry fiscal risks that must be managed. PPPs often require government guarantees to attract private partners and opaque arrangements can create scope for corruption by guaranteeing revenues of private partners that exceed their risks. They can thus reduce the strain on budgets in the short-term but expand medium-term contingent liabilities. The extent to which PPPs provide better value for money over the medium term

7 Bosnia and Herzegovina Global Fiscal Framework 2019–2021.

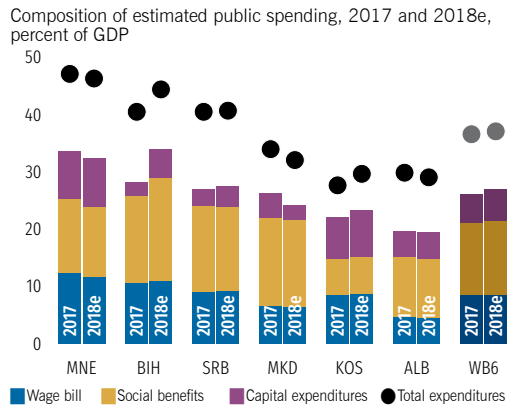
Figure 4.3. Higher spending went mainly to capital investment and social benefits.

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

depends on risk-sharing agreements and other details set out in PPP contracts. Transparent reporting on the performance of active PPPs and comprehensive monitoring and disclosure frameworks can help manage the risks and ensure value for money.⁸

There is ample room to improve fiscal balances by curtailing unproductive or untargeted social benefits and transfers (Figure 4.4). In Bosnia and Herzegovina and Kosovo the increased spending in 2018 went mainly to a rise in pensions and public wages (and spending on benefits to war veterans continued to be high); public investment also increased. In North Macedonia, while overall spending went down due to lower public investment, spending on social benefits continued to increase in 2018. Higher capital spending on the Bar-Boljare motorway in Montenegro raised public debt levels in recent years which forced governments

8 Comprehensive monitoring and disclosure frameworks for active PPPs can help manage the risks, ensure value for money, and support a range of objectives, including (1) better management of fiscal risks; (2) timely intervention in underperforming projects; (3) learning from PPP successes and failures; (4) increasing government accountability and value for money; and (5) building up market confidence. For more information see World Bank (2018), "Procuring Infrastructure Public Private Partnerships Report", Washington, D.C.: The World Bank.

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

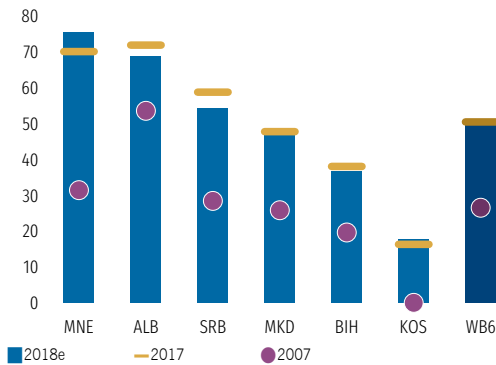
to curb untargeted social benefits and public sector wages, improving the quality of public spending. Overall, in 2018 budgets in the Western Balkans continued to be burdened by spending on wages, pensions, and untargeted social benefits, highlighting that there is ample room to boost the efficiency of public spending and thus the quality public services.

Countries with mature fiscal consolidation continued to see their debt fall, but in others public and publicly-guaranteed (PPG) debt has edged up; public debt is particularly high in Albania and Montenegro (Figure 4.5). In 2018 economic growth, fiscal consolidation, and active debt management brought down the share of PPG debt in Albania, Bosnia and Herzegovina, and Serbia. Between 2017 and 2018, tighter fiscal policy helped to further reduce public debt as a share of GDP in Serbia from 58.7 to 54.3 percent and in Albania from 71.8 to 68.6 percent.⁹ Montenegro's overall PPG debt, which remains high due to the financing of highway construction, is projected to have reached 75.4 percent of GDP in 2018. In North Macedonia, PPG debt rose from

9 This includes general government arrears.

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

Public and publicly guaranteed debt, percent of GDP



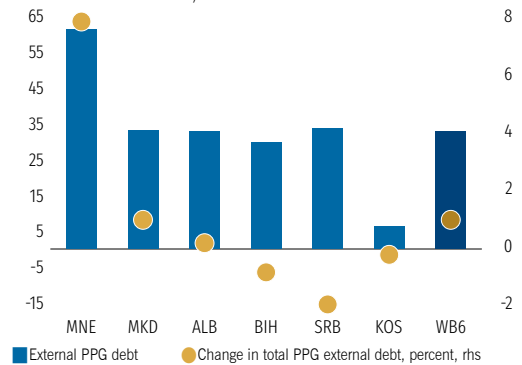
Source: National statistical offices and Ministries of Finance; World Bank estimates.

47.7 to 48.4 percent of GDP due to a new Eurobond issue. Kosovo's PPG debt—though still the lowest in the region—rose during the year, reaching 17.7 percent of GDP due to higher social benefits and better execution of public investment projects. External PPG debt pressures rose in countries that tapped international financial markets (Figure 4.6). In Bosnia and Herzegovina and Serbia, external PPG debt fell in 2018. By contrast, external PPG rose in Montenegro, North Macedonia, and to a lesser extent in Albania. The growth of Montenegro's external PPG debt was driven mainly by financing of the Bar-Boljare highway, and the issuance of a large Eurobond.

Reducing risks to fiscal sustainability requires reining in pension spending, better controlling state-owned enterprise (SOE) debt, increasing discipline in local government financial management, and improving the efficiency of public spending and tax collection. Pension and health spending needs to be contained given that these are a large source of fiscal risk in several countries in the Western Balkans, as spending is bound to keep rising as the population ages.

Figure 4.6. External PPG debt rose in Montenegro, North Macedonia and Albania as they tap international credit markets.

External PPG debt as a percent of GDP, and percent change in total external PPG debt, 2018



Against this background, North Macedonia recently reformed the social protection system to safeguard pension and health services by amending the pension indexation, limiting early retirement options, and increasing social contributions. And Montenegro centralized the procurement of pharmaceutical to reduce costs while more needs to be done to contain pharmaceutical spending. Fiscal risks also arise from inefficient SOEs, which cost the public purse hundreds of millions of euros each year (for example, in terms of subsidies and guarantees for loans for SOEs), when they could in a different scenario produce revenue.¹⁰ The forthcoming World Bank's Municipal Finance Review for the Western Balkans highlights that local governments need more fiscal discipline and greater accountability, especially as related to budget arrears and municipal borrowing, as well as stronger capacity to deliver public services efficiently and effectively. Meanwhile, more efficient public spending in areas like education, health, infrastructure, and

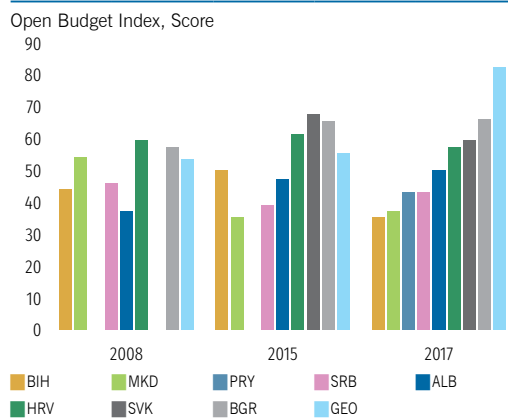
10 Note that in some countries there is a strong presence of SOEs. For example, in Serbia, about 1 in 4 of the largest 100 companies is state-owned, including the largest companies in banking, insurance, and transportation, as well as all utility companies.

agricultural subsidies could yield significant savings and growth dividends—in North Macedonia, for example, the World Bank’s forthcoming Public Finance Review notes that the country could save 13 percent of total public spending by improving its efficiency. Lastly, more tax revenue can be collected, for example, by modernizing tax administration, encouraging formalization, and reviewing tax exemptions and tax rates—perhaps ‘sin taxes’ on items that have adverse health or environmental impact. Furthermore, there is scope for improving the progressivity of the personal income taxation, balancing efficiency and equity in revenue collection (see Box 4.1).

Beyond sustainability, it is necessary to strengthen fiscal transparency and build strong fiscal institutions. Bosnia and Herzegovina, North Macedonia, and Serbia seem to be depriving taxpayers of information about how their money is spent.¹¹ The Open Budget Index (OBI), which measures transparency, shows limited improvement in

transparency since 2010 (Figure 4.7). One area to highlight is the need to capture and report fiscal risks arising from off-budget spending, SOEs, government arrears, and contingent liabilities from public-private partnerships so that they can be effectively addressed. In this context, well-designed and implemented fiscal responsibility frameworks can promote policy credibility, enhance investor confidence, and contribute to sustained growth.

Figure 4.7. Full fiscal transparency is needed.



Box 4.1. Balancing Efficiency and Equity in Revenue Collection with the Personal Income Tax.

There is room for fiscal policy in the Western Balkans to become more progressive while allowing for higher revenue collection. Western Balkan countries need to collect higher revenues to ensure better service delivery and infrastructure investment in the coming years to accelerate their convergence towards EU living standards. At the same time, the nature of fiscal policy should become more progressive to avert rising inequality. In the absence of higher transfers to households at the lower end of the income distribution, governments should consider more progressive personal income taxation schemes with higher top rates for higher incomes, and to shift the composition of their revenues towards a larger share coming from direct taxation. This would bring their revenue composition closer to that of EU countries and also act as a powerful redistributive policy.

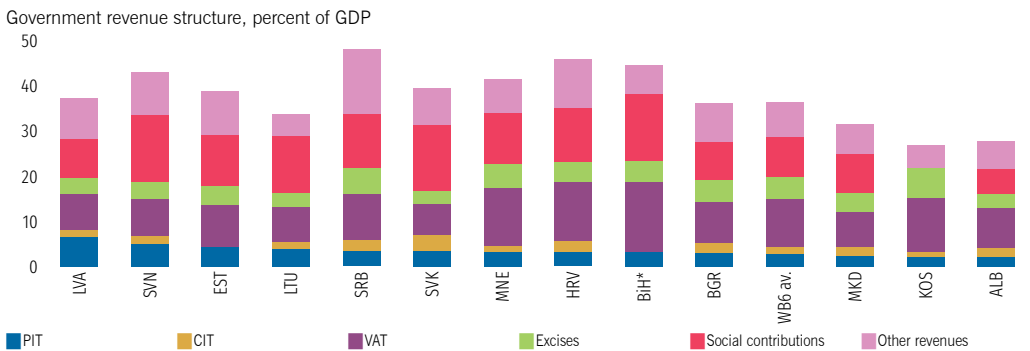
In Western Balkan countries the personal income tax (PIT) contributes little to revenues. Instead, they generate a large share of their revenues from social security contributions (SSCs) and

¹¹ The latest available OBI index uses information until 2017. Since then some countries in the Western Balkans have taken actions to increase the transparency of public finances.

Box 4.1 continued

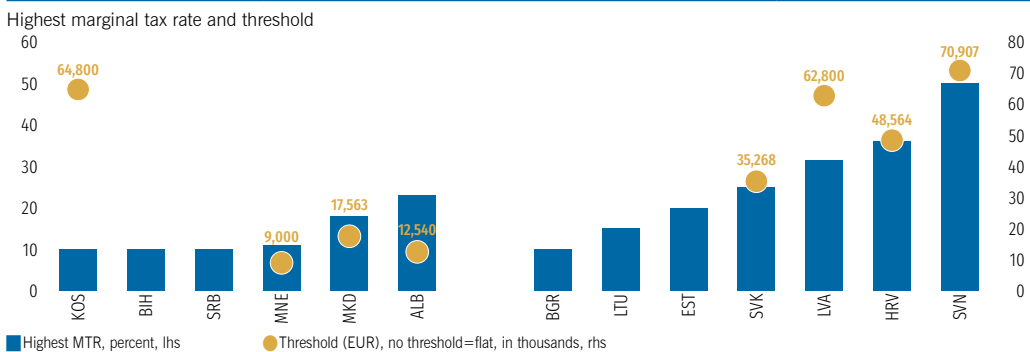
indirect taxes like the value-added tax (VAT). For instance, the average Western Balkan country collects about 37 percent of GDP in revenues, of which less than 5 percent come from direct taxes (PIT and corporate income tax), a sizable 16 percent from indirect taxes (VAT and excises), and the rest from SSCs and other sources. The revenues of Western Balkan governments are similar to those of Eastern European EU member countries in terms of both total collection and general composition (Figure B4.1.1). But the new EU member countries rely more on direct taxes, especially PIT, and less on VAT revenues. Western Balkans PIT rates are also generally lower (Figure B4.1.2). As a result, PIT collection in the Western Balkans averaged 2.7 percent of GDP in 2017, compared to 3.0–6.6 percent in comparator countries.

Figure B4.1.1. Taxes often constitute the largest public revenue category



Source: National accounts data, Eurostat, and World Bank calculations.
 Note: For Bosnia and Herzegovina, the PIT data combines both PIT and CIT for 2016.

Figure B4.1.2. Top marginal PIT rates in the Western Balkans are lower than those of EU members



Source: Deloitte (International Tax) data; World Bank calculations.

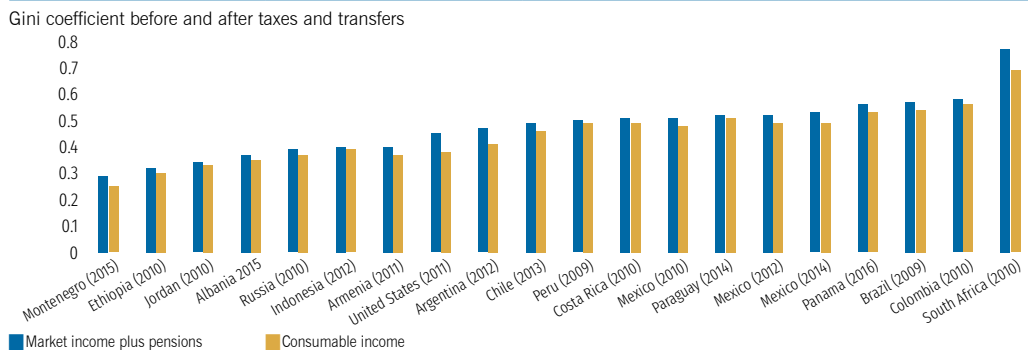
In addition, the PIT structure is often less progressive in the Western Balkans (Figure B.4.1.2). New EU member states are more likely to apply progressive tax schemes (4 of 7 countries), with more than half having top marginal rates of 25 percent or more—Slovenia’s is 50 percent. Meanwhile, two Western Balkan countries have a flat 10 percent tax rate; Montenegro has a temporary PIT structure of 9 and 11 percent that is scheduled to return to a flat rate of 9 percent by the end of 2019.^a All Western Balkan countries except Montenegro have personal tax allowances—which allows for some progressivity—and Bosnia and Herzegovina also has a family allowance. Of the Western Balkan

Box 4.1 continued

countries that apply progressive taxation, the top marginal rate are still relatively low compared to EU countries with 23 percent in Albania, 18 percent in North Macedonia, and 10 percent in Kosovo.^c Income thresholds for top tax rates vary considerably and tend to grow with the top rate. For example, Slovenia has both a high top rate and the highest income threshold, about €70,000. However, Montenegro's current top rate of 11 percent begins to apply at an annual income of €9,000 and North Macedonia's at an annual income of €18,000. Kosovo's PIT rates are compressed: income below €11,520 pays no tax, rates of 4 to 8 percent apply for incomes between €11,520 and €64,800, and higher earnings are taxed at 10 percent. This explains why the direct taxation share of total revenues is very low in Kosovo.

In the Western Balkans the low progressivity of the PIT and the somewhat heavier reliance on indirect taxes limit the redistributive impact of fiscal policy. Recent analysis suggests that in Albania and Montenegro fiscal policy—both taxation structure and government transfers—tends to have relatively limited redistributive effects (Figure B4.1.3). For example, direct taxation in Albania reduces inequality only at the margin—inequality measure by the Gini coefficient falls from 0.37 at market income (income plus pensions) to 0.35 for consumable income (subtracting all taxes and contributions and adding direct transfers). But fiscal policy as a whole, especially the VAT, has a small poverty-increasing effect that is not sufficiently offset by direct social transfers. The analysis for Montenegro in 2015, when PIT rates were more progressive with a top rate of 15 percent, found that income inequality falls by 4 Gini points after the combined effect of taxes, contributions, and social benefits are taken into account (including a relatively well-targeted last resort social assistance program). But moving back to a flat PIT of 9 percent would reduce this redistributive impact significantly.

Figure B4.1.3. Fiscal policy has a small redistributive effect in Albania and Montenegro



Source: Data from Lustig (2018) and Dávalos et al. (2017), and World Bank calculations.

a. Early in 2013, Montenegro introduced a temporary “crisis” tax, when a higher PIT rate of 15 percent was introduced on net monthly wages exceeding EUR 480 (about the average wage level), otherwise 9 percent. The temporary “crisis” tax has been gradually reduced to currently 11 percent of monthly gross wages above EUR 750 (roughly the average wage).

b. Macedonia Public Finance Review (2018).

c. In 2014, Albania adopted a progressive income tax system from a flat tax rate system of 10 percent. In December 2018, North Macedonia moved from a flat rate of 10 percent to introducing a top PIT rate of 18 percent for incomes above DEN90,000 per month, effective January 2019.

Box 4.1 continued

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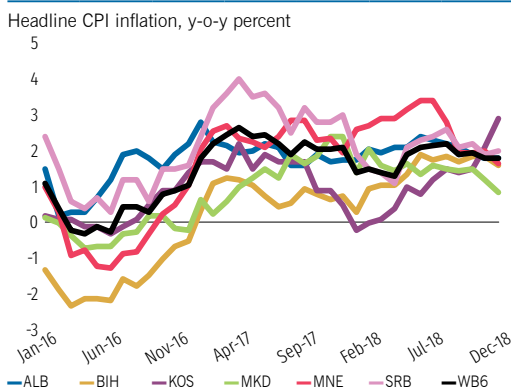
5. Inflation picked up and monetary policy stayed accommodative

Inflation rose slowly in 2018 as tax rates and prices for imported food and energy rose. After picking up in the first half of the year, inflation dynamics softened toward the end of the year. Domestic demand pressures on inflation remain low in most Western Balkan countries, with temporary hikes in food prices and rising oil prices contributing the most to inflation (Figure 5.1). Core inflation was stable, which suggests that long-term inflationary pressures are under control (Figure 5.2). Kosovo experienced the highest inflation in the region in 2018, driven by a rise in food price inflation which rose steadily since July and reached 5.5 percent in December—the 100 percent tariffs introduced on imported goods from Serbia and Bosnia and Herzegovina may have contributed to the acceleration of inflation at the end of the year. In Bosnia and Herzegovina, inflation was driven by higher prices for transport, housing, alcoholic beverages, and tobacco, the latter two

due to excise tax increases. In Albania, North Macedonia, and Serbia, inflation during the year mostly responded to food and oil price dynamics, with additional pass-through effects from appreciation of the exchange rate in Albania.

Monetary policy was eased to support credit growth. In floating-exchange-rate countries (Albania and Serbia) and in North Macedonia, which has a de facto pegged exchange rate, the central banks cut interest rates and intervened in the foreign exchange (forex) market to ease short-term currency fluctuations and related impacts on inflation (Figure 5.3 and Figure 5.4). In Serbia, the policy rate was lowered in March to 3.25 percent and in April to 3 percent, which prevailed through the year. The easing of monetary policy in Serbia is consistent with the somewhat more expansionary fiscal policy in 2018. In Albania, lower-than-expected inflation associated with exchange

Figure 5.1. Inflation, though slowly building, is still contained.



Source: Central banks and World Bank estimates.

Note: Food and energy prices are included in headline but not core price indexes. Data for Western Balkans and EU28 are calculated as weighted averages.

Figure 5.2. Food and oil prices mainly drove inflation, but core inflation remains low.

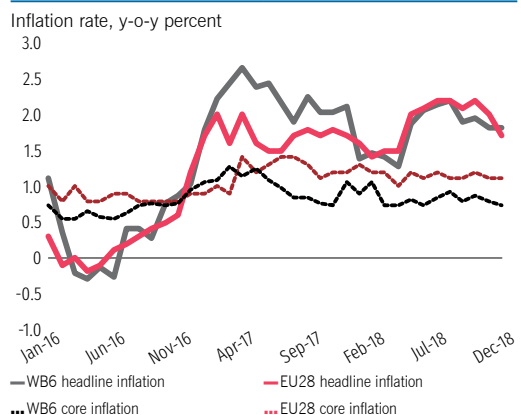
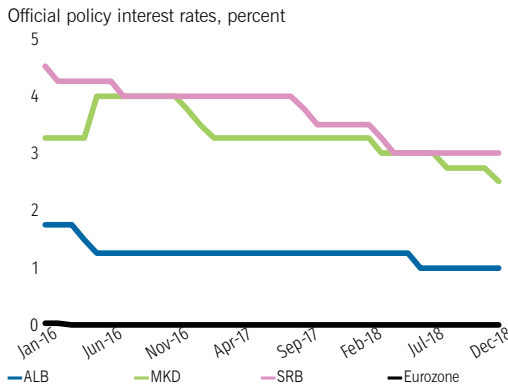


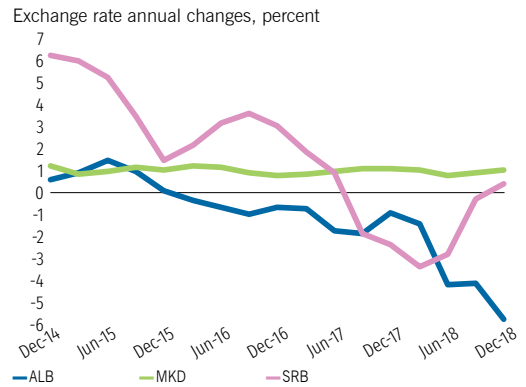
Figure 5.3. Central banks further eased monetary policy in Albania, North Macedonia, and Serbia.....



Source: Central banks and ECB estimates.

rate appreciation triggered a rate cut in June by 25 basis points, to 1 percent. In North Macedonia, where prices were stable because of the narrowing output gap and the improved external position, the central bank lowered the policy rate three times; in December it reached a historically low 2.5 percent. While except in Albania most of the policy easing was in monetary aggregates, its transmission through the credit channel was reduced by euroization and structural bottlenecks in the credit market (see Section 6). Western Balkan countries are engaging in de-euroization through, e.g., use of macroprudential tools to reduce incentives for borrowing in foreign currencies. Keeping inflation and inflation expectations low and stable, building up the resilience of the financial sector, heightening the transparency of financial services, and building a market for instruments to hedge foreign exchange—together these can ensure effective transmission of monetary policy to the real economy.

Figure 5.4. ...and intervened in forex markets.

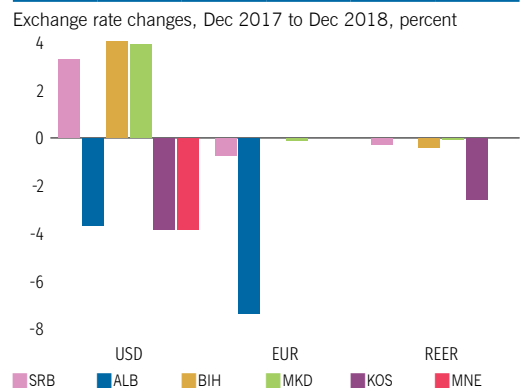


Source: Central banks estimates.

Note: Increase indicates depreciation.

Pressures for exchange rate appreciation were driven by foreign currency inflows from exports and one-off factors. Appreciation against the euro in Albania and Serbia were highest, because demand for their exports is higher (Figure 5.5). With volatility higher in emerging markets, however, currency appreciation may not last (see Section 8).

Figure 5.5. Appreciation pressures also intensified.



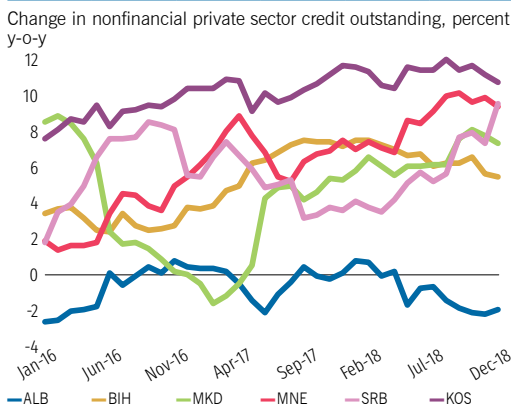
Source: Central banks, Eurostat, and World Bank estimates.

Note: Increase indicates depreciation.

6. A wider range of financing instruments is needed to boost lending to businesses

Credit outstanding¹² continued to rise in most Western Balkan countries, with household lending again growing faster than corporate. In 2018 Kosovo continued to show the fastest growth of credit to the private sector at over 11 percent, thanks to improving credit terms, reforms to reinforce contract enforcement, and less bank risk aversion (Figure 6.1). In Montenegro and Serbia, credit to the private sector accelerated, exceeding 9 percent in December 2018, as asset quality continued to improve and deposits, a major source of funding for local banks, grew substantially. At 5–7 percent, lending was also robust in Bosnia and Herzegovina and North Macedonia. In Albania, however, total credit

Figure 6.1. Credit outstanding continued to increase in most countries.



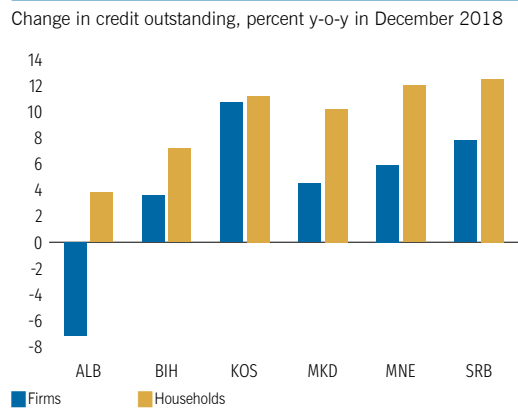
Note: Consistent data on private sector credit growth in Albania, Bosnia and Herzegovina, Republic of North Macedonia, and Serbia are from the IMF *International Financial Statistics* (IFS). Data on household and corporate credit are from national central banks. Other depository corporations surveyed are expressed in local currency (except in euros for Kosovo). Data for Montenegro are based on central bank statistics for credit to residents but not to governments and financial institutions.

¹² Credit here refers to the stock of nonfinancial private sector credit outstanding. Its growth reflects changes in both new credit (positive) and NPL write-offs (negative). In 2018, due to large write-offs in several countries (for which the data are not always current), the dynamic of credit outstanding did not match new credit growth. This effect is likely to ease by yearend as write-offs slow.

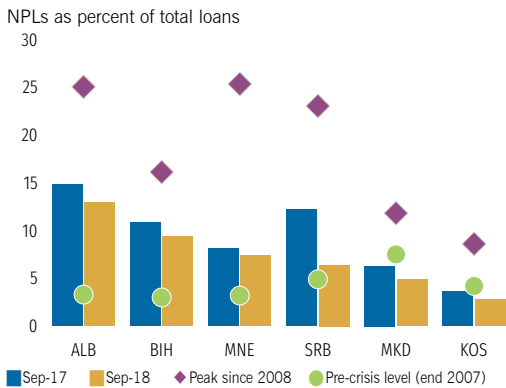
outstanding is still negative at -2 percent, partly because the recent exchange rate appreciation reduced the value of loans denominated in foreign currency.¹³ As lending to households continues to drive credit growth, lending to corporations is more uneven, with write-offs of NPLs still suppressing credit growth (Figure 6.2). De-euroization strategies are pushing up lending in domestic currencies, which reduces currency risk for unhedged borrowers. Despite general progress in deepening credit markets across the Western Balkans, domestic credit to the private sector is still far below EU levels.

With NPLs declining in all countries, lending is gradually becoming more available. As of

Figure 6.2. Credit to households grew rapidly and outpaced credit growth to firms.



¹³ Excluding the impact of cleaning up bank balance sheets and exchange rate effects, in Albania credit to the private sector had grown 5.9 percent by the end of 2018 (Bank of Albania Quarterly Monetary Policy Report 2019/I).

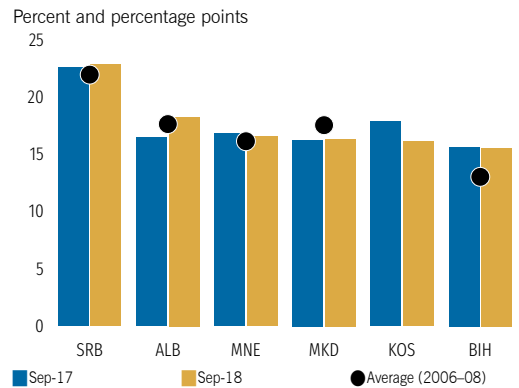
Figure 6.3. Nonperforming loans are declining.

Source: IMF FSIs, Central banks.

September 2018, the regional NPL average was 7.3 percent of total loans, down 2 pp from a year earlier (Figure 6.3). While NPLs in Albania have declined steadily from over 20 percent at peak in September 2014 to 12.9 percent in September and 11.1 percent in December 2018, they are still the highest in the region; at 2.7 percent Kosovo's NPLs are the lowest. Recent reforms have helped to reduce NPLs considerably as Albania, Montenegro, North Macedonia, and especially Serbia where NPLs continue to decrease due to selling and write offs. New insolvency laws are in place in Albania, the Bosnia and Herzegovina entity Republika Srpska, and Kosovo.¹⁴ Moreover, the Central Bank of Albania is preparing a framework for voluntary bank out-of-court restructuring of large NPLs. And Montenegro has expanded coverage of its credit registry to enhance the capacity of lenders to assess credit risk; Montenegro is also working to reclassify NPLs and revise its capital requirements to comply with the EU Capital Requirements Directive.

Banks in the Western Balkans are well-capitalized, but there is some vulnerability.

¹⁴ In the Federation of Bosnia and Herzegovina a new insolvency law is being considered by Parliament.

Figure 6.4. Banks are adequately capitalized.

Source: IMF FSIs, Central banks.

As of September 2018, bank capital adequacy averaged 17.6 percent (Figure 6.4). Profitability, though low, is on the rise—as of September 2018 the regional average return on assets was 1.7 percent. At the same time, domestic bank vulnerabilities continue to raise concerns about asset quality and the health of specific banks. In Montenegro, the regulator placed two undercapitalized domestic banks under temporary administration in December 2018; they are currently undergoing restructuring or liquidation procedures. So far, Montenegro has shown no visible signs of bank deposit declines or liquidity pressures, but if bank resolution remains protracted, it may jeopardize macro-financial stability, increase the cost of resolution, and erode confidence in the system. In Serbia, despite improvements in the banking system as a whole, the quality of state-owned bank assets is a worrisome risk. Improvement in the operations of state development banks in Bosnia and Herzegovina is incomplete, with some deficiencies in the governance and business model still unresolved. Given the size of Western Balkan economies and financial sectors, there is room for further consolidation, entrance of reputable players, and banking sector efficiency gains.

Across the region corporate lending is still limited and would benefit from a wider range of financing instruments. On the demand side, access to financial services is a major obstacle for Western Balkan businesses. According to a recent survey by the European Commission,¹⁵ an average of 15 percent consider access to finance to be the most important problem faced by their firms, compared to 7 percent in the EU28. Access to finance was cited as their biggest problem by 24 percent of SMEs in Montenegro,

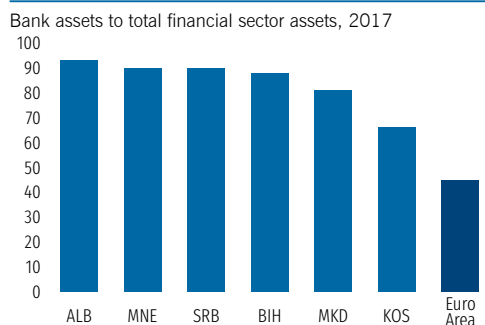
17 percent in Bosnia and Herzegovina, and 15 percent in Albania. Of those SMEs that found bank loans to not be relevant to them, an average of 33 percent in the region saw high interest rates as the main obstacle, far more than the 8 percent in the EU28. Yet factoring, leasing, and capital market instruments are not frequently in use in the Western Balkans. Diversifying financial systems is important to broaden access to finance; and the availability of term financing would foster investments—and ultimately economic growth (see Box 6.1).

Box 6.1. Diversification of Financial Systems for Greater Access to Finance.

Improving access to finance is a priority in the Western Balkans. A decade after the last global financial crisis, countries in the region are making progress on addressing NPLs but credit has not yet recovered much. Gradually improving asset quality is helping drive credit growth, but financial depth, measured by the ratio of private sector credit to GDP, averages only 44 percent (down from 48 percent in 2008), compared to 96 percent in the EU.

Greater diversification of financial systems can create opportunities for enhancing access to finance. In the Western Balkans, banks account for about 85 percent of financial sector assets, considerably more than the Euro area's 45 percent (Figure B6.1.1). Insurance, pensions, mutual funds, leasing, factoring, and capital markets are underdeveloped in all six countries. Four of the six have stock markets—Albania and Kosovo do not—but the value traded is small. Few companies are listed, and there is no secondary market liquidity. Average stock market capitalization-to-GDP in the region is about 33 percent (48 percent in the EU) and government securities-to-GDP is about 22 percent, compared to 159 percent in the EU. Despite the high liquidity in Western Balkan banking systems, the private sector is not using nongovernment bond markets for its financing needs. Initial public offerings (IPOs) are rare; 2018 saw the first IPO in Serbia since 1940. Diversification of financial markets is crucial for term financing to foster investments, and ultimately economic growth. A wider range of financing instruments would supply the needs of both households and enterprises.

Figure B6.1.1. Financial systems in the Western Balkans are not diversified.



Source: Central banks.

15 European Commission, Survey on the access to finance of enterprises - Analytical Report, 2018.

Box 6.1 continued

By limiting alternatives to bank financing, the lack of financial sector diversification exposes the private sector to external shocks. Firms that want to grow must rely on bank financing, which is difficult for micro, small, and medium-sized enterprises (MSME) to access despite ample bank liquidity. Bank loans are also short-term, and usually accessible only to firms in business for several years, sufficient collateral, and good financial accounts, which disadvantages both start-ups and micro and small firms. Limited diversification also means that private firms are vulnerable to fluctuations in the credit cycle—as happened during the global financial crisis—and have few other sources to tap in funding shortfalls.

Policies to promote financial sector diversification could stimulate long-term growth and job creation. Western Balkan countries increasingly recognize the importance of furthering integration and diversification of financial systems through, e.g., building up capital markets to boost investment, as envisaged in the 2017 Western Balkans Multi-Annual Action Plan (MAP) for a Regional Economic Area. Enacting supportive laws for leasing, factoring, venture capital, private equity, and microfinance can spur market development and financial system diversification. Governments can also invest in educating businessowners and managers about the advantages and disadvantages of different financing options. In general, the preconditions for building capital markets are not yet in place in the Western Balkans. It is therefore important to grow the institutional investor base, that is, insurance, pensions, mutual funds, and make it more attractive to companies to use capital markets. Policymakers can also improve the operation of government bond markets to establish a reliable yield curve for pricing financial instruments.

7. Although exports grew, in most of the region external deficits stayed high

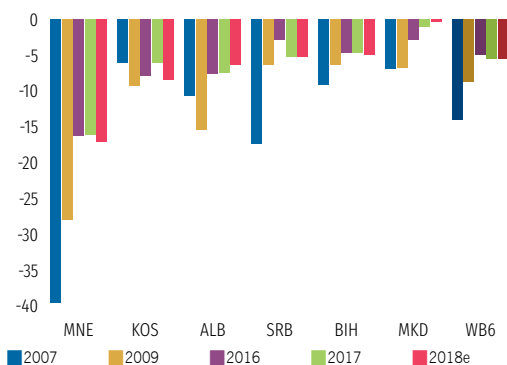
In 2018 external deficits widened in Bosnia and Herzegovina, Kosovo, and Montenegro but narrowed in Albania, North Macedonia, and Serbia (Figure 7.1). Kosovo and Montenegro saw their current account deficits (CADs) expand most, while in Albania the CAD narrowed by 1.2 pp. The change in Bosnia and Herzegovina was relatively small, and in Serbia the CAD was unchanged as a percent of GDP. The high CAD in Montenegro—which widened in 2018 from 16.1 to an estimated 17.1 percent as construction-related imports rose—is a threat to external sustainability because of both its size and its dependence on foreign financing. A rise in investment-related imports was also the main cause of the widening of the CAD in Kosovo, which registered the highest CAD deterioration in the region (2.5 pp), hitting 8.4 percent of GDP. Bosnia and Herzegovina’s CAD deficit increased by 0.2 pp reaching 4.9 percent of GDP due to higher trade deficits. The CAD in North Macedonia improved significantly in

2018, ending the year at 0.3 percent of GDP, compared to 1 percent in 2017; the reduction in the CAD deficit was mainly driven by a rising exports which reduced the trade balance. Though Serbia’s CAD did not change in 2018, it is an elevated 5.2 percent of GDP because surpluses in trade in services and in net transfers failed to compensate for rising imports and a still high primary income deficit.

Net goods exports grew in all countries except Kosovo and Serbia and net service exports grew in all countries except Albania. Still, rising consumption and investment means that imports grew faster (Figure 7.2). In 2018, increased demand from the EU benefited Western Balkan exporters, and a pickup in international prices benefited commodity exporters Albania, Bosnia and Herzegovina, Montenegro, and North Macedonia. In most WB6 countries net services exports also went up, driven by tourism and transport. Montenegro had the largest rise in net services exports, which

Figure 7.1. CADs widened in Bosnia and Herzegovina, Kosovo, and Montenegro.

Current accounts balances, percent of GDP



Source: Central banks, national statistical offices, World Bank estimates.

Figure 7.2. Goods imports were the main factor in changes to CADs.

Contribution to changes in current account deficit, 2018e, percent of GDP



Source: Central banks, national statistical offices, World Bank estimates.

went up 0.6 pp to reach 20.4 percent of GDP, due to higher tourism receipts. Nonetheless, because exports and infrastructure construction depend heavily on imports of intermediate goods in the Western Balkans, imports also rose substantially in 2018. Throughout the region the rise in imports outpaced the rise in exports of goods and services, worsening trade deficits in most countries. Kosovo's trade deficit went up by 3.1 pp of GDP, also because of lower exports of base metals and despite higher net services exports from tourism income from diaspora travelers. Serbia's trade deficit increased by 1.9 pp as exports of goods including auto manufacturing rose less than expected due to a slowdown of economic activity in major trading partners, particularly Italy. In Bosnia and Herzegovina, the trade deficit remained stable due to higher goods exports of mineral products, base metals, chemicals, and machinery and robust growth

in services exports of tourism and transport which compensated for the rise in construction-related imports for large infrastructure projects. In Albania, the trade balance improved because exceptionally favorable weather facilitated hydropower generation, which translated into a significant rise in energy exports; and goods imports slowed as two large energy infrastructure projects neared completion. In North Macedonia, improvement in the trade balance was driven by broad-based growth in exports from sectors led by foreign direct investment (FDI), mainly motor vehicle manufacturing, and also in non-FDI-led sectors (iron and steel, furniture, and services). Goods exports have also become more skill- and technology-intensive in North Macedonia and Serbia over the last decade as both countries benefitted from FDI into the export-intensive car manufacturing sectors (Box 7.1).

Box 7.1. Export Sophistication in the Western Balkans.

As they have become better able to grow faster, transition countries can now produce goods that are more sophisticated and more competitive in international markets. Over time, they have been replacing low-value-added with high-value-added goods. Foreign direct investment (FDI) has enhanced the process and participation in global value chains (GVCs) allows for more knowledge spillovers, encouraging links with other domestic industries. In general, countries that produce more sophisticated products will benefit more and move faster up the technological ladder to higher economic growth.

Over the past several years and to different degrees, the Western Balkan countries have benefitted from this nexus between sophistication and growth. During the transition period in general they have been increasing export-to-GDP ratios, largely because manufactures now constitute a larger share of their exports. North Macedonia and Serbia in particular are benefiting from rising FDI and active integration into GVCs, and to a lesser extent has Bosnia and Herzegovina. They have also improved the technology structure of their exports, at the expense of low-skill and technology-intensive ones (Figure B7.1.1).

Higher skill-intensity has resulted in more sophisticated product exports¹⁶ (Figure B7.1.2), especially in North Macedonia and Serbia. The process of convergence to the manufactures of high-income countries has been advancing fast, but it is far from evenly distributed, with the other

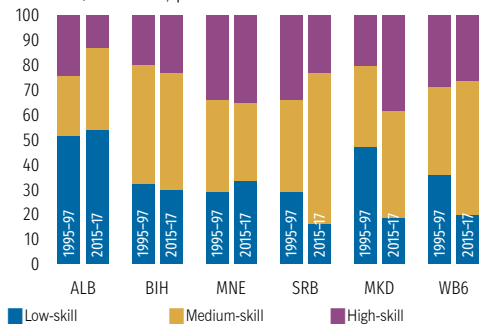
¹⁶ The sophistication of production and exports index EXPY is constructed using the Hausmann et al., 2007 methodology.

Box 7.1 continued

countries far behind North Macedonia and Serbia. By 2017 the sophistication of North Macedonia's exports of manufactured goods was on a par with high-income countries, with Serbia not far behind. Their participation in GVCs stimulates the upgrading of exports, and thus potentially also economic growth. Shimbov et al. (2019) found that an increase of 10 percent in FDI or in trade in parts and components (as a proxy for participation in GVCs) is accompanied by an improvement in the export sophistication index of more than 1.6 percentage points. The rise of export sophistication in North Macedonia and Serbia are primarily driven by FDI from high income countries into the export-intensive motor vehicles manufacturing industries. While these foreign firms boost both countries' exports, many of these firms import a high share of their inputs and source only few goods and services domestically.

Figure B7.1.1. Exports from the Western Balkans have become more skill- and technology-intensive.

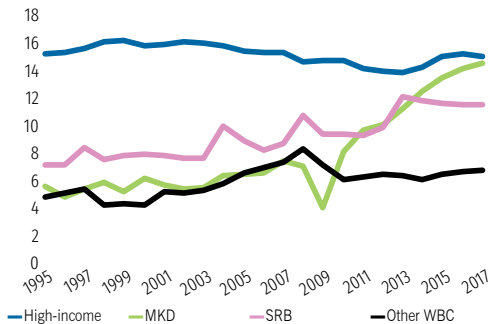
Manufacturing exports by skill and technology intensity, avg. 1995–97/2015–17, percent



Source: Shimbov et al. (2019) and World Bank calculations.

Figure B7.1.2. In North Macedonia and Serbia exports have become more sophisticated, while other countries are lagging.

Export sophistication in manufacturing, in thousands

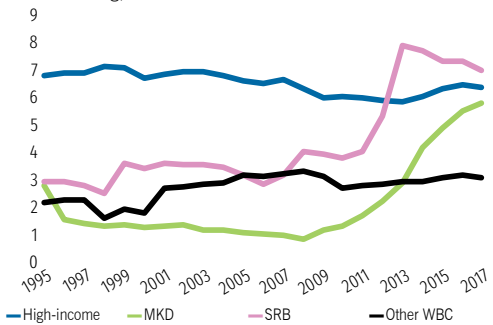


The extent to which FDI in export-intensive industries boosts productivity and growth, however, also depends on the creation of linkages between foreign and domestic firms. Such linkages with the domestic economy would facilitate knowledge and technology transfer to domestic suppliers (Javorcik, 2004, 2008). It is thus critical that the extent of knowledge spillovers to the domestic economy is analyzed in more detail and that Western Balkan countries review the incentives and costs for foreign firms to source more domestic goods and services.

Examining the skill and technological intensity of manufacturing exports in the region reveals the same picture (Figure B7.1.3). North Macedonia and Serbia achieved convergence in this segment, with Serbia's sophistication topping the average for high-income countries. They have expanded their production frontier over time and acquired new skills and technologies. Shimbov et al. (2019) found that a rise of 10 percent in the

Figure B7.1.3. The increased export sophistication was driven by medium skill and technology manufacturing.

Export sophistication in medium skill and technology manufacturing, in thousands



Source: Shimbov et al. (2019) and World Bank calculations.

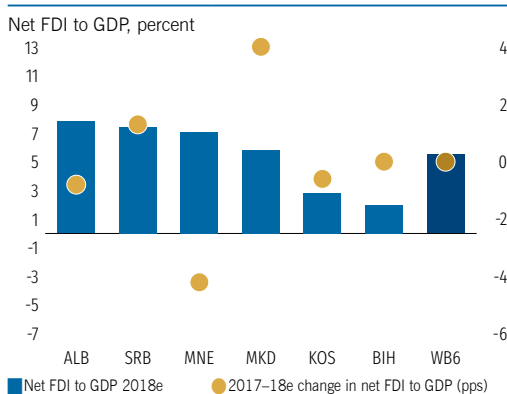
Box 7.1 continued

sophistication in a country's manufactures entails a rise in the growth of its GDP per capita of 0.1 percentage points. However, they also found that the influence of human capital on growth and the quality of economic institutions also has a robust influence on the sophistication of production and subsequent growth in the Western Balkans.

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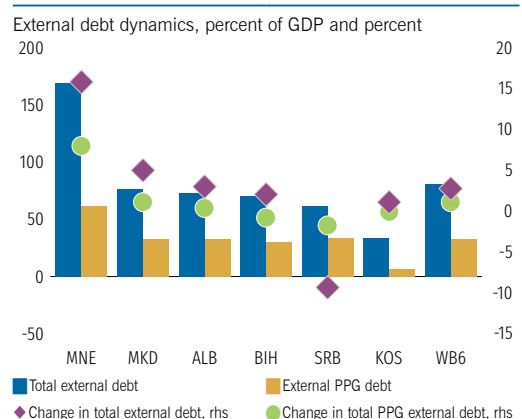
Figure 7.3. FDI levels remain low and they are growing slowly.



Source: Central banks, national statistical offices, World Bank estimates.

FDI and remittances helped finance external imbalances in 2018, despite a slight decline in FDI (Figure 7.3). Remittance inflows were relatively unchanged in all countries except for increases of 0.7 percent of GDP in Serbia and 0.5 percent in Kosovo, where they financed significant portions of the trade deficits. On average, for 2018 FDI into the Western Balkans was an estimated 5.5 percent of regional GDP, slightly less than the 5.7 percent average of the past three years, mainly because

Figure 7.4. External debt increased in 2018.



Source: Central banks, national statistical offices, World Bank estimates.

in Montenegro large net FDI-financed infrastructure projects are near completion, and because other countries, e.g., Bosnia and Herzegovina, were slow to improve the business environment. In 2018 the FDI-to-GDP ratio was highest in Albania at 7.8 percent of GDP (fully financing the CAD), driven by FDI in energy infrastructure and manufacturing. The net FDI-to-GDP ratios of Serbia (7.4 percent of GDP) and Montenegro (7.1 percent) are quite sizable and do much to explain their

large external financing needs. FDI in Kosovo declined slightly in 2018 but was enough to finance the CAD. In North Macedonia FDI inflows increased sharply following the resolution of the political crisis and are estimated at around 5.8 percent of GDP in 2018; the highest level since 2008. Bosnia and Herzegovina has the least FDI, mainly because the political environment is difficult and the country's reforms have not progressed much. Although growth in Western Balkan countries has enjoyed substantial support from FDI, current investment levels are too low to sustain growth over the long term (see Section 8).

Sources of external financing in the Western Balkans need to be closely monitored (Figure 7.4). After peaking at 82.1 percent of GDP in 2015, average external debt in the region declined in 2016 and 2017 to 78.9 percent, but it is estimated that in 2018 external debt went up to 80.7 percent—mainly because of higher external public debt, which countries are using to finance either large infrastructure projects or budget deficits—with more being used to finance current spending than for investment (see Section 4). The exception is Serbia, where it is estimated that both public and private external debt declined by 7.7 pp of GDP. The growth of exports and FDI inflows in recent years should be positive for the external positions in Western Balkan countries, but in several countries the CAD is sizeable and worsening. If CADs continue to rise, they will put pressure on official foreign currency reserves, which would intensify external debt and make countries more vulnerable to shocks in foreign investment flows. In 2018, however, all Western Balkan countries had foreign currency reserves of more than 4 months of imports.

8. Stable outlook, rising risks, and growing public discontent—reform momentum is needed

The Western Balkans region is projected to grow by 3.5 percent in 2019 and 3.8 percent in 2020 (Table 8.1). Regional growth in 2019 is projected to moderate, as growth slows in Albania, Montenegro, and Serbia, and then recovers gradually in 2020. The region is expected to grow faster than the EU through 2020, and at a similar pace as the average for Central and Eastern European (CEE) countries.

Table 8.1. The Growth Trajectory in the Western Balkans, 2017–20f.

Real GDP growth, percent				
	2017	2018e	2019f	2020f
Albania	3.8	4.2	3.8	3.6
Bosnia and Herzegovina	3.2	3.0	3.4	3.9
Kosovo	4.2	4.2	4.4	4.5
North Macedonia	0.2	2.7	2.9	3.2
Montenegro	4.7	4.4	2.9	2.4
Serbia	2.0	4.2	3.5	4.0
Western Balkans	2.6	3.8	3.5	3.8
EU28	2.6	2.1	1.8	1.7
Central and Eastern Europe	4.9	4.3	3.6	3.2

Source: For the Western Balkans: World Bank estimates based on data from national authorities. For EU28 and Central and Eastern Europe: European Commission Winter Economic Outlook (https://ec.europa.eu/info/publications/european-economic-forecast-winter-2019_en).

Notes: Growth in the Western Balkans is a weighted average by population. EU28 comprises the 28 EU members countries. Central and Eastern Europe comprises Bulgaria, Croatia, Czech Republic, Hungary, Poland, and Romania.

In 2019 the dynamics of growth will differ by country, with growth accelerating in Bosnia and Herzegovina, Kosovo, and North Macedonia and decelerating in Albania, Montenegro, and Serbia. Deceleration will be worst in Montenegro (1.5 pp relative to 2018), where private investment is expected to level off after rising steeply in 2018, in part because higher uncertainty may dent investor confidence. Growth in Serbia is projected to

slow by 0.7 pp as the temporary stimulus of public sector wages and pensions in 2018 fades and EU demand for Serbian exports slows. In contrast, growth in Bosnia and Herzegovina and North Macedonia is expected to accelerate by 0.4 and 0.2 pp in 2019, driven by public investments in the energy sector in Bosnia and Herzegovina and higher domestic demand in North Macedonia as investor and consumer confidence improves now that the country's long-standing name dispute with Greece is resolved.

Expected drivers of growth for 2019–20 also vary by country. In Kosovo, where growth is expected to be stronger thanks to large capital investment projects, the economy is expected to expand by 4.5 percent on average during 2019–20. In Albania, as energy production returns to normal and two large energy infrastructure projects are completed, growth is expected to moderate to 3.8 percent in 2019 and 3.6 percent in 2020, with domestic demand a major contributor. In Serbia, increasing investment activity and a steady rise in consumption will feed growth. In Bosnia and Herzegovina, solid consumption and investment is expected to bring growth of 3.9 percent in 2020. In North Macedonia, the recent resolution of diplomatic disputes with Greece has significantly reduced political uncertainty, facilitating higher investment and consumption and ultimately a brighter economy. In Montenegro, however, the completion of large public investment projects and fiscal consolidation is expected to slow growth to 2.4 percent.

The region's stable economic outlook is, however, vulnerable to interacting external and domestic risks, the materialization of which could significantly hurt growth, job creation, and poverty reduction. Externally, geopolitical risks are adding to an increasingly volatile environment. Prolonged trade disputes between the United States and China, potential trade restrictions between the United States and the EU, and uncertainty about Brexit talks between the EU and the United Kingdom are generating anxiety about protectionist policies that would ultimately hurt global, and therefore Western Balkan growth prospects. For instance, United States tariffs on European cars could have significant impact on exports from the auto industries in North Macedonia and Serbia. If regional trade tensions in the Western Balkans remain elevated—like Kosovo's tariffs on imports from Serbia and Bosnia and Herzegovina—this would affect economic prospects.

Slower-than-projected growth in the EU is a risk to the outlook for the Western Balkans.

Economic growth slowed in the EU in the last two quarters in 2018, somewhat disrupting car production in several Eurozone members, and in the last quarter EU industrial production contracted by 1.1 percent. By yearend, Italy, one of the largest trading partners of the Western Balkans, had fallen into recession. The *Global Economic Prospects* issued by the World Bank in January 2019 revised down its June 2018 projections for 2019 EU growth by -0.4 pp for the EU28 and -0.6 pp for the Euro area; any further slowing would have negative spill-over effects on Western Balkan countries because of both lower external demand for their exports and lower inflows of remittances and FDI.

Further tightening of monetary policy in the US and the EU would increase the region's borrowing costs and crowd out productive domestic spending. Western Balkan economies—especially Albania, Montenegro, and North Macedonia—have high PPG debt that has increasingly been financed from foreign sources. A rise in global interest rates would raise their financing costs enough to crowd out productive public investment in infrastructure and social services. The underdevelopment of domestic sovereign bond markets also amplifies their exposure to hikes in global interest rates. If the real economy in the United States weakens, the Federal Reserve may not increase interest rates in 2019. And as the European Central Bank stopped quantitative easing at the end of 2018, it may postpone raising interest rates at least until the end of 2019. Nonetheless, it would be wise for Western Balkan countries to prepare for higher global interest rates.

In contrast, resolution of the dispute with Greece over its name has significantly improved North Macedonia's economic outlook.

Its economy, which averaged growth of just 1.9 percent in the previous three years, has begun to pick up and through 2020 growth is expected to reach 3.2 percent. Resolution of the name issue—which has been inflicting political and economic damage on the country since 1991—is an opportunity to advance its accession to the EU and to become more deeply integrated into regional and global markets.

Growing public discontent over the slow pace of reforms in some Western Balkan countries carry not only domestic risk but also a unique opportunity to build momentum for reforms. Dissatisfaction with the economic and political situation is reflected in recent anti-government protests in Albania, Bosnia

and Herzegovina, Montenegro, and Serbia. The public discontent is also reflected in increasing political polarization in Albania, Montenegro, and Serbia; in all three, opposition parties recently rejected the European Commission's appeal to end their boycotts and return to their parliaments. These developments may worsen the growth outlook because political instability erodes the confidence of investors and consumers. The rising public discontent over the lack of economic opportunities is also rooted in incomplete or slow-moving reforms. These developments therefore also provide an opportunity to advance structural reforms to boost potential growth in the medium term. In all countries in the region, large and unreformed public sectors have built-in inefficiencies that have undermined the quality of education, health, and public infrastructure and reduced competitiveness. In several countries, governance and rule of law indicators have deteriorated¹⁷; growth could well have been faster if the corresponding reforms were given more priority.

In summary, the economic outlook for the Western Balkans is vulnerable to risks and rising public discontent which make it imperative for countries to accelerate structural reforms. This report highlights policy options in selected reform areas: (1) deepening trade integration and connectivity; (2) unshackling firms by changing a policy environment that favors a few dominant market players over startups; and (3) investing in people. Reforms in these and other areas will help mitigate risks and sustain faster growth. The prospects of EU membership remain a major reform anchor and should embed a heightened commitment to improve the rule

of law and battle corruption. Western Balkan countries have improved the connectivity of their economies with the rest of the world, but they still trail most other Eastern European countries though the potential gains from more economic integration in the region are large. For example, Box 8.1 highlights policies to enhance economic connectivity, which could boost annual growth in the Western Balkans. Labor market reforms should thus be accompanied by continuous improvements to trade connectivity and to the business environment to enhance competitiveness and create conditions for vital private sector-led growth. This will not be possible without building the public institutions that enforce fair market competition to ensure that no one benefits from special treatment and to encourage entrepreneurs to adopt new technologies and innovate. Western Balkan countries with high debt levels must show a firm commitment to rebuild fiscal buffers to guard against downside risks. It is therefore crucial for Western Balkan countries to make public spending more efficient so that resources can be freed for high impact investments in infrastructure and social services. More effective, accountable, and transparent policymaking is also necessary to regain citizens' trust and to reduce the emigration of skilled young people.

This report features a focus section titled "Human Capital in the Western Balkans: A Missing Link to Growth and Inclusion" which highlights the need to invest more efficiently in people. The Focus Section notes the need to improve education, health, and social protection systems to allow workers and firms in the Western Balkans to be prepared to take the opportunities that new technologies are creating.

¹⁷ As evidenced by recent rankings by internationally recognized think-tanks and NGOs.

Box 8.1. Enhancing Multidimensional Connectivity in the Western Balkans.

The benefits of connectivity accrue not only from opening to greater trading opportunities but also, and perhaps more important, from knowledge transfers between countries. Trade, investment, and the movement of people, among other forms of connectivity, lead to exchanges of information and ideas. A recent World Bank report, *Critical Connections: Promoting Economic Growth and Resilience in Europe and Central Asia* (Gould 2018), examines connectivity measures not typically considered that matter for the transfer of knowledge and thus influence on long-term economic growth. This includes the interconnected networks of trade, FDI, transport, migration, and ICT. Much of the transfer of knowledge gained from connectivity comes from *tacit* knowledge—learning by doing and face-to-face interactions. Unlike *explicit* knowledge, tacit knowledge cannot be transferred in texts and blueprints. Being part of regional or global supply chains, where firms invest in other firms and where people migrate for jobs or study abroad, can transfer useful tacit knowledge.

Many channels of connectivity interact to support higher economic growth. It is hard to imagine new forms of trade emerging without people traveling to discover new markets, or e-commerce growing without transport and high-speed internet. Countries therefore need to balance different types of connections. Such complementarities are particularly important for building supply chains, where the exchange of producers with countries of intermediate inputs, investment, managerial talent, and transport is central.

Being well-connected to countries that are well-connected to other countries can enhance knowledge spillovers. For example, Serbia's trade with Germany provides additional knowledge spillovers compared to trade with Italy, because Germany has wider global connections.

Table B8.1.1. Multidimensional connectivity has improved for the Western Balkans since the early 2000s.

Early 2000s							
	Multidimensional Connectivity	Trade	FDI	Migration	ICT	Airlines	Portfolio Flows
North Macedonia	70	65	67	108	45	72	83
Bosnia and Herzegovina	85	80	86	114	117	91	108
Serbia	83	82	100	25	42	80	NA
Albania	101	95	105	111	49	79	113
Latest Period							
	Multidimensional Connectivity	Trade	FDI	Migration	ICT	Airlines	Portfolio Flows
Serbia	57	74	37	49	54	74	NA
Bosnia and Herzegovina	60	60	63	88	49	63	82
North Macedonia	61	52	58	83	65	58	69
Albania	75	79	75	37	60	48	75

Source: Gould (2018).

Note: The table shows global rankings, from best (1) to worst (113), in combined per capita connectivity. FDI=foreign direct investment; ICT=information and communication technology; NA=not available. Earliest and latest period available for connectivity varies by country and channel of connectivity; the most common start date is 2000 and end-date is 2014.

Box 8.1 continued

Though Western Balkan countries have improved the connectivity of their economies with the rest of the world, they still trail many other European countries. Table B8.1.1 shows how Western Balkan countries (data not available for Kosovo and Montenegro) are ranked in the Multidimensional Connectivity Index (MDC); rankings range from 1 (highest connectivity) to 113 (lowest), which is the number of countries in the sample. Serbia currently ranks highest in the region with a ranking of 57, up from 82 in the early 2000s, and is in the middle of the global sample of countries. Albania ranks 75, down from 10, close to the bottom of the sample. Overall, the Western Balkans rank in the middle globally but low compared to the average for Europe and Central Asia (ECA), which ranks in the upper 25 percent. However, average FDI connectivity has increased in most of the Western Balkans, particularly Serbia, which is ranked 37 globally in the MDC sub-index for country connections and FDI per capita. Though migration connectivity has also improved, the measure must be taken with a degree of skepticism, because many citizens of the former Yugoslavia are classified as “foreign born” in census data of recipient countries, despite never migrating. Connectivity has also improved in trade, ICT, airline, and portfolio financial flows.

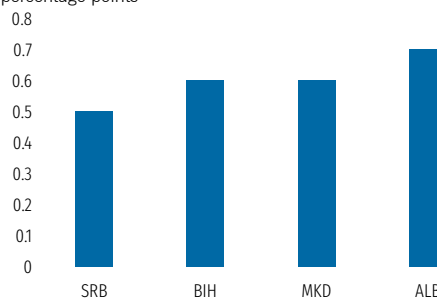
The potential gains from more economic integration in the region are large. Figure B8.1.1 shows what could happen to overall growth if countries in the region improve their connectivity to the EU average, which is in the top 15 percent globally. Because Albania is ranked lowest in connectivity, it has the most to gain: improving its connectivity to the EU average could generate 0.7 pp of additional GDP growth per year. Serbia, the most connected country in the Western Balkans, would gain over 0.5 pp annually.

How can Western Balkan countries become better connected? Since 2008, the number of bilateral investment treaties signed by Western Balkan countries is among the highest in ECA, but FDI is still modest. This suggests a need to deepen trade and investment treaties to further reduce tariffs and attract FDI; perhaps more important is to make the investment environment more attractive. The 2017 Western Balkans Multi-

Annual Action Plan to develop a Regional Economic Area (MAP-REA) provides a roadmap for expanding connectivity in trade, investment, labor mobility, and the digital economy, and aligning regulation in preparation for eventual EU accession. A firm commitment to advance such reforms will help Western Balkan countries achieve balanced connectivity (Gould 2018). With regard to trade, besides upgrading physical infrastructure and aligning tariffs, the Western Balkans need to establish national Single Windows to reduce nontariff barriers to trade and streamline border crossings. On investment, policies to attract FDI need to be supported by measures to strengthen competition (see Box 2.1). On mobility, policy options are mutual recognition of academic qualifications and reforms to build human capital (see Focus Section). On digital connectivity, priorities are elimination of regional roaming charges, a unified approach to digital security and data protection, affordable and accessible high-speed broadband, and promotion of digital skills. A comprehensive agenda

Figure B8.1.1. Raising multidimensional connectivity to EU averages could boost annual growth in the Western Balkans from about 0.5 to 0.7 percent.

Annual long-term contribution to growth by increasing Multidimensional Connectivity to the EU28 average, percentage points



Source: Gould (2018).

Note: Annual long-term contribution to growth by raising MDC to the EU28 average. MDC impact on growth is estimated based on initial levels of income, education, investment, size of government, inflation, and quality of governance.

Box 8.1 continued

is necessary to facilitate transfers of knowledge and technology for faster and sustained economic growth in the Western Balkans.

Reference

Gould, David Michael (2018). *Critical Connections: Promoting Economic Growth and Resilience in Europe and Central Asia*. World Bank, Washington, DC. <https://www.worldbank.org/en/region/eca/publication/critical-connections>

9. Spotlight #1: Competitive Markets Needed

Markets with active competition are central to the growth in productivity that supports sustainable growth. Lack of competition between firms pushes up prices, reduces production, and limits incentives for innovation. The World Bank Group and the OECD are currently preparing Product Market Regulation assessments for Albania, North Macedonia, and Serbia, to analyze policy options to further strengthen competition policy.

In recent years, Western Balkan countries have started to align their competition policy to EU standards but the implementation of these policies is lagging. Restrictive regulation of services still hinder competition in, e.g., energy and telecommunications, and in professional services (e.g., lawyers, accountants, engineers). Furthermore, enforcement of state aid control is poor and adherence to competitive neutrality principles limited. Institutional capacity needs to strengthen to ensure a “level playing field” where firms can compete on their merits; currently weak implementation of competition laws and anemic competition authorities do not act to discourage anticompetitive business practices.

Policies to facilitate market competition and firm entry could help to raise productivity. For example, some countries now allow competition in electricity generation and supply. Often, however, rules to make entry effective are missing—for example, terms of access to the grid: in North Macedonia, the Energy Regulatory Commission cannot apply penalties; and in Albania, the government may

give the Energy Regulatory Entity guidance in its decisions. In telecommunications, the enforcement of rules to curb potential anticompetitive practices by operators with significant market power has improved. However, there are still issues regarding spectrum policy that could restrict competition in wireless services and network constructions, for example in Bosnia and Herzegovina and Serbia.

Hindering competition in professional services can undermine the affordability and quality of services to the rest of the economy. In North Macedonia, the number of lawyers and notaries is limited by law and industry barriers to entry; and in Serbia there are territorial restrictions on notaries. In North Macedonia and Serbia, restrictions on activities persist for lawyers, including limitations on advertising and additional barriers for other professionals qualified to provide some types of lawyer services. Price regulation further limits the ability to compete, such as binding prices for lawyers in North Macedonia and Serbia and for accountants in North Macedonia.

Rules that guarantee neutrality in markets where state-owned enterprises (SOEs) operate with state aid would help firms to enter the market, compete, and expand based on productivity and innovation. In public utilities, governments interfere directly in SOEs, undermining their governance and commercial independence, as by the political appointment of CEOs in Serbia and North Macedonia, and control of SOEs by line ministries rather than by a dedicated office in

Serbia, North Macedonia, and Albania (Figure 9.1). Finally, even though SOEs are subject to antitrust rules across the Western Balkans, they tend to enjoy privileges that may distort market outcomes. For instance, in North Macedonia and Serbia SOEs can receive financing not available to private companies (Figure 9.2). Moreover, in Albania and North Macedonia SOEs participate in both commercial and noncommercial activities with no legal requirement to separate the activities.

All Western Balkan countries have EU-based state-aid regulations, but there are implementation gaps. The laws in Albania, North Macedonia, Kosovo, Montenegro, and Serbia are largely aligned with the EU; Bosnia and Herzegovina lacks clear criteria for state aid. There are also significant shortcomings in secondary legislation, and few resources for enforcement. The Albanian State Aid Unit, part of the State Aid Commission (SAC), has only two technical staff; and Kosovo’s SAC has one staff member though six are planned. Moreover, the authorities charged with scrutinizing state aid in Albania, Montenegro, and Serbia are not

independent. Finally, there is evidence from Kosovo, Montenegro, Serbia, and Bosnia and Herzegovina that grants of state aid are not monitored (World Bank Group 2019).

Failure to act against anticompetitive practices undermines competition policy and discourages firms from following the law. Western Balkan laws are aligned to Articles 101 and 102 of the Treaty of the Functioning of the European Union but only Albania, Montenegro, and Serbia have made unannounced inspections; North Macedonia, Serbia, and Montenegro have moved against cartels; and Bosnia and Herzegovina and Albania have sanctioned anticompetitive practices, but fines are too low for deterrence. And while all Western Balkan countries have ex ante controls of mergers, authorities tend to approve all and rarely move to remedy anticompetitive effects. Proactive use of structural or behavioral remedies is crucial to minimize the anticompetitive effects on consumers. Furthermore, fees for merger reviews are seen as a source of revenue, creating an undue burden on the private sector—in

Figure 9.1. SOEs are sometimes controlled by line ministries rather than by independent institutions...

Management of state equity holdings in publicly-controlled firms

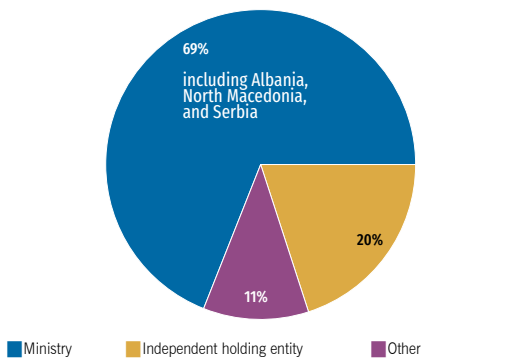
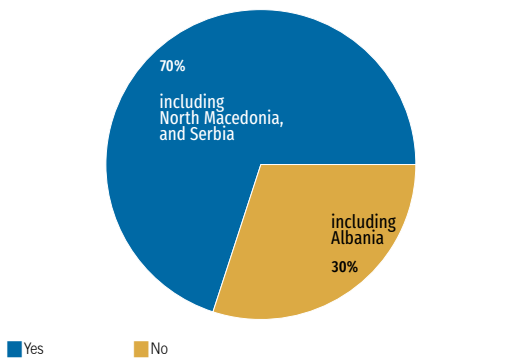


Figure 9.2. ...and SOEs have access to finance that is not available for private firms.

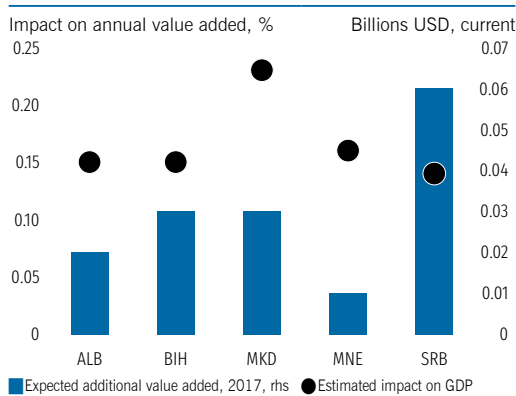
SOEs financing not available for private firms



Source: World Bank Group (WBG) Product Market Regulation (PMR) assessment; 2019 preliminary data for Albania, North Macedonia, and Serbia; for other countries: OECD and OECD–WBG PMR data.

2018 Bosnia and Herzegovina doubled fees for mergers to raise up to the elevated levels of Serbia and Montenegro.

Figure 9.3. Strengthening competition in energy, water, transport, and telecoms can accelerate growth.



Source: World Bank calculations based on Barone and Cingano (2011), EORA-country Input-Output tables 2015, and World Development Indicators.

Notes: Calculations based on Input-Output (I-O) tables for 2015, which have information on 26 sectors for the region except North Macedonia, for which it has information on 61 markets. Impact calculations are additional value-added as percentage of the GDP at current local prices, generated by improvements in a specific sector. Following Barone and Cingano (2011), the estimate assumes a multiplier effect of 0.75 percentage points in all service-intensive sectors due to joint reforms of selected services. The estimates assume that the structure of the economies remain constant, meaning that the estimated relative impact of changes on GDP were the same in both 2015 and 2017. (*) The impact calculation also covers reforms of professional services, which could be identified in a specific country due to a larger and more disaggregated I-O table.

Finally, inability to integrate competition principles into design of legislation deters competition. Although most competition authorities are mandated to conduct market assessments and advise the government on how to promote competition, their resources and powers are inadequate. Moreover, they are often sidelined—the competition authority of Montenegro was not consulted on the competition principles in the new procurement law before public consultations started. A formal system could help assess the impact of proposed legislation on markets and competition, but there is little collaboration between competition authorities and other institutions.

Simulations for Western Balkan countries show potential for positive effects of reforms in services that could have positive effects on value-added growth and productivity (Arnold et al. 2008; Barone and Cingano 2011; Conway et al. 2006; and De Rosa et al. 2009). In particular, Barone and Cingano (2011) suggest that liberalizing regulated input services generates gains in value-added growth in service-dependent industries in OECD countries. A simulated scenario for the Western Balkans, where countries, other things being equal, undertake pro-competition reforms in services suggests that annual GDP growth could rise from 0.14 to 0.23 percentage points (Figure 9.3).

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10. Spotlight #2: Labor Taxation in the Western Balkans¹⁸

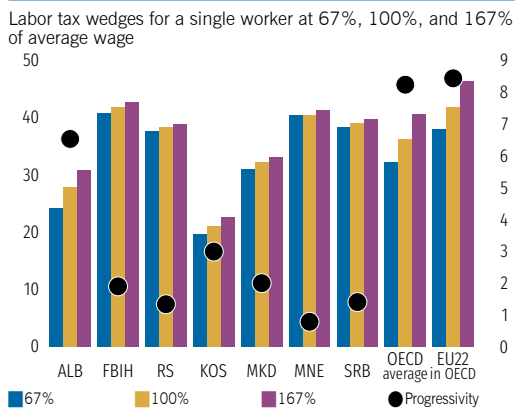
A larger difference between the total costs of an employee for a firm and the net take home wage for a worker—referred to as the labor tax wedge—implies less incentives for individuals to work and higher costs for firms to hire employees. The labor tax wedge measures the difference between the costs of a worker to her employer and the employee’s net (take home) wage. It therefore measures both incentives for individuals to work (labor supply side) and the costs for firms to hire employees (labor demand side). Specifically, the higher the labor tax wedge, the larger are the disincentives for individuals to work and for firms to hire workers.

In the Western Balkans, labor tax wedges are relatively high, especially for low-wage earners. There is some diversity of labor tax burdens within the region (Figure 10.1), but compared to EU and OECD countries, labor

tax wedges in the region are significantly higher than in most developing countries. Wedges on the average wage are high in Montenegro (40.3 percent), Serbia (39.6 percent), and Bosnia and Herzegovina (Federation of Bosnia and Herzegovina—41.7 percent; Republika Srpska—38.2 percent). In these three countries wedges are comparable to those of the EU and OECD wedges for high-wage earners, but they are much higher for low-wage earners due to low progressivity.

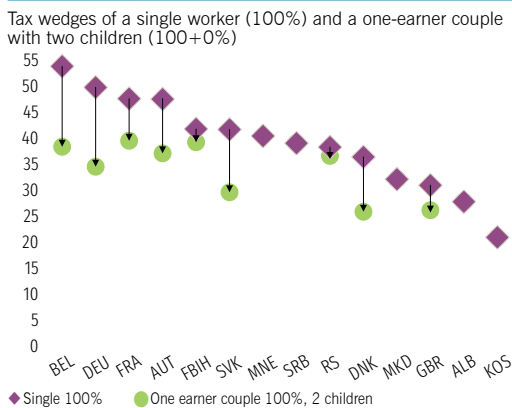
The relative lack of tax-free family allowances suggests that in the Western Balkans the effective tax burden per employee is even higher than in the EU. In Albania, Kosovo, Montenegro, and Serbia, personal income tax (PIT) rates are levied on gross wage (minus the personal allowance, which does not exist in Montenegro). In both entities in Bosnia and Herzegovina and in North Macedonia,

Figure 10.1. Labor tax wedges for low-wage earners are high in several Western Balkan countries.



Source: For Western Balkans countries: World Bank (2019), “Western Balkans Labor Market Trends 2019.” For others, OECD.

Figure 10.2. Labor tax wedges are high for workers with dependents.



¹⁸ Based on World Bank (2019).

the PIT base is lower since, following common international practice, the PIT rate is levied after deduction of employee social security contributions (SSCs) and, in the Bosnia and Herzegovina entity Republika Srpska, after an additional deduction of family benefits for dependents. Figure 10.2 shows the difference between the tax wedge for a single worker earning 100 percent of the average wage and that of a worker with a non employed spouse and two children. For the latter family Montenegro shifts from the 7th highest labor tax wedge to the top one. Similarly, Serbia moves from 8th highest to 4th highest. International comparisons based on single-worker wedges underestimate the true differential for Western Balkan workers with dependents.

The relatively high labor tax wedges for low-wage earners and those with a family imply higher raise their hiring costs and reduce their take-home wages and employment.

A major simultaneous reform of the entire system of labor taxation and social insurance in the region may be the most promising way to revitalize its labor markets. Introducing progressivity through personal deductions or family allowances and levying PITs after SSC deductions would improve the labor market position of low-wage workers with dependents. A rebalance between PITs and SSCs would require deep discussion and a strenuous effort to reform the design and ensure the sustainability of social security regimes in the region.

Reference

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11. Focus Section on Human Capital in the Western Balkans: A Missing Link to Growth and Inclusion

Introduction

Too often countries do not give priority to investments in human capital; their payoffs are not realized immediately, so there are no ribbon-cutting ceremonies on near-term achievements. But the hard reality is that neglecting to invest in human capital dramatically erodes a country's competitiveness and growth prospects. Improving education and health is central to ensuring that people benefit from job opportunities now and in the future. A healthy, well-educated, skillful population provides the foundation for a prosperous society. It enables workers to compete in the dynamic labor markets of technologically fast-changing economies, and it allows firms to hire the skilled workers they need to handle increasingly complex production processes. Endowing a country's most vulnerable citizens with quality human capital also helps them escape poverty by giving them a much higher chance of landing a stable job that pays better—and thus contribute to national prosperity. A country that fails to invest in human capital is failing its citizens.

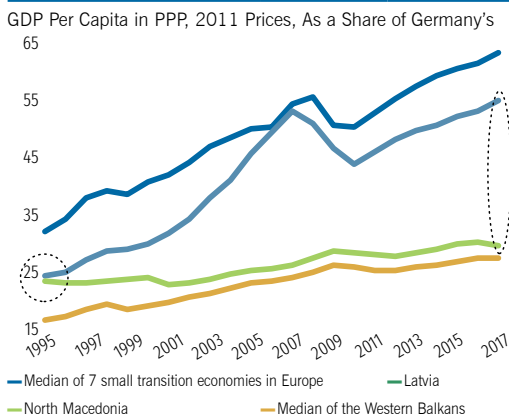
Since 1995 Western Balkan countries have achieved significant economic growth while reducing poverty. Between 1995 and 2017 living standards increased almost six-fold in Bosnia and Herzegovina¹⁹, nearly tripled in Albania, and almost doubled in Serbia. In the early 2000s, about 33 percent of the people in the region lived on less than US\$5 a day; by 2008, that was true of just 20 percent.

19 Albeit from a low base due to war.

Other human development indicators, such as life expectancy, literacy, and access to public services also improved.

Yet the six Western Balkan countries are still among the poorest in Europe, and the pace of income convergence to European standards has slowed. Other small transition economies in Europe, such as Slovenia, Croatia, Slovakia, Estonia, Latvia, and Lithuania, have converged much faster. For instance, in 1995, per capita incomes in both Latvia and the Republic of North Macedonia were about 25 percent of Germany's (Figure 11.1). Today Latvia's GDP per capita is twice that of North Macedonia. After the global financial crisis, growth stagnated in the Western Balkans, but early accession countries quickly caught up with the rest of the EU.

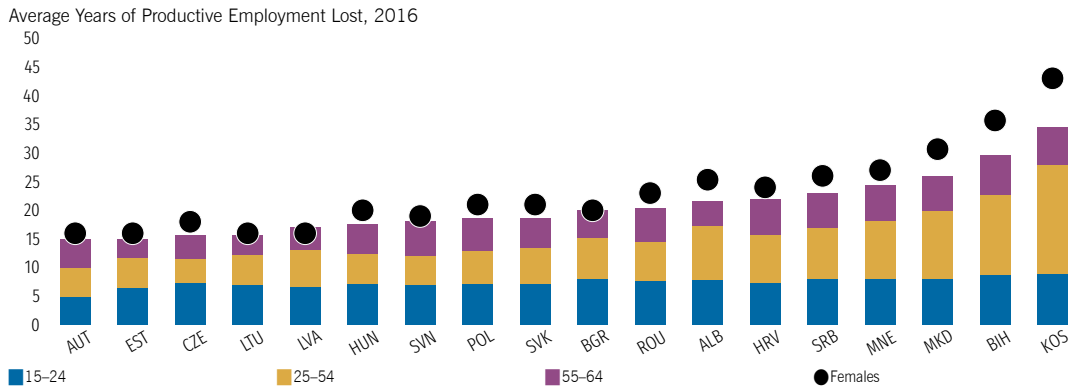
Figure 11.1. Disparities are growing among transition economies.



Source: World Bank calculations based on data from national authorities, World Development Indicators, and Eurostat.

Lagging economic growth has led to a persistent jobs challenge, which results in a considerable waste of working years.

Figure 11.2. The Western Balkans face severe employment challenges, which result in a considerable waste of working years.



Source: World Bank (2018d).

Note: Methodology based on Arias et al. (2014). The average years of employment potentially lost is equal to the share of total working years for the age group, multiplied by one minus the employment rate for the same age group.

Only 44 percent of working-age people in the Western Balkans have jobs. Unemployment is high (about 17 percent), and inactivity even higher (47 percent). Labor market outcomes for youth, minorities, and the vulnerable are even worse. In all six Western Balkan countries many youths are not engaged in employment, education, or training (NEET), with the highest rates being 24 to 26 percent in Bosnia and Herzegovina, North Macedonia, Kosovo, and Albania. Structural labor market deficiencies also cause a considerable loss of working years. The average male worker in the Western Balkans loses more than 20 years of his productive lifetime because of unemployment and inactivity. For women, the loss is over 30 years (Figure 11.2). The jobs challenge also adds to the incentives to migrate: in some countries, the share of emigrants outside the region is close to a third of the resident population.

Poor human development outcomes are contributing to lagging growth and dim employment prospects. Western Balkan countries have for the most part mastered the human development challenges common to

low- and middle-income countries (limited access to education, malnutrition, low life expectancy), but a new generation of challenges is now affecting them. The human capital challenge starts early in life and builds throughout the life cycle. Minimal investment in early childhood development (ECD) translates into poor performance in primary and secondary education, so students are not prepared to acquire the skills they need to operate effectively in today's increasingly competitive labor markets. Poor-quality technical education and universities also affect the transition from school to work. As a result, many graduates are unemployed for a long time and cannot build work experience. Meanwhile, social assistance programs do not adequately alleviate poverty and give vulnerable households sufficient support. Moreover, inefficient health systems are not addressing the dramatic rise of noncommunicable diseases (NCDs) and inadequate health insurance coverage heightens the risk of impoverishment due to the catastrophic costs of sickness.

Stunting, a measure of height for age that is closely associated with malnutrition, has been associated with less time in school, lower test scores, lower incomes, and a higher likelihood of poverty (Hoddinott et al. 2013). Disability and workplace accidents also undermine long-term earnings potential, as does obesity (Campolieti and Krashinsky 2006; Brunello, Michaud, and Sanz-de-Galdeano 2009; Gilleskie and Hoffman 2014).

Western Balkan countries need to invest more efficiently in human capital. In education, the quality, relevance, and inclusion of current systems need attention. In health, efforts should focus on addressing the lifelong consequences of poor ECD, the rise of NCDs, and exceedingly high out-of-pocket spending on health. And social assistance systems should give more priority to poverty alleviation and the employability of the poor, integrating case management to ensure effective support throughout the lifecycle.

Education systems that fail many students in the labor market

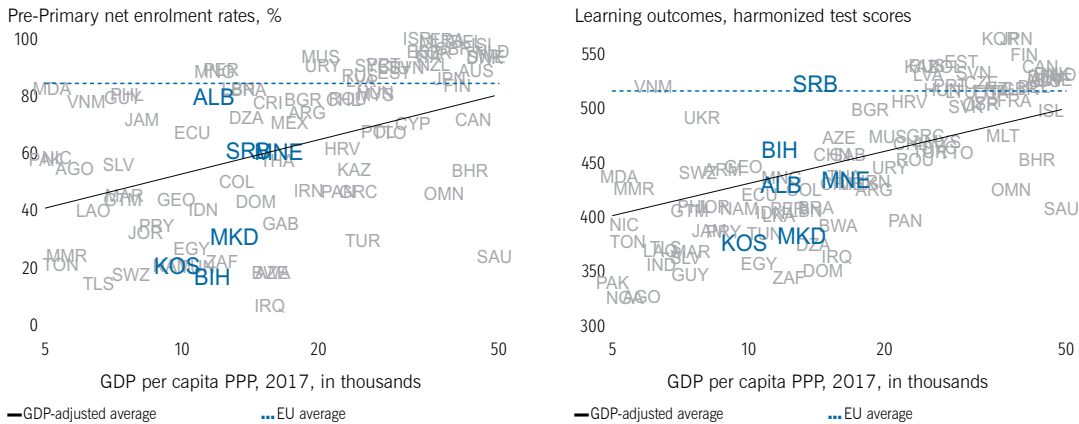
Education is lifelong. Education starts with adequate stimulation at a very early age, which promotes brain development. It continues with early childhood education to lay the foundation for solid socioemotional development and cognitive learning. Basic education then equips students with general skills that will help them throughout their lives. In higher education and technical and vocational education and training (TVET), students deepen skills that allow them to integrate effectively into the labor market; and throughout adulthood, lifelong learning helps people switch careers and stay current with progress.

At almost every stage, with few exceptions, education systems in the Western Balkans fail to provide the skills the labor market requires. Systems also fail to provide students with the skills they need to successfully complete each stage and move confidently to the next. These challenges persist all the way up the education ladder, from preschool education to graduate university degrees.

Preprimary enrollment in the Western Balkans is far below EU averages. Investing in young children—especially those from disadvantaged backgrounds—is essential to ensure proper brain development as a solid basis for children to learn. It has been shown to reduce inequalities and raise the productivity of the entire society (Heckman and Masterov 2007). In Bosnia and Herzegovina, Kosovo, and North Macedonia, preprimary enrollment is close to the average for low-income countries and far below the average of countries with similar incomes; and except in Albania, preprimary enrollment is far below the average for EU member states (Figure 11.4, left panel). Nor is much known about the quality of early childhood education, although that is crucial to generate positive net returns to early education (Elango et al. 2016). Albania, for instance, does not have national standards for early childhood education for children between 0–3 years old.

Poor-quality basic education systems fail to endow many students with the basic skills they need to function in society. Except in Serbia, learning outcomes are far below the EU-member averages; and for Albania, Kosovo, North Macedonia and Montenegro, they are below the average of peers with similar income levels (Figure 11.4, right panel)—in some cases, close to the scores of low income countries. Poor-quality basic education is a

Figure 11.4. In some Western Balkan countries, education outcomes are well below those in peer countries.



Source: World Bank calculations based on World Development Indicators and World Bank data.
 Note: For details about the methodology used to build Harmonized Test Scores see Altinok, Angrist, and Patrinos (2018).

fragile basis upon which to build the higher-level skills needed for productive jobs.

The educational quality challenge, ubiquitous in the Western Balkans, should not be underestimated.

An analysis based on 2015 PISA assessments, which test the skills and knowledge of 15-year-old students,²² found that at age 15 about 70 percent of the students in Kosovo and North Macedonia, and about 50 percent of Albanian students are still functionally illiterate, which means they cannot comprehend the text they read, and are therefore not qualified for good jobs. Nearly 50 percent of Montenegrin students are not attaining basic proficiency in science and mathematics, and 40 percent are not proficient in reading. And even in Serbia, the top performer in the Western Balkans, 40 percent of students are functionally innumerate and about 30 percent are functionally illiterate, compared to an OECD average of 20 percent

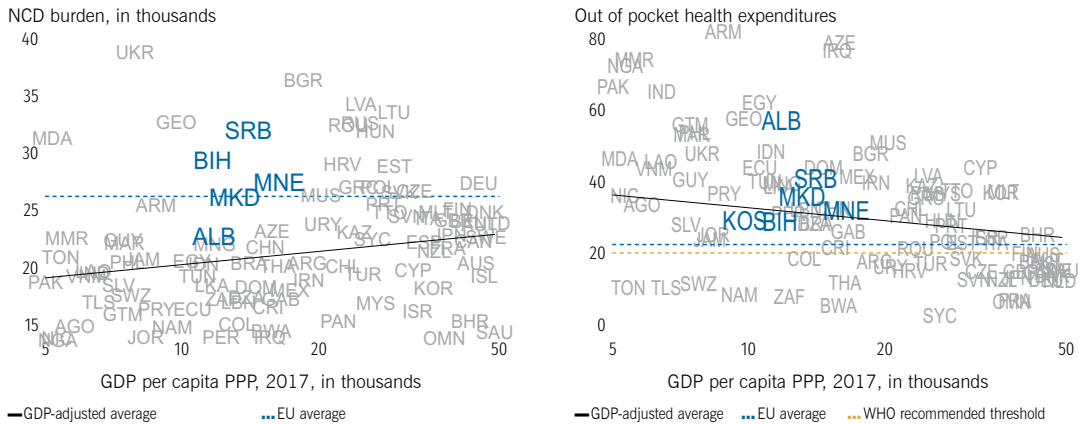
for reading (OECD 2016; World Bank 2017). And trends are often not encouraging: in North Macedonia, average learning outcomes declined between the last two waves of PISA assessments. There is a need for Western Balkan countries to move promptly to boost education quality: calculations based on PISA data suggest that at the current rate of progress, it would take Western Balkan countries 29 years to reach today’s EU reading average.

Higher education and TVET systems are failing to instill in students the technical and socioemotional skills they need to be productive in jobs.

Surveys to capture workforce skills consistently show a mismatch between the skills with which graduates leave technical and higher education, and expressed private sector needs (World Bank 2018a, 2018b, and 2019, among others). The gaps are not only in job-specific technical skills but also in higher-order cognitive and socioemotional skills like communication and people skills (for managers and professionals) and basic cognitive and time management skills. Firms in the region also find it hard to find workers with soft skills

22 The *Programme for International Student Assessment (PISA)* is a triennial international survey evaluating education systems worldwide by testing the skills and knowledge of 15-year-old students. See <http://www.oecd.org/pisa/>.

Figure 11.5. There is room to improve Western Balkan's health systems to properly insure people and deliver better outcomes.



Source: World Bank calculations based on World Development Indicators.

Note: Disability-Adjusted Life Years (DALY) capture lost years of "healthy" lives. For details, see https://www.who.int/healthinfo/global_burden_disease/metrics_daly/en/.

like reliability, resilience, adaptiveness, problem solving, and teamwork.

Health systems that impoverish people and fail to address new diseases

NCDs are rising dramatically in all Western Balkan countries except Kosovo. In all except Kosovo an aging population is contributing to a rise in NCDs, especially cardiovascular diseases, diabetes, and cancers. Across the Western Balkans, the burden of NCDs is already higher than the average for their level of development, and in Bosnia and Herzegovina, Montenegro, and Serbia it is higher than the EU average (Figure 11.5, left panel). This directly affects the ability of citizens to contribute economically and socially to their country's prosperity. In North Macedonia, for example, almost 20,000 productive years are lost annually due to premature deaths from NCDs, and many more from disability or early retirement (World Bank 2018d). Among other substantial risk factors associated with NCDs are the fact that tobacco consumption in all

six countries is still pervasive, and overweight in the adult population is prevalent (North Macedonia and Montenegro) or increasing rapidly (Albania and Serbia).

Health systems in the region have not yet been reformed to address these new challenges, leading to poor outcomes. Health systems are costly but ineffective because they are overwhelmingly hospital-centric. There is little health promotion or preventive care in communities or workplaces. Funding of cost-effective primary health care, which is more efficient in preventing and treating NCDs, has not kept up with the speed with which NCDs are growing. Substantial gains in population health could also be achieved by controlling tobacco use and improving air quality (Fuchs, Orlic, and Cancho 2019). Without reforms, premature mortality caused by NCDs will remain much higher in the Western Balkans than in the EU.

Western Balkan countries are also facing difficulties in addressing children's early health and development, and a few also

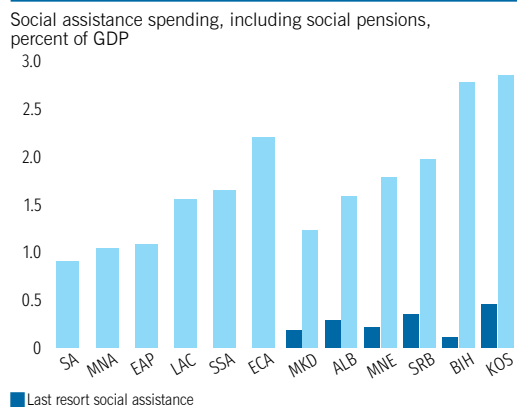
face high rates of maternal and child mortality. The number of women dying in childbirth in Albania is estimated to be more than double that in many EU countries, and in North Macedonia rising child mortality rates are more than triple the EU average (World Development Indicators). Almost one in five Roma children in Serbia, Kosovo and North Macedonia are stunted, a sign of long-standing malnutrition (compared to around one in twenty non-Roma children). Some of the most basic health care activities, such as immunization against infectious diseases, are also not reliably performed. Only around 90% of children in the poorest wealth quintile in Serbia, Kosovo and North Macedonia are vaccinated against measles, for example—less than the number required to reliably prevent outbreaks (UNICEF 2019).

Impoverishment due to the catastrophic cost of severe illness is also a major threat. While except for Kosovo all Western Balkan countries have public health insurance, coverage tends to be low or inadequate. The share of out-of-pocket payments in total spending on health ranges from 29 percent in Bosnia and Herzegovina to 57 percent in Albania (Figure 11.5, right panel). The recommended WHO threshold is 20 percent. High out-of-pocket expenditures also make it likely that the poorest households forego needed health care because for them it is unaffordable. Soaring NCDs are bound to make financing health even more problematic. Making public spending on health more efficient has become even more urgent.

Out of focus social assistance

Western Balkan countries spend heavily on social assistance, ranging from 1.2 percent of GDP in North Macedonia to 2.8 percent in Kosovo (Figure 11.6). In Bosnia and Herzegovina, Kosovo, and Montenegro it exceeds the average social assistance spending of countries in Eastern Europe and Central Asia, the region that spends the most on social assistance; and in all Western Balkan countries it is also higher than regional averages for South Asia, the Middle East and North Africa, and East Asia.

Figure 11.6. Social assistance spending is relatively high but is not necessarily intended for the poor.



Source: World Bank (2018g); World Bank (2018c) for LRSA; and World Bank calculations for Montenegro (2017) and Bosnia and Herzegovina (2017).

Note: Latest year available. Figures include social pensions but not all social protection expenditures such as pension transfers. The ECA average does not include the Western Balkans.

However, most social assistance spending is not designed to support the poor. Programs specifically designed to support the poor (Figure 11.6) represent only a small proportion of total spending on social assistance, from 4 percent in Bosnia and Herzegovina to 17 percent in Albania and Serbia. Most social assistance spending in the region is distributed to specific categories of people, not all of whom are poor.

An incidence analysis shows that the percentage of individuals receiving social assistance, directly or indirectly, in the poorest income quintile varies from 44 percent in Bosnia and Herzegovina to 22 percent in Montenegro; for comparison, coverage of the poorest quintile is close to 90 percent in Romania, and more than 60 percent in Bulgaria and Ukraine (World Bank 2018c, latest year available).

In some Western Balkan countries, poverty alleviation programs are massively outspent by grants to groups falling beyond the scope of social assistance. Grants to war veterans, for instance, amount to 1.9 percent of GDP in Bosnia and Herzegovina (against 0.8 percent for disability, families with children, and poverty alleviation programs; World Bank 2018e); and Kosovo spends about 2 percent on war-related schemes and pensions (World Bank 2018c). Introducing means-testing in these programs would free up large amounts that could be used to better alleviate poverty.

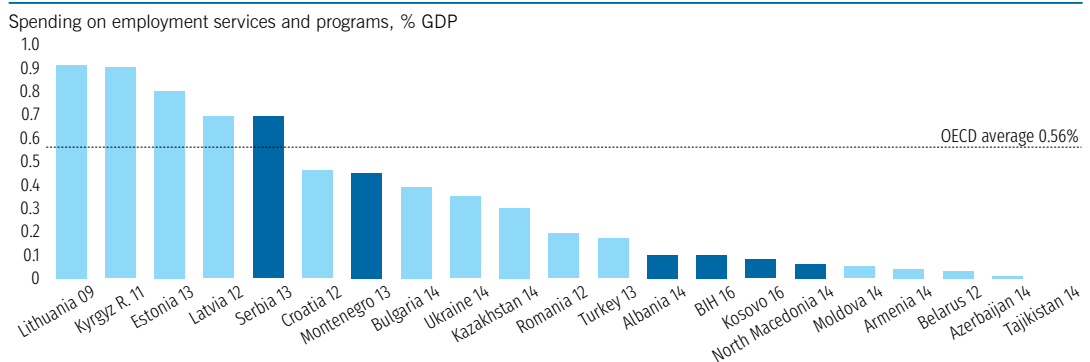
In most Western Balkan countries there is also a weak link between the social assistance system and employment services and programs. Eligibility rules for some

last-resort social assistance programs may in fact discourage beneficiaries from seeking employment. And despite the region's massive unemployment problem, apart from Serbia and Montenegro spending on employment services and active labor market programs (ALMP) is far below the OECD average of 0.56 percent of GDP (Figure 11.7). Employment programs and intermediation services are also often tailored to the profiles of formal sector and middle-class workers, rather than the needs of the poor. More could be done to enhance the employability of the poor to help them escape poverty. In North Macedonia, for example, the World Bank's Public Finance Review notes that in the last decade social assistance did little to reduce poverty and improve labor outcomes, mainly due to the low and fragmented coverage of social assistance programs.

A pressing and persistent lack of inclusion

Poor human development outcomes can be linked to a persistent lack of inclusion: some vulnerable groups have significant gaps in human capital that affect countries' ability

Figure 11.7. Spending on employment services and programs remains low in most countries in the Western Balkans.



Source: World Bank (2018c), and World Bank estimates for Bosnia and Herzegovina.

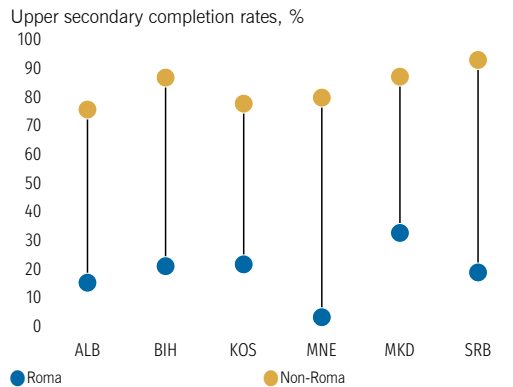
to improve overall human development outcomes. At age 15, for instance, children in rural areas are on average a full year behind in their learning compared to children in urban areas; and children from the poorest 20 percent of households are almost three years behind children from the richest 20 percent (PISA data and World Bank 2017).

For some minority groups, such as the Roma, human development outcomes remain dismally low. A recent EU-UNDP-WB survey of vulnerable communities in the Western Balkans found that only 20 percent of Roma youth aged 22–25 had completed upper secondary school, compared to 80 percent of non-Roma youth in the same neighborhoods (Figure 11.8). Differences in human development outcomes extend beyond education, to labor market and health outcomes, among others. The proportion of youth not in employment, education, or training averages 68 percent in vulnerable Roma communities, against 34 percent for their non-Roma neighbors; and stunting is three times more prevalent among Roma children under 5 than among majority children in Montenegro, North Macedonia, and Serbia. Roma women and minorities women are at even more disadvantageous position (Robayo-Abril and Millán 2019).

Addressing the inclusion challenge matters not only for poverty reduction but also for growth. Without appropriate human capital endowments, vulnerable youth cannot realize their full potential to contribute to economic activity. And with populations aging in most of the region and fertility rates higher among the poor, more and more new labor market entrants will be from relatively deprived backgrounds. In Serbia, for instance, by 2030 an estimated

30 percent of new labor market entrants will be from vulnerable and minority backgrounds (World Bank 2015). Failure to address the inclusion challenge will affect not only the well-being of the poor, but also national competitiveness and economic performance.

Figure 11.8. Education outcomes among vulnerable Roma remain dismally low.



Source: Robayo-Abril and Millán (2019).

Note: Vulnerable groups aged 22–25.

The way forward: More and better investments in human capital

Western Balkan countries need to invest more efficiently in human capital. The region has achieved notable progress in expanding access to basic education and health, and setting up social protection systems to protect the vulnerable. With stronger human capital Western Balkan societies would be better prepared to take advantage of the opportunities offered by rapid technological changes, mitigate risks, and create dynamic growing economies where young people can thrive and realize their aspirations. Digital technologies (robotics, ICT, artificial intelligence) will transform the world of work, but could increase inequality as some workers see wages stagnate or jobs displaced. Investments in people are thus needed so that citizens are positioned to flourish.

Improving human capital requires deep reforms that build on one another; significant investments; and time—a considerable amount of time. Meaningful improvements in the quality of education can take from 10 to 30 years²³; In Brazil and Chile, it took 15 years and continuous efforts to integrate social assistance programs and build a comprehensive social registry; and for Peru to achieve one of the world’s most successful reductions in stunting (15 percentage points), it took 11 years of sustained effort (Marini and Rokx 2016). Given the magnitude of the human development challenges in the Western Balkans—especially from the perspective of EU accession—it is imperative for countries to act quickly.

In education, there is a need to improve the quality, relevance, and inclusion of existing systems. In the early ages, access to quality childcare centers needs to be expanded—with children from poor and vulnerable backgrounds given priority. In basic education, teacher and curriculum reforms and better school management could go a long way in ensuring that students acquire solid foundational skills. And in TVET and higher education institutions, ensuring quality certification and accreditation and closer links with the private sector could boost the labor market relevance of the teaching and training that is imparted. At all levels of education, there is also a need to more carefully monitor student performance and outcomes, and to give more support to poor and low-performing students.

Health reforms should concentrate on addressing the lifelong consequences of poor ECD, the rise of NCDs, and excessive out-of-

pocket health expenditures. Reforms should be directed to reproductive health and antenatal care services and children’s health care. Health care at all levels also needs to better adapt to aging populations and the dramatic rise of NCDs. As a first step, primary care should be enhanced and expanded into the places where people live and work. Health insurance systems also need to be broadened and optimized to reduce out-of-pocket spending, in particular among poorer households, for whom health care is significantly worse and payments higher, which leaves them with the dreadful choice of not seeking treatment or falling further into poverty.

Social assistance systems should concentrate on alleviating poverty and vulnerability and integrating case management to ensure effective support throughout the lifecycle.

Social assistance systems should not only support people suffering from poverty but also promote acquisition of human capital and the employability of the poor throughout the active life cycle. Integrating programs and case management and tailoring social services to the vulnerabilities of different types of households have consistently proven to be effective in reducing poverty, ensuring that poor children learn and remain in good health, and promoting employment. Social assistance must be refocused to address actual needs and vulnerabilities, rather than covering broad categories of beneficiaries whether or not they need it. Programs and case management can also be better integrated: only two Western Balkan countries have a well-established social registry (the basis for integrated case management), although others are currently developing it. And more efficient investment in ALMPs, as well as better integrating employment

23 That is, increasing learning outcomes by half a standard deviation; see Hanushek and Woessmann (2008).

programs with social assistance, could enhance the employment prospects of the poor.

Even if all goes smoothly, improving human capital will take several political cycles, hence consensus-building and evidence-based policy making should be integral to any reform. Progress is too often impeded by a lack of coherence and consistency across reform cycles. Sustainable improvements in human capital require broad political consensus and willingness of the entire polity to maintain reform momentum and ensure that future governments will build upon the foundations laid down by past ones—rather than dismantling achievements and starting from scratch. Solid, gradual progress may be better at times than major but controversial reforms. Evidence-based policy making, with reforms adapting international best practices to the local context and their success assessed against carefully defined, measurable objectives helps shield reforms from political cycles. These reforms will take time. But there is an urgent need to agree on a clear path forward to boost human capital in the region and, even if in small steps, start acting now.

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Country Notes

Albania

- In 2018, a rise in energy production helped to push economic growth in Albania to 4.2 percent.
- Unemployment has declined due to job creation and increased labor force participation in recent years.
- A primary fiscal surplus resulting from fiscal consolidation and appreciation of the exchange rate have helped to reduce public debt, but off-balance-sheet risks are mounting.
- Strong services exports helped narrow the current account deficit to 6.3 percent of GDP.
- Growth is projected to moderate to 3.7 percent through 2020 as economic dynamism gradually closes the output gap. The positive outlook is subject to external and domestic risks, though these can be mitigated by a firm government commitment to macroeconomic sustainability and structural reforms.

Recent Economic Developments

Growth accelerated in 2018 to an estimated 4.2 percent. With hydrological conditions exceptionally favorable, energy production more than doubled in the first nine months, making up for nearly half of the GDP growth for that period. Tourism boosted growth of services; the number of foreign citizens visiting the country for leisure rose by 15.9 percent year-on-year (y-o-y) in 2018. On the spending side, consumption contributed 1.9 percentage points (pp) to estimated growth, supported by higher employment and wages. Net exports, especially of energy and services, contributed 1.3 pp. Private investment moderated due to the winding down of two large energy projects financed by foreign direct investment (FDI), but public investments in infrastructure speeded up; by year-end the contribution of investment to growth was 1 pp.

Growth supported job creation in all sectors, and with more Albanians participating in the labor force, unemployment went down. Average employment growth in 2018 was strongest in industry (4.7 percent y-o-y) and services (4.2 percent). The labor market

dynamics encouraged job searchers and entry into the labor force, despite a four-year drain on the working-age population due to emigration. However, labor force participation is still low at 59.4 percent, and there are major gaps between male and female participation rates. The unemployment rate, after declining for 11 consecutive quarters, slightly increased by 0.1 p.p at 12.3 percent at the end of the year. Youth unemployment rate fell by 2.3 pp y-o-y. The average real wage increased by 1.6 percent at the end of 2018.

Minimal inflationary pressures prompted an easing of monetary policy, in line with the Bank of Albania's (BoA) price stability framework. Headline inflation of 1.8 percent at year-end 2018 was below the BoA's 3 percent target. Inflation dynamics during the year reflected mostly food prices, with some pass-through effects resulting from the exchange rate appreciation in the second half of the year. Inflationary trends as indicated by core inflation (0.4 percent at year-end) show little demand pressure. After the exchange rate appreciation, the BoA intervened in the foreign exchange market and in June eased monetary policy by taking the policy rate to a record

low of 1 percent; the change was transmitted to short-term government securities and, to a lesser extent, deposit and lending rates.¹ Through 2018 the lek appreciated by about 5 percent against the euro.

The banking system is well-capitalized and liquid, but credit to the private sector continued to contract. As the BoA continued its efforts to reduce nonperforming loans, they had fallen to 11.1 percent of total loans by December 2018. Despite monetary easing, credit to the private sector as a share of GDP fell by 2 percent (y-o-y). The main cause was the decline of credit in foreign currency and related exchange rate dynamics; credit in local currency mostly went to households and SMEs. Deleveraging by EU-owned banks is constraining credit supply, and on the demand side, BoA surveys indicate that firms and households have little interest in borrowing.

Fiscal consolidation has helped to reduce public debt; now there is a need to address such fiscal risks as contingent liabilities from public-private partnerships (PPPs) and from state-owned enterprises (SOEs). Fiscal consolidation efforts continued in 2018 in the form of spending restraints. Revenues declined from 27.7 percent of GDP in 2017 to 27.2 percent, partly due to the clearance of accumulated value added tax (VAT) refund arrears and to the effect of the exchange rate appreciation on VAT on imported goods. However, personal income tax (PIT) revenue and social security contributions rose slightly, supported by wage increases and measures to reduce informality. With revenue

underperforming, curbs on the wage bill and social benefits brought current spending as a share of GDP down from 25.3 percent in 2017 to 24.3 percent. Capital spending went up slightly, by 0.3 pp of GDP as new infrastructure projects were launched—PPPs for infrastructure projects rose rapidly. Though PPPs do alleviate funding constraints in the short term, they increase contingent liabilities that may narrow the fiscal space for new investments in later years. Thus PPPs need to be continuously re-evaluated. Budgetary arrears (e.g., VAT refunds and road infrastructure and local government arrears) amounted to about 1.5 percent of GDP in 2018, thwarting budget execution and undermining the credibility of the fiscal consolidation, with negative effects on private sector growth. The stock of public debt and arrears declined to 68.6 percent of GDP in 2018, mostly due to the exchange-rate appreciation, but that is still high and carries risks for debt sustainability in case of adverse shocks. The government successfully placed a seven-year €500 million Eurobond at 3.5 percent in October and used €200 million to buy back a portion of its €450 million 2015 Eurobond expiring in 2020.

Strong exports and slowing growth in imports improved the external position in 2018. The current account deficit (CAD) narrowed from 7.5 percent of GDP in 2017 to 6.3 percent in 2018. The trade deficit narrowed to 13.5 percent of GDP, as rising exports of electricity and services, supported 16.7 percent export growth. FDI grew by 6.4 percent, which fully financed the CAD. Year-end foreign reserve coverage of 6½ months of imports mitigated the risks posed by high external debt of 62.1 percent of GDP.

¹ Forex interventions were temporary introduced in June, to prevent excessive fluctuations in the exchange rate following capital conversions of some commercial banks to domestic currency, and as announced, without compromising the commitment to maintain exchange rate flexibility.

Outlook and Risks

Albania's economic growth is expected to moderate to 3.7 percent through 2020, with the return of energy production to normal and the completion of major investment projects. Services and construction are expected to lead growth, which will be supported by private consumption fueled by labor income gains, further government investment in infrastructure, and improvement in the business environment. Medium-term projections assume that consumption will continue to grow at about 3.4 percent a year and fixed capital formation at 3 percent. Net exports are also expected to support growth as market access expands, but their contribution is expected to be smaller as imports respond to domestic demand.

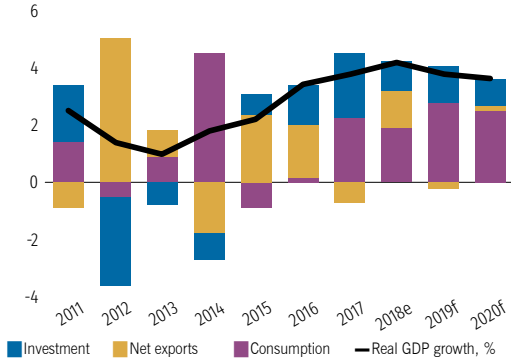
By 2020 the fiscal deficit is projected to increase to 2.1 percent. The rise will be driven by government efforts to clear arrears and the adoption of fiscal incentives such as VAT exemptions, lower income tax rates, and a higher ceiling for the high-income PIT tax bracket. Current expenditures on wages, social transfers, and operation and maintenance are expected to be contained as a share of GDP, but capital spending will rise to 4.8 percent. PPPs are expected to finance an increasing share of public projects, some of them already signed in 2018 or in the pipeline, which will increase contingent liabilities.

Medium-term growth projections depend on the pace of structural reforms and progress with EU accession. Efforts to sustain fiscal consolidation, mitigate fiscal risks from contingent liabilities, and accelerate energy sector reform are needed to safeguard macroeconomic sustainability. Improving the business climate and the rule of law remain priorities for EU accession and such efforts should be complemented by investments in infrastructure and human capital. That would reap the benefits of EU accession and ensure poverty reduction and shared prosperity. Given Albania's limited resources, investments will need to be prioritized.

Albania is vulnerable to a slowdown in Europe, particularly in its neighboring main trading partners. A lack of growth in these countries could mean lower Albanian exports, remittances, and FDI. The expected tightening of monetary policy in advanced economies would also raise financing costs given the country's high public debt, which is increasingly being refinanced through foreign sources. A slower-than-expected pace of reforms would also affect economic and social prospects.

Growth accelerated in 2018, driven by net exports and investment.

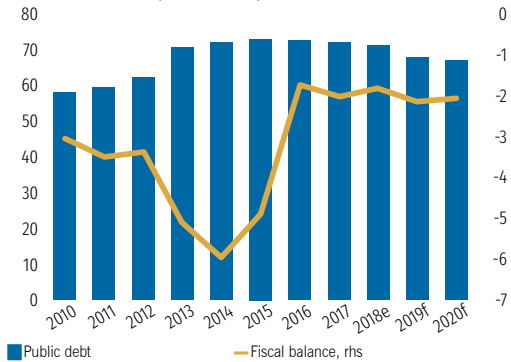
Contribution to GDP growth, percentage points



Source: Instat and World Bank staff projections.

Fiscal consolidation is helping reduce public debt.

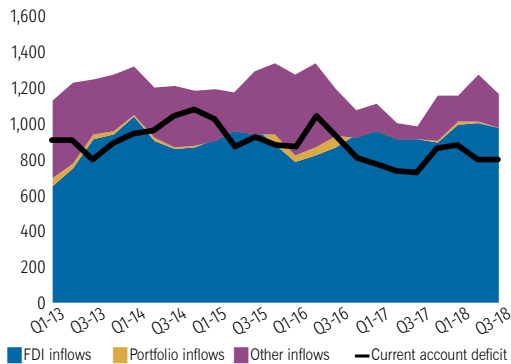
Fiscal balance and public debt, percent of GDP



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

External imbalances were reduced.

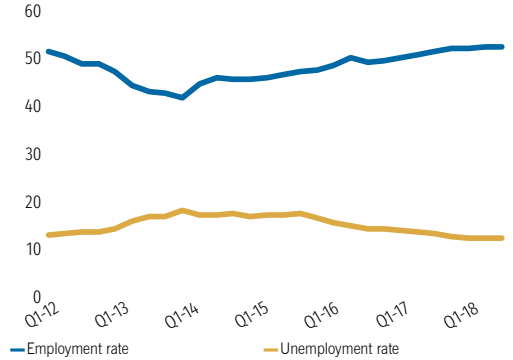
€ million



Source: Bank of Albania.

The labor market improved.

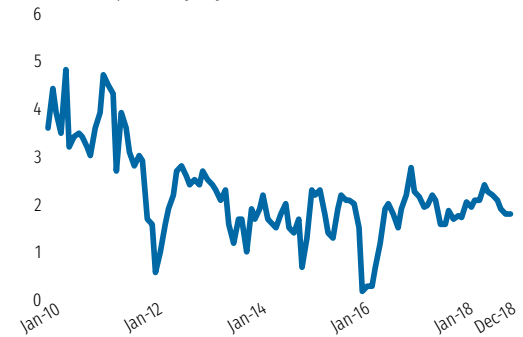
Percent



Source: Instat.

Exchange rate appreciation helped keep inflation low.

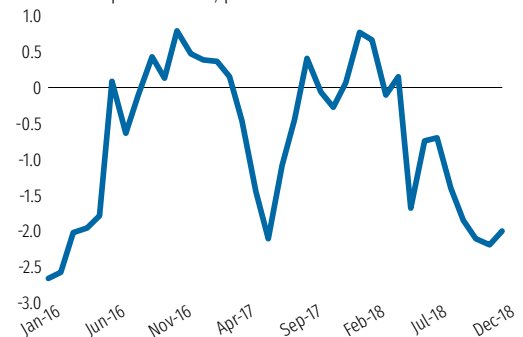
CPI inflation, percent, y-o-y



Source: Instat.

Private sector credit declined.

Credit to the private sector, percent



Source: Bank of Albania.

ALBANIA	2014	2015	2016	2017	2018e	2019f	2020f
Real GDP growth (percent)	1.8	2.2	3.4	3.8	4.2	3.8	3.6
Composition (percentage points):							
Consumption	4.5	-0.9	0.1	2.3	1.9	2.8	2.5
Investment	-0.9	0.7	1.4	2.2	1.0	1.3	0.9
Net exports	-1.8	2.4	1.9	-0.7	1.3	-0.2	0.2
Exports	0.9	0.5	6.5	4.6	3.0	3.3	3.4
Imports (-)	2.7	-1.9	4.6	5.3	1.7	3.5	3.2
Consumer price inflation (percent, period average)	1.6	1.9	1.3	2.0	2.1	2.5	2.9
Public revenues (percent of GDP)	26.3	26.6	27.6	27.7	27.2	27.2	27.1
Public expenditures (percent of GDP)	32.3	31.5	29.4	29.8	29.0	29.4	29.2
Of which:							
Wage bill (percent of GDP)	5.1	5.1	4.6	4.7	4.5	4.6	4.4
Social benefits (percent of GDP)	9.9	9.9	10.3	10.4	10.2	10.4	10.3
Capital expenditures (percent of GDP)	4.3	4.4	4.0	4.4	4.7	4.9	4.8
Fiscal balance (percent of GDP)	-6.0	-4.9	-1.8	-2.0	-1.8	-2.1	-2.1
Primary fiscal balance (percent of GDP)	-3.1	-2.2	0.5	0.0	0.4	0.1	0.1
Public debt (percent of GDP)	66.1	69.1	68.7	67.8	64.6	63.0	62.1
Public and publicly guaranteed debt (percent of GDP)	72.0	72.7	72.3	71.8	68.6	65.8	64.7
Of which: External (percent of GDP)	29.6	34.2	32.6	32.6	32.8	31.9	31.9
Goods exports (percent of GDP)	9.3	7.5	6.6	6.9	7.4	6.2	6.3
Goods imports (percent of GDP)	31.6	29.9	30.9	31.3	30.1	31.6	32.2
Net services exports (percent of GDP)	3.2	5.1	7.4	9.4	9.2	11.8	12.6
Trade balance (percent of GDP)	-19.0	-17.3	-16.8	-15.1	-13.5	-13.6	-13.3
Remittance inflows (percent of GDP)	5.9	5.8	5.7	5.5	5.3	5.3	5.3
Current account balance (percent of GDP)	-10.8	-8.6	-7.6	-7.5	-6.3	-6.4	-6.2
Net foreign direct investment inflows (percent of GDP)	8.1	8.0	8.7	8.6	7.8	6.8	6.8
External debt (percent of GDP)	69.5	74.4	73.4	68.7	62.1	59.8	59.1
Real private credit growth (percent, period average)	-1.3	-1.8	-2.1	-2.3	-3.0	n.a.	n.a.
Nonperforming loans (percent of gross loans, end of period)	22.4	18.2	18.3	13.2	11.1	n.a.	n.a.
Unemployment rate (percent, period average)	17.5	17.1	15.2	13.7	12.3	n.a.	n.a.
Youth unemployment rate (percent, period average)	32.5	33.2	28.9	25.9	23.1	n.a.	n.a.
Labor force participation rate (percent, period average)	53.7	55.7	57.5	58.3	59.4	n.a.	n.a.
GDP per capita, PPP (current international \$)	10,645	10,926	11,276	11,693	n.a.	n.a.	n.a.
Poverty rate at US\$5.5/day, PPP (percent of population)	n.a.	37.4	36.7	35.9	35.2	34.4	33.5

Sources: Country authorities, World Bank estimates and projections.

Note: Youth unemployment rate is for labor force aged 15-29.

Bosnia and Herzegovina

- In 2018 Bosnia and Herzegovina (BiH) maintained steady growth estimated at 3 percent. The pace of growth is projected to pick up slightly in 2019, but this outlook rests largely on a rise in infrastructure investment and the timely formation of new governments and their advancement of structural reforms.
- Modest job creation helped to decrease unemployment slightly, but it is still high.
- Given the time it is taking to form the new government of the Federation of BiH and the BiH Council of Ministers, planned reforms to enhance the efficiency of public investments and to make the tax system and social security contributions more efficient and equitable—critical to sustainable and equitable growth—are likely to be delayed.
- The economic outlook is stable, but vulnerabilities related to both domestic and external factors remain high. Slower-than-expected growth in the EU, tighter financial conditions internationally, and domestic political turmoil and divided views about BiH's program for NATO accession are the main downside risks. To mitigate them will require a faster pace of structural reform.

Recent Economic Developments

In 2018, BiH's economy continued to grow at a stable pace, but it remains highly dependent on consumption. Growth reached an estimated 3 percent in 2018, down slightly by 0.2 percentage points (pp) from 2017. Domestic demand remained the dominant driver, with consumption adding 3.6 pp and investment 0.5 pp. Greater external demand has supported export growth, but imports offset this momentum so that net exports subtracted 1.0 pp from growth. Growth in exports was mainly in the same commodities as a year earlier: mineral products, base metals, chemical products and machinery, which totaled 50.7 percent of export growth; similarly, as in 2017, growth in imports was driven by the same four categories as exports plus transportation equipment—together they explain 47.7 percent of import growth. BiH trade flows clearly need more diversified exports. For production, the main contributors to growth in 2018 were services (2.1 pp), industry (0.9 pp) and agriculture (0.1 pp).

Though trending upward, BiH's employment rate is still low for the Western Balkans. With growth stable over the last three years, there have been modest gains in employment rate, which reached 34.3 percent in 2018. Most jobs created were in industry and services; agricultural employment fell in absolute terms. Combined with a fall in the activity rate, the slight rise in the employment rate reduced the unemployment rate from 20.5 percent in 2017 to 18.4 percent in 2018, though that is still high.² Long-term unemployment went down by nearly 2 pp but is still at 80 percent. The minimal improvements in the labor market highlights the need for BiH to address structural rigidities if it is to stimulate private sector job creation and reduce disincentives to employment and labor market participation.

Prices continued to rise in 2018. Inflation as measured by the consumer price index (CPI), grew by 1.6 percent y-o-y in December 2018, driven by higher prices for transport, tobacco, and rental housing. Core inflation remained

² According to the latest Labor Force Survey (2018).

low. Given that growth in nominal salaries was 4.9 percent y-o-y, the effect on real incomes was positive.

The fiscal position is estimated to have returned to deficit in 2018. The BiH 2018 fiscal deficit was an estimated 0.5 percent of GDP, compared to a surplus in 2017 of 2.6 percent.³ In 2018, revenues rose due to collection of more in indirect taxes. However, the rise in revenues was offset by higher public spending, mainly current spending related to social benefits, wages (i.e., the one-time increase for demobilized veteran benefits in the Federation and a wage rise in Republika Srpska), and capital projects. Though capital spending went up, it is still not sufficient and there are also long-standing project implementation delays. Total public and publicly guaranteed debt was estimated at 36.7 percent of GDP⁴ (down by 1.3 pp from 2017), of which 29.8 percent of GDP is concessional debt to international financial institutions.

The banking sector is liquid and well-capitalized. Though again declining, the system-wide NPL ratio in Q3 was still a high 9.4 percent. Profitability, however, went down, with return on equity at 11.1 percent in Q3, down from 12.1 percent in Q2 but up from 10.2 percent in 2017 Q4. The capital adequacy ratio is still relatively stable at 15.5 in 2018 (Q3). Capital buffers are within legal requirements.

The current account deficit (CAD) widened slightly in 2018 as both imports and exports started to pick up. It went from 4.7 percent of GDP in 2017 to 4.9 percent. BiH exports, particularly machinery and chemical products,

have a high import content that reduces the positive impact on the CAD of export growth, although the import content has been growing in recent years, even if at a slower rate. Base metals and mineral products represented 51 percent of total exports in 2018, but also 49 percent of total imports, which have 1.6 times more value than exports. The services surplus from transport, travel, construction, and remittances was almost unchanged and 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. Estimated net FDI inflows increased in nominal terms but decreased in terms of GDP by 0.1 pp, financing 42 percent of the CAD.

Outlook and Risks

Economic growth is projected to strengthen gradually to 3.9 percent by 2020, supported mainly by domestic demand. This pickup in growth is hinged on timely formation of a new government and advancement of the BiH Reform Agenda. In the medium term, growth would be driven by higher investment in energy, construction, and tourism, and by higher exports, although demand for imports for infrastructure projects would outpace export growth. While some rebalancing away from public consumption is expected, private consumption is forecast to remain a major driver of growth, driven by steady remittance flows.

The fiscal balance is expected to improve in 2019, rebalancing to capital spending. As the planned construction of highways moves forward, the share of capital spending is expected to grow faster than the average of the previous three years. The share of recurrent

³ See the CBBiH web portal panorama for data on GFS.

⁴ See the CBBiH web portal panorama for debt data.

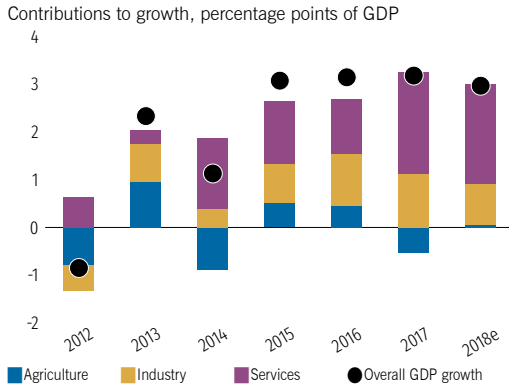
spending is expected to fall in the medium-term, given the authorities' commitment not to increase the wage bill further. Sustaining this commitment will be important to reverse BiH's public expenditure patterns which remain concentrated current spending including wages, pensions and social transfers. In 2019 the stock of public debt should continue to decline, falling to 35.6 percent. However, fiscal risks will remain significant, including from arrears and other SOE-related liabilities.

Central to the BiH reform agenda is addressing persistent unemployment, boosting growth, and maintaining macroeconomic stability.

Although fiscal deficits and debt levels continue to be moderate, the tax burden is high and public spending is inefficient, as evidenced by the poor targeting of benefits. Planned fiscal reforms are designed to reinforce the social contribution system and introduce a progressive income tax. In combination with others, these reforms will help structure a fairer and more growth-enhancing tax system. Provision of a safety net, however, will not be effective if structural rigidities in spending are not addressed—especially the high public wage bill. A strong and sustained commitment is needed to advance reforms in entity governments called for in the Economic Programs. Support from partners can help the authorities to deliver on their challenging reform agenda.

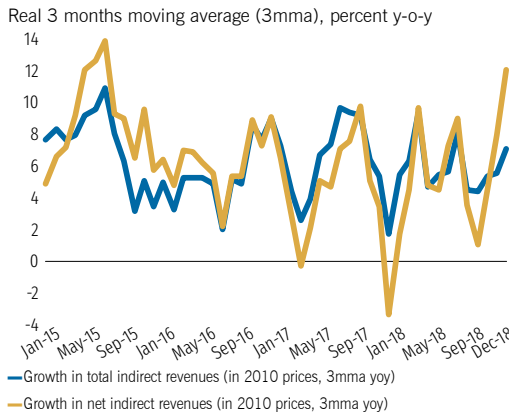
There are notable risks to the outlook, both domestic and external. The main domestic risks are the challenging political environment and the slow pace of structural reform. Externally, delays in NATO accession, slower-than-expected growth in the EU, and tighter financial conditions in global markets are of concern. On the positive side, in 2019 BiH could receive a ruling from the European Commission accepting its candidacy status, which could help to accelerate reforms.

GDP growth slowed moderately in 2018.



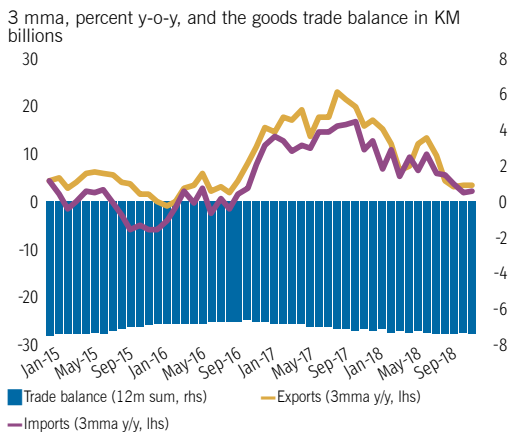
Source: BiH Agency for Statistics, World Bank.

Collection of indirect gross tax revenues improved at year-end.



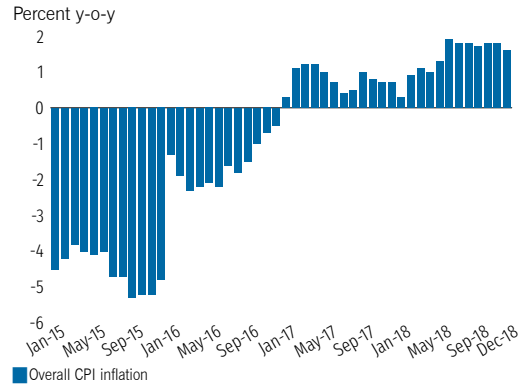
Source: BiH Indirect Tax Office, World Bank.

The deficit in the goods trade continued to widen.



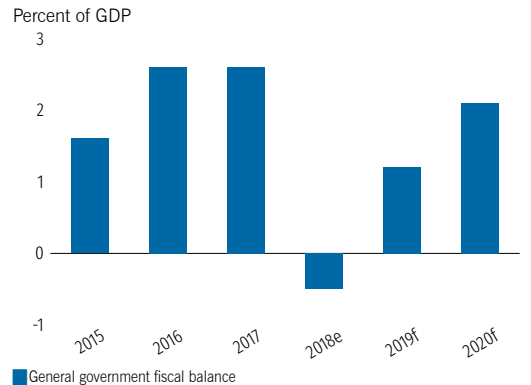
Source: BiH Agency for Statistics, World Bank.

Consumer price inflation stabilized in the second part of 2018.



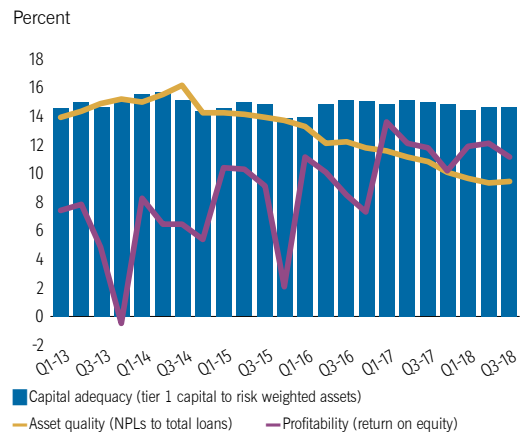
Source: BiH Agency for Statistics, World Bank.

The fiscal balance is expected to remain in surplus in the medium term.



Source: Fiscal authorities, World Bank estimates.

Nonperforming loans in commercial bank portfolios remain high but trending down.



Source: Central Bank of BiH, World Bank calculations.

BOSNIA AND HERZEGOVINA	2014	2015	2016	2017	2018e	2019f	2020f
Real GDP growth (percent)	1.1	3.1	3.1	3.2	3.0	3.4	3.9
Composition (percentage points):							
Consumption	n.a.	n.a.	n.a.	n.a.	3.6	2.7	3.1
Investment	n.a.	n.a.	n.a.	n.a.	0.5	0.9	0.8
Net exports	n.a.	n.a.	n.a.	n.a.	-1.0	-0.2	0.0
Exports	n.a.	n.a.	n.a.	n.a.	1.7	1.8	1.4
Imports (-)	n.a.	n.a.	n.a.	n.a.	2.7	2.0	1.3
Consumer price inflation (percent, period average)	-0.9	-1.0	-1.6	0.8	1.4	1.1	1.1
Public revenues (percent of GDP)	43.7	43.1	42.7	43.0	43.8	42.0	41.4
Public expenditures (percent of GDP)	45.8	42.5	41.5	40.4	44.3	41.7	40.2
Of which:							
Wage bill (percent of GDP)	11.9	11.5	11.0	10.6	11.0	10.6	10.2
Social benefits (percent of GDP)	17.0	16.5	15.9	15.2	18.0	16.7	16.2
Capital expenditures (percent of GDP)	4.3	2.0	2.4	2.4	4.9	4.2	3.9
Fiscal balance (percent of GDP)	-2.0	0.7	1.2	2.6	-0.5	0.3	1.2
Primary fiscal balance (percent of GDP)	-1.2	1.6	2.1	2.6	0.5	1.2	2.1
Public debt (percent of GDP)	42.0	41.9	42.4	36.1	35.1	34.0	33.2
Public and publicly guaranteed debt (percent of GDP)	43.1	43.2	43.3	38.0	36.7	35.6	34.8
Of which: External (percent of GDP)	34.7	35.0	35.9	30.6	29.8	29.0	28.4
Goods exports (percent of GDP)	25.0	25.2	25.7	29.8	29.9	31.2	32.1
Goods imports (percent of GDP)	53.8	50.3	49.4	53.3	53.5	55.3	56.5
Net services exports (percent of GDP)	6.1	6.7	7.0	7.2	7.4	7.7	7.7
Trade balance (percent of GDP)	-22.7	-18.5	-16.7	-16.3	-16.2	-16.4	-16.6
Remittance inflows (percent of GDP)	10.3	9.0	9.1	8.4	8.3	8.3	8.0
Current account balance (percent of GDP)	-7.3	-5.3	-4.7	-4.7	-4.9	-5.3	-5.5
Net foreign direct investment inflows (percent of GDP)	2.9	1.8	1.7	2.1	2.0	2.1	2.1
External debt (percent of GDP)	77.1	72.2	71.0	67.6	70.5	67.4	66.7
Real private credit growth (percent, period average)	4.1	2.3	4.7	5.3	5.1	n.a.	n.a.
Nonperforming loans (percent of gross loans, end of period)	14.0	13.7	11.8	10.0	n.a.	n.a.	n.a.
Unemployment rate (percent, period average)	27.5	27.7	25.4	20.5	18.4	n.a.	n.a.
Youth unemployment rate (percent, period average)	62.7	62.3	54.3	45.8	38.8	n.a.	n.a.
Labor force participation rate (percent, period average)	43.7	44.1	43.1	42.6	42.1	n.a.	n.a.
GDP per capita, PPP (current international \$)	11,164	11,526	12,173	12,875	13,200	13,775	14,258
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.

Note: Nonperforming loans show year-to-date actuals.

Kosovo

- In 2018 the economy continued to grow at an estimated 4.2 percent, driven by higher service exports and private and public investment.
- The 2018 fiscal deficit is estimated at 2.7 percent of GDP, (in line with the fiscal rule) and was driven by higher infrastructure spending.
- Kosovo continues to experience economic growth without job creation. The recovery in employment in the second half could not compensate for the job losses in the first half, despite strong economic growth.
- The outlook is positive, with average growth projected at 4.5 percent through 2020, but is subject to risks from political uncertainty, proliferation of untargeted social benefits, the new law on public salaries, and dilatory execution of infrastructure investments.

Recent Economic Developments

Growth in 2018 remained solid at 4.2 percent.

Public and private investment contributed 5.7 percentage points (pp) to growth, up from 1.5 pp in 2017. Private investment continued to increase, through higher investment lending and partly by a recovery of FDI in the second half of the year. Public investment also accelerated, financed by privatization proceeds. Consumption contributed 2 pp, drawing on higher public wages, remittances, and consumer lending. Net exports subtracted 3.5 pp from real GDP growth; imports were higher to meet the demand for capital goods. Exports added a mere 1.8 pp to growth due to lower exports of base metals, but there was encouraging growth in tourism services, due mainly to higher spending by the Kosovar diaspora.⁵

Higher growth did not translate into job creation.

The recovery in the number of employed during the second half of 2018 could not compensate for the job losses in the first half. Employment rate declined by 1 pp in 2018 and employment at 28.8 percent remains low. The unemployment rate also

declined by 1 pp in 2018, however this was driven by a decrease in labor force participation by 1.9 pp. Youth unemployment increased by 2.6 pp y-o-y, adding to social pressures. Labor force participation is also chronically low at 40.9 percent as a share of working age population.

The fiscal deficit was 2.7 percent in 2018 but was in line with the fiscal rule.⁶

Higher growth supported a rise in revenues of 4.5 percent, despite the lower than expected performance of excise tax revenues. Indirect tax revenues grew by 2.2 percent thanks to growth in VAT revenue of 8.1 percent, and nontax revenues grew by 5.6 percent. Direct tax revenues grew 12.1 percent, as corporate income tax collection went up 15.7 percent and personal 11.1 percent. Spending went up 9.8 percent driven by an 8.8 percent increase in current expenditure and 13 percent growth in capital expenditures which pushed up capital spending to 8.1 percent of GDP. The absorption of IFI-financed capital investments under the investment clause, however, was weak for the second consecutive year. While overall capital

5 2018 GDP figures are estimate; fourth quarter 2018 GDP statistics will be released on April 4, 2019.

6 Overall fiscal balance per fiscal rule definition excludes PAK-financed capital spending; and IFI financed capital spending through the investment clause.

spending increased, capital spending declined in nominal terms by 4.3 percent, not counting the spending financed by privatization proceeds. This allowed for reallocation of spending for underbudgeted items. Spending for war veterans' benefits in 2018 exceeded the cap of 0.7 percent of GDP set by law. Increases in social transfers and spending on goods and services were the main reasons for growth in current expenditure: social transfers-including veteran's benefits, were up 12 percent and goods and services spending by 9.6 percent. The 2018 deficit was 2.7 percent of GDP, but the deficit subject to the Kosovo's fiscal rule definition was only 1.3 percent as it excludes capital spending financed by privatization receipts. Public and publicly guaranteed debt reached almost 18 percent of GDP by end-2018.

Credit growth fueled both investment and consumption. By year-end nonperforming loans (NPLs) were down to 2.7 percent of total loans. Improved market conditions and lower interest rates again spurred growth in private credit, by 10.8 percent. Loans to households grew by 11.2 percent, and deposits grew by 8.7 percent.

For most of 2018 consumer prices went up only slightly but the pace began to accelerate at the end of the year. Average inflation was only 1.1 percent but also picked up late in the year: In December, y-o-y inflation was 2.9 percent due to increases in prices for fuel, food, tobacco, alcohol, and transportation. Tariffs imposed on goods imports from Serbia and Bosnia and Herzegovina may have contributed to the rise in consumer price inflation.

The current account deficit (CAD) widened to 8.4 percent of GDP as higher service exports could not compensate for the surge

in investment-driven imports. Remittances and FDI inflows continued to finance the CAD, even though net FDI inflows were down by 10.5 percent in 2018. Most FDI (85.8 percent) continued to be in real estate, driven by investments from members of the diaspora in Switzerland and Germany.

Outlook and Risks

High capital spending is expected to keep economic growth strong in 2019, with a growth forecast of 4.4 percent, primarily driven by higher investment, both public and private. Several large public investment projects are expected to be commence implementation, notably railway and regional road projects financed by IFIs. Private investment is expected to increase, driven by favorable lending conditions and by FDI in the energy sector and in real estate. However, given the large number of new entrants into the labor market, higher public spending will not be sufficient to significantly reduce chronically high unemployment.

The positive outlook is vulnerable to domestic political uncertainty, less IFI investment than expected, and slower growth in the EU. Moreover, the expansion of public investment as a driver of growth through 2020 may suffer from Kosovo's limited capacity to carry out the investment program.

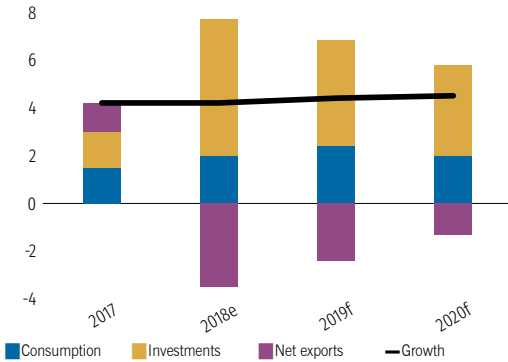
Fiscal risks are on the rise. The new law on public salaries, if not regulated through prudent secondary legislation, could result in higher deficits that the fiscal rules or lead to a deterioration in the composition of public spending. Because the law comes into force only at the end of 2019, the full impact

will not be felt until 2020. Higher wages in the public sector can also put pressure on private sector wages, which could undermine the competitiveness of Kosovar exporters. Additional fiscal risks might arise from increases in untargeted social protection spending. By 2025 public and publicly guaranteed debt could reach 30 percent of GDP if growth in recurrent spending continues to exceed growth in revenue.

To counterbalance the risks, reforms should be directed to preserving fiscal stability; shifting resources toward tradable sectors; investing more in education and health to realize the benefits of the demographic dividend and to improve skills; engaging and employing youth and women by reducing disincentives to labor market participation; increasing productivity by addressing the regulatory burden on businesses, improving the judicial system; addressing corruption; and building up environmental sustainability.

Investment and consumption were the main reasons growth accelerated in 2018.

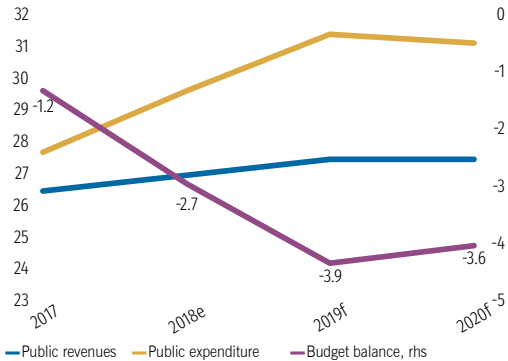
Growth contributions, percent



Source: Statistics Agency of Kosovo and World Bank.

Despite fiscal pressures, the overall budget balance (right) stayed within the fiscal rule.

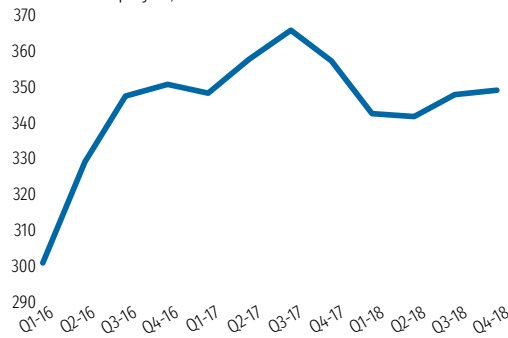
Percent of GDP



Source: Ministry of Finance and World Bank.

For three quarters employment declined quarters but started recovering in Q3.

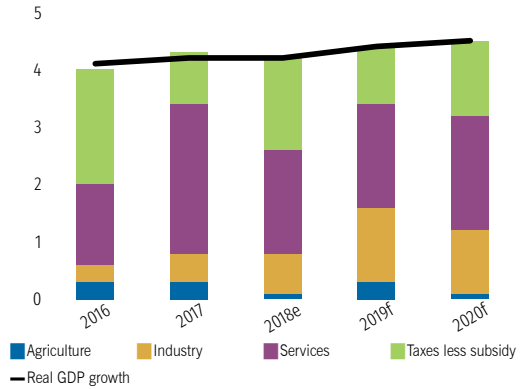
Number of employed, in thousands



Source: Statistics Agency of Kosovo, LFS.

Services were the main engine of growth in 2018.

Growth contributions, percent



Source: Statistics Agency of Kosovo and World Bank.

Consumer price inflation accelerated late in 2018 and into 2019.

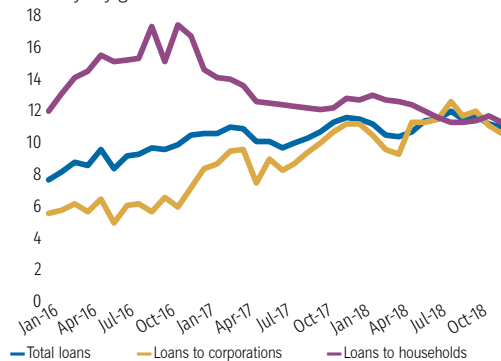
Percent y-o-y growth



Source: Kosovo Agency of Statistics and World Bank.

Credit growth continues to spur private investment.

Percent y-o-y growth



Source: Central Bank.

KOSOVO	2014	2015	2016	2017	2018e	2019f	2020f
Real GDP growth (percent)	1.2	4.1	4.1	4.2	4.2	4.4	4.5
Composition (percentage points):							
Consumption	3.8	2.5	4.7	1.5	2.0	2.4	2.0
Investment	-1.4	2.9	2.1	1.5	5.7	4.4	3.8
Net exports	-1.2	-1.3	-2.7	1.2	-3.5	-2.4	-1.3
Exports	2.9	0.5	0.5	4.0	1.8	2.0	2.4
Imports (-)	4.1	1.8	3.2	2.8	5.2	4.4	3.7
Consumer price inflation (percent, period average)	0.4	-0.5	0.3	1.5	1.1	2.6	1.9
Public revenues (percent of GDP)	24.0	25.1	26.3	26.4	26.9	27.4	27.4
Public expenditures (percent of GDP)	26.6	27.1	27.7	27.6	29.6	31.3	31.0
Of which:							
Wage bill (percent of GDP)	8.7	9.0	9.0	8.6	8.8	8.9	8.9
Social benefits (percent of GDP)	5.0	5.4	6.1	6.1	6.3	6.5	6.4
Capital expenditures (percent of GDP)	7.4	7.0	7.2	7.3	8.1	8.8	8.4
Fiscal balance (percent of GDP)	-2.6	-2.0	-1.4	-1.2	-2.7	-3.9	-3.6
Primary fiscal balance (percent of GDP)	-2.4	-1.7	-1.1	-0.9	-2.4	-3.5	-3.2
Public debt (percent of GDP)	10.4	12.7	14.1	15.6	16.9	18.6	20.0
Public and publicly guaranteed debt (percent of GDP)	10.6	12.8	14.4	16.3	17.7	19.3	20.7
Of which: External (percent of GDP)	5.8	6.2	6.2	6.6	6.4	7.1	7.5
Goods exports (percent of GDP)	5.8	5.6	5.1	5.9	5.6	5.7	5.7
Goods imports (percent of GDP)	42.8	41.9	42.8	44.3	46.4	48.3	49.3
Net services exports (percent of GDP)	8.3	7.9	10.5	12.4	11.6	13.1	14.1
Trade balance (percent of GDP)	-28.7	-28.5	-27.2	-26.1	-29.2	-29.4	-29.5
Remittance inflows (percent of GDP)	11.2	11.5	10.5	11.3	11.8	12.0	12.8
Current account balance (percent of GDP)	-6.9	-8.6	-7.9	-6.0	-8.4	-8.9	-10.3
Net foreign direct investment inflows (percent of GDP)	2.2	4.7	2.9	3.4	2.8	4.0	4.5
External debt (percent of GDP)	31.2	33.3	33.2	32.6	33.9	34.2	34.8
Real private credit growth (percent, period average)	3.3	7.8	8.7	8.8	10.1	n.a.	n.a.
Nonperforming loans (percent of gross loans, end of period)	8.5	6.2	4.9	3.1	2.7	n.a.	n.a.
Unemployment rate (percent, period average)	35.3	32.9	27.5	30.5	29.5	n.a.	n.a.
Youth unemployment rate (percent, period average)	61.0	57.7	52.4	52.7	55.3	n.a.	n.a.
Labor force participation rate (percent, period average)	41.6	37.6	38.7	42.8	40.9	n.a.	n.a.
GDP per capita (US\$)	4,055	3,745	3,698	3,957	4,108	4,442	4,619
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.

Montenegro

- In 2018 strong investment activity, another record-high tourism season, and a surge in industrial production drove up GDP growth to an estimated 4.4 percent.⁷
- The labor market responded to higher economic growth, with the unemployment rate hitting a historic low and participation and employment rates reaching historic highs.
- Gradual fiscal consolidation is reducing the deficit, but because of higher than planned growth in public spending, the objective of balancing the budget is not likely to be met until 2020.
- The financial sector has so far been stable during the ongoing resolution process for two ailing banks.
- The outlook is positive but with significant downside risks, both domestic and external. Mitigating the risks will require firm commitment to fiscal consolidation, rapid resolution of vulnerable banks in accordance with the relevant laws and regulations, and an acceleration of structural reforms.

Recent Economic Developments

In 2018, economic growth in Montenegro was again better than expected. GDP growth is estimated to have been 4.4 percent, supported by higher private and public investment and another strong tourism season: foreign tourist arrivals were up 10.6 percent year-on-year (y-o-y). Because of strong employment growth, an easing of credit, and the influx of tourists, consumption contributed an estimated 3 percentage points (pp) to GDP growth. Heavier investment in tourism and energy and acceleration of construction of the Bar-Boljare highway fueled total investment, which contributed an estimated 5.8 pp to growth. Because many investments are highly import-dependent, negative net exports continued to weigh on economic activity, subtracting 4.4 pp from growth. Meanwhile, a surge in industrial production was led by energy, where production grew by 62.1 percent, allowing

Montenegro to export more electricity. By year-end, manufacturing was ahead of 2017, but mining contracted. A surge in construction financed by investments in energy, tourism, and transport recorded 25 percent growth for the sector and retail trade contributed another 3.4 percent to growth.

The labor market improved in 2018. Employment grew by 4.3 percent, mostly in construction, tourism, services, and the public sector. The registered unemployment rate was 17.8 percent in December 2018, down from 22.4 percent a year earlier, with a youth unemployment rate about double the national average. The survey-based unemployment rate, which is lower because it better captures informal employment, declined to a historic low of 15.2 percent in 2018. The decline was more pronounced for women; as a result, the unemployment rates for women (15.1 percent) and men (15.2 percent) are quite close. Moreover, there were record highs in the survey-based activity rate (56 percent) and the employment rate (47.5 percent). Strong economic activity has also had a positive effect

⁷ During the process of preparing this report the Statistic Office of Montenegro issued a new GDP estimates for 2018. Based on those preliminary estimates growth in 2018 reached 4.9 percent due to higher than previously estimated private consumption.

on youth unemployment, which declined to 29.7 percent. But despite the strong economic activity in 2018 nominal wages increased by only 0.1 percent while real wages declined by more than 2 percent.

The external deficit widened in 2018 to an estimated 17.1 percent of GDP. Solid growth of exports of goods and services was led by rising exports of tourism, transport, electricity, and chemical products. Export growth, however, was outpaced by real import growth, largely because investment was highly import-dependent. Leading the import surge were machinery and equipment, oil, steel, iron, minerals, and furniture. The primary income account surplus declined because of higher dividend and interest payments. In 2018, net FDI inflows declined from 11.3 percent of GDP in 2017 to 7.1 percent as FDI outflows surged because of repayment of intercompany debt and government repurchases of shares of the power utility company. By December foreign exchange reserves had risen to €1.1 billion, covering 5.2 months of merchandise imports. By yearend, external debt had reached an estimated 168 percent of GDP.

Higher inflation in 2018 eroded real gross wages. Average annual CPI inflation rose from 2.4 percent in 2017 to 2.6 percent, primarily driven by an increase in the VAT rate. Higher excises and the cost of oil and pharmaceutical products pushed up producer prices by 1.7 percent. With nominal wages flat, inflation caused real gross wages to decline by more than 2 percent.

Vulnerabilities in the financial sector remain after a protracted resolution of ailing banks. Three banks have faced vulnerabilities since 2015, leading to the bankruptcy of one

of them, and the establishment of interim administration on a second one, along with a moratorium on deposit withdrawals. While this situation has not translated into a significant decrease in deposits, a protracted resolution has the potential to erode confidence from depositors and investors and increase the cost of resolution. On a systemic basis, key figures of the financial sector are largely stable. The capital adequacy ratio of 16.5 percent as of October 2018 is above the 10 percent regulatory minimum. Credit to the private sector grew by 9.4 percent in 2018, mostly driven by lending to households. Deposits grew by 5.9 percent y-o-y from both corporate and households. Non-performing loans (NPLs) increased somewhat in absolute terms (by 3 percent) in 2018 but less than total loans so that the share of NPLs of total loans declined to 7.7 percent in December 2018 from 8.0 percent a year earlier.⁸ The banking sector is somewhat moderately profitable overall, but profitability is unevenly distributed among banks, and net interest margins narrowed compared to 2017.

The gradual fiscal consolidation program has reduced the deficit, but higher than planned public spending is delaying the goal of balancing the budget. After reaching 5.6 percent of GDP in 2017, it is estimated that the fiscal deficit fell to 3.8 percent in 2018. Revenue growth of 10.1 percent (1.1 pp of GDP) was supported by higher VAT, income tax, and non-tax revenues, though excise revenues dropped. Public spending went up by 5.5 percent—but declined by 0.8 pp as a share of GDP given higher nominal GDP growth—due to higher capital spending and spending

⁸ NPLs include interest receivables and accrued fees, as reported by the Financial Stability Reports. The Central Bank of Montenegro does not include those items and reports a share of NPLs of total loans of 6.9 percent in December 2018, down from 7.29 a year earlier.

on goods and services. Public sector wages also went up due to additional hiring early in 2018. Despite the declining fiscal deficit, it is estimated that public debt peaked at 71 percent of GDP in 2018 and public and publicly guaranteed debt is now 75.4 percent.

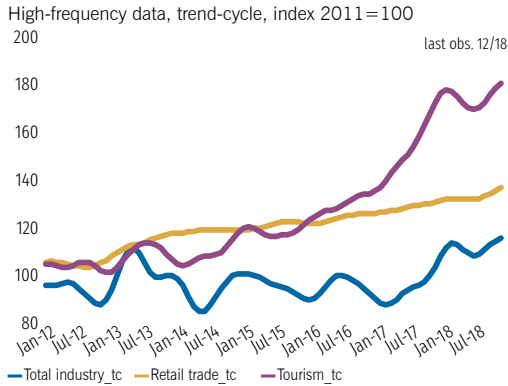
Outlook and Risks

In 2019–20, the Montenegrin economy is expected to grow on average by 2.7 percent.

Growth is expected to slow in 2019/20 as private investment levels off after the strong increase in 2018 and with a gradual phasing-out of large infrastructure projects, such as the submarine electricity transmission cable between Montenegro and Italy and the first phase of the Bar-Boljare highway. Consumption and employment are expected to moderate somewhat in 2019 due to the impact of fiscal consolidation and the implementation of the government's ambitious plan to reduce public administration staff. The growth slowdown will also be in part a response to the political and overall uncertainty weighing on consumption and investments. External imbalances are projected to moderate gradually in 2020 as investment-dependent infrastructure projects are finalized.

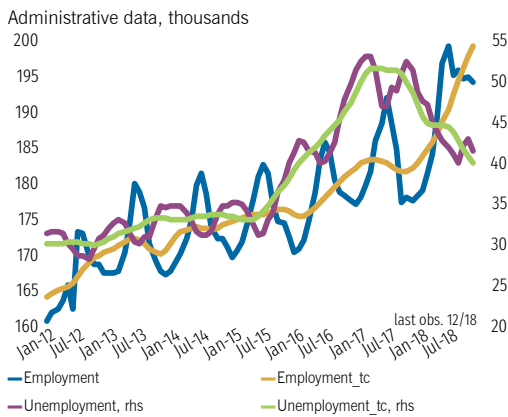
Though the outlook is generally positive, there are significant downside risks. Among external factors that could affect Montenegro are weaker growth in the EU, tightening of financial markets, and a heightening of trade tensions. Among emerging domestic risks are increasing political uncertainty, further motorway cost overruns, the vulnerability of some smaller banks, and possible pressures on public spending in the run-up to the 2020 elections. Mitigating these risks will require the government's firm commitment to the fiscal consolidation plan and the implementation of critical structural reforms in the labor market, social sectors, and public administration. It will also be necessary to reinforce the public institutions that enforce fair market competition to ensure that no one benefits from special treatment which would force entrepreneurs to compete by innovating. This will not only mitigate the risks but also help unleash private sector-led growth in Montenegro.

Another record-breaking tourism season and strong industrial production led by energy...



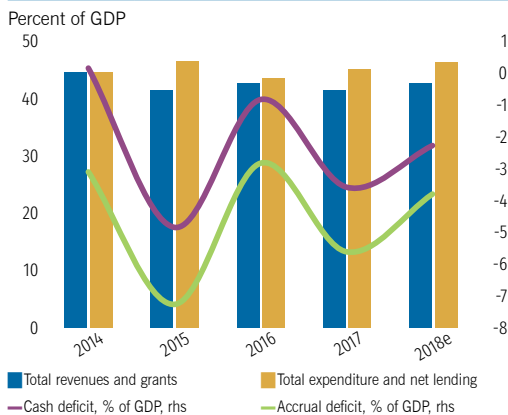
Source: MONSTAT data, tc = trend cycle.

Strong growth is finally reflected in labor market performance.



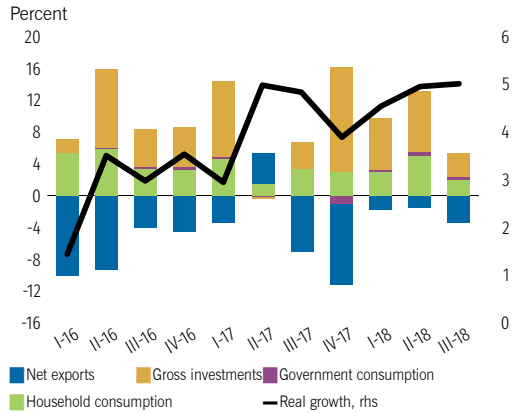
Source: MONSTAT data, tc = trend cycle.

Although the government deficit fell by an estimated 1.8 percentage points compared to 2017...



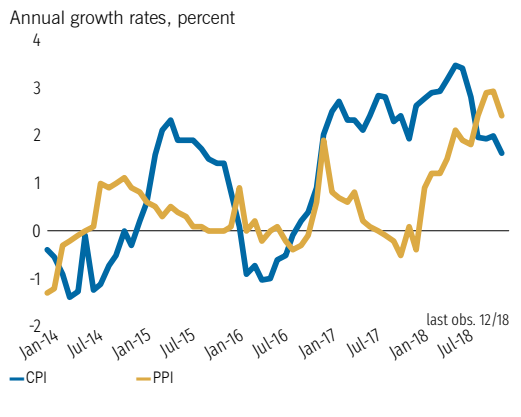
Source: MoF data.

...supported robust growth, which is mainly led by intensified investment activity.



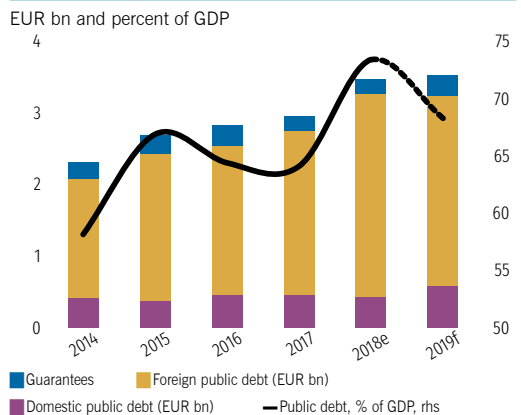
Source: MONSTAT.

Inflationary pressures eased in the second half of 2018 due to lower excises on tobacco and oil prices.



Source: MONSTAT data.

...public debt rose to a peak of 71 percent of GDP.



Source: MoF data.

MONTENEGRO	2014	2015	2016	2017	2018e	2019f	2020f
Real GDP growth (percent)	1.8	3.4	2.9	4.7	4.4	2.9	2.4
Composition (percentage points):							
Consumption	2.6	2.2	4.5	3.0	3.0	1.5	1.9
Investment	0.5	1.9	6.3	7.3	5.8	2.8	-1.2
Net exports	-1.3	-0.7	-7.9	-5.6	-4.4	-1.4	1.8
Exports	-0.3	2.2	2.3	0.7	2.6	1.5	1.8
Imports (-)	1.0	2.9	10.2	6.3	7.0	2.8	0.1
Consumer price inflation (percent, period average)	-0.7	1.5	-0.3	2.4	2.6	2.0	1.9
Public revenues (percent of GDP)	44.6	41.5	42.5	41.4	42.5	42.5	41.8
Public expenditures (percent of GDP)	47.7	48.8	45.3	47.0	46.2	45.4	41.6
Of which:							
Wage bill (percent of GDP)	13.5	12.9	12.7	12.3	11.7	11.7	11.7
Social benefits (percent of GDP)	15.1	13.9	14.6	13.0	12.1	11.6	11.5
Capital expenditures (percent of GDP)	6.1	8.7	4.2	8.3	8.5	9.2	6.9
Fiscal balance (percent of GDP)	-3.1	-7.3	-2.8	-5.6	-3.8	-3.0	0.2
Primary fiscal balance (percent of GDP)	-0.9	-4.9	-0.7	-3.2	-1.8	-0.9	2.0
Public debt (percent of GDP)	59.9	66.2	64.4	64.2	70.8	67.2	64.3
Public and publicly guaranteed debt (percent of GDP)	67.1	73.7	71.4	70.0	75.4	71.6	68.6
Of which: External (percent of GDP)	47.9	55.7	52.8	53.4	61.2	55.0	51.9
Goods exports (percent of GDP)	10.3	9.1	8.9	8.9	9.5	9.8	10.1
Goods imports (percent of GDP)	50.1	49.5	50.8	52.2	53.9	53.1	51.1
Net services exports (percent of GDP)	20.0	21.8	19.4	19.8	20.4	19.5	19.1
Trade and services balance (percent of GDP)	-19.8	-18.6	-22.5	-23.4	-24.1	-23.7	-21.9
Remittance inflows (percent of GDP)	4.2	4.1	3.7	3.7	3.8	3.4	3.3
Current account balance (percent of GDP)	-12.4	-11.1	-16.2	-16.1	-17.1	-17.1	-14.9
Net foreign direct investment inflows (percent of GDP)	10.2	17.1	9.4	11.3	7.1	8.7	8.4
External debt (percent of GDP)	162.3	171.0	162.5	160.5	168.3	162.1	159.0
Real private credit growth (percent, period average)	-1.5	0.3	3.5	4.4	5.9	n.a.	n.a.
Nonperforming loans (percent of gross loans, end of period)	16.8	13.4	11.1	8.0	7.7	n.a.	n.a.
Unemployment rate (percent, period average)	18.0	17.6	17.7	16.1	15.2	15.4	15.0
Youth unemployment rate (percent, period average)	35.8	37.6	35.9	31.7	29.7	n.a.	n.a.
Labor force participation rate (percent, period average)	52.7	53.7	54.5	54.7	56.0	n.a.	n.a.
GDP per capita, PPP (current international \$)	15,371	16,337	17,866	19,352	19,584	19,819	20,057
Poverty rate at US\$5.5/day, PPP (percent of population)	4.8	4.6	4.2	4.4	4.8	4.7	4.6

Sources: Country authorities, World Bank estimates and projections.

Note: Nonperforming loans show year-to-date actuals (including interest and accruals).

North Macedonia

- Growth rebounded to 2.7 percent in 2018, driven by consumption and net exports; and investment began a recovery.
- Unemployment fell to a historical low, and wage pressure continues, led by labor shortages in some sectors.
- The fiscal deficit narrowed in 2018 as revenue grew and capital spending was significantly under-executed. Nevertheless, public debt increased.
- As the political outlook improved, the emphasis should be on economic reforms to reignite the EU convergence process.

Recent Economic Developments

In 2018 the economy grew by 2.7 percent.

Supported by consumption and net exports, economic activity picked up in 2018 after stagnating in 2017. Private consumption was the main driver of growth, contributing 2.4 percentage points (pp) because of rises in employment, wages, and lending to households. Net exports, mainly FDI-related, contributed 1.7 pp. The remaining 0.8 pp. came from government consumption as investments deducted from growth 2.2 pp. On the production side, wholesale and retail trade and transportation services were the main drivers of growth, contributing 2.3 pp. The manufacturing contribution of 0.6 pp was driven by higher production, mainly of motor vehicles and electric machinery, by foreign-owned firms and by domestic producers of, for example, food and beverages, pharmaceuticals, and basic and fabricated metal products. Construction rebounded from October, adding 0.02 pp to growth, thanks to the launch of public investment projects and a continued recovery of private investment.

The labor market again improved in 2018.

Employment grew by 2.5 percent y-o-y in 2018. Most of the new jobs created were

in manufacturing, transport and storage, and professional services. Even though the employment rate improved to 45.1 percent in 2018, more than half of working-age population is still either unemployed or not looking for work. The unemployment rate fell to a historical low in 2018 averaging 20.7 percent throughout the year.

Wage pressures continue to be high in labor-intensive sectors.

The higher mandatory minimum wage continued to put pressure on labor-intensive industries, which requested temporary government support to deal with the increased labor cost. Led by agriculture, manufacturing, trade, and the public sector, real wage growth was 4.4 percent in 2018—more than double the 2017 level. Low-wage labor-intensive sectors saw real wages grow by over 10 percent in 2018, far exceeding the growth in labor productivity over the past several years. Further mandated wage increases may erode the competitiveness of low-value-added industries.

In 2018 external imbalances improved.

The current account deficit (CAD) declined to 0.3 percent of GDP in 2018, compared to 1 percent in 2017. The continued solid export performance of FDI-related industries

like motor vehicles and electrical machinery was supplemented by growth of exports in such traditional products as iron and steel, and furniture. This helped to bring down the goods trade deficit to 16.2 percent of GDP. Net services exports surplus remained solid at 3.3 percent of GDP, driven by transport and services for processing manufactured goods. Though net private transfer inflows continued increasing, they were more than sufficient to cover the entire goods and services deficit. Net FDI inflows picked up in the second half of the year, reaching 5.8 percent of GDP in 2018, due to significant investments coming from UK. Gross external debt, excluding central bank transactions, increased in September to 77.6 percent of GDP (up 4.5 pp y-o-y), reflecting the January 2018 issuance of Eurobonds.

Credit growth increased in 2018. Household credit grew by 10.3 percent and corporate lending to the private sector accelerated from 2.3 percent in 2017 to 4.5 percent in 2018 as investment picked up. Lending should further increase because bank assets have improved; corporate NPLs declined from 9.8 percent in 2017 to 7.8 percent in 2018, and total NPLs from 6.1 percent to 5.1 percent. The loan-to-deposit ratio was kept at 86.2 percent, suggesting that banks have additional space to lend more. A survey of credit activity found that in 2018 credit requirements had gone down and corporate credit demand had gone up, implying that there is room to expand corporate lending.

Monetary policy was even more accommodative than it had been in 2017. In 2018, in three steps the Central Bank lowered the key interest rate by 25 bps, to a historic low of 2.5 percent. The easing was based on

favorable developments in the foreign exchange market, moderate inflation, and continued solid deposit growth. Inflation in 2018 was just 1.5 percent, although prices were higher for beverages and energy (including oil). Core inflation in December 2018 was 1.4 percent.

Revenue growth and under-execution of capital investments brought the fiscal deficit down in 2018. General government revenues rose 4.9 percent, tracking rises in social contributions, excises, and corporate and personal income tax revenues. Net VAT revenues also increased, despite a surge in refunds to clear arrears to businesses. Spending went down by 0.4 percent because the historically largest drop in capital spending made up for higher current spending by 4.6 percent caused by a surge in social transfers and higher subsidies to firms. The general government deficit declined from 2.7 percent in 2017 to 1.8 percent. (Adding in the financing of the Public Enterprise for State Roads raises the deficit to an estimated 2.3 percent of GDP.)

Although the deficit was lower, public debt increased. Public and publicly guaranteed (PPG) debt increased from 47.7 percent in 2017 to 48.4 percent. The increase is due to issuance of a new Eurobond—a 7-year €500 million bond at 2.75 percent (the best terms ever)—that covered government borrowing requirements for 2018 with a reserve for early 2019. Meanwhile, guaranteed debt declined, from 8.3 to 8.0 percent of GDP, as disbursement of the Chinese loan for highway construction slowed.

Outlook and Risks

The economic outlook is positive, and growth is expected to gradually rise to 3.2 percent in 2020. The resolution of the name issue is expected to accelerate EU accession negotiations, strengthening investor confidence, and stimulating growth in the next few years. Large infrastructure projects, in particular roads, and the lifting of the moratorium on local government issuance of building permits will further boost investments. Consumption is expected to remain a stable source of growth, sustained by rises in employment, wages, and household lending. Net exports, especially those that are FDI-related, are expected to contribute positively to growth.

With the political outlook improved, emphasis should now turn to economic reforms. The main challenges to growth will be the low and declining productivity of local firms, weak state institutions, low human capital, a mismatch between skills and the evolving labor market demands of a modern economy, and policy barriers to competition and investment. The more competitive legal framework for businesses has yet to translate into a vibrant private sector that drives growth and jobs.

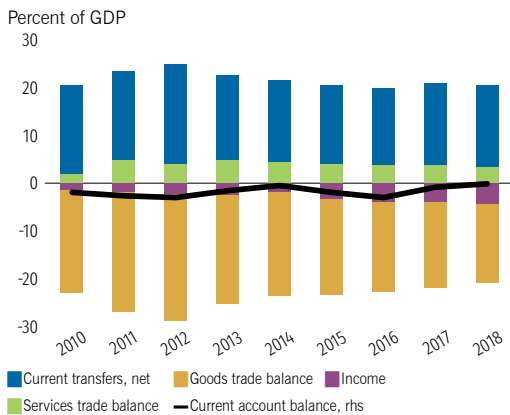
More efficient public spending and a broader tax base would help stabilize public debt and rebuild fiscal buffers against future shocks. In the government baseline fiscal scenario, by 2020 the PPG debt-to-GDP ratio is expected to rise to 54.4 percent, which underscores the need for strong and frontloaded structural reforms to stabilize debt.

Economic growth strengthened during 2018...



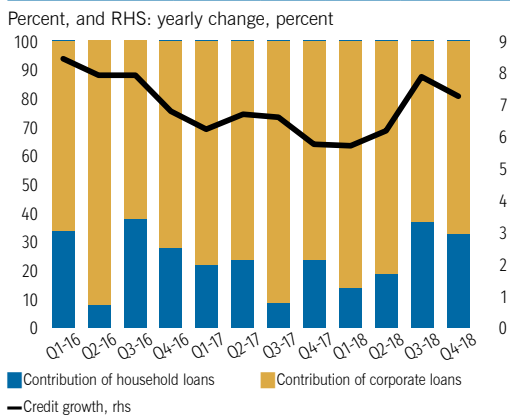
Source: State Statistics Office.

The external deficit was kept low by rising exports.



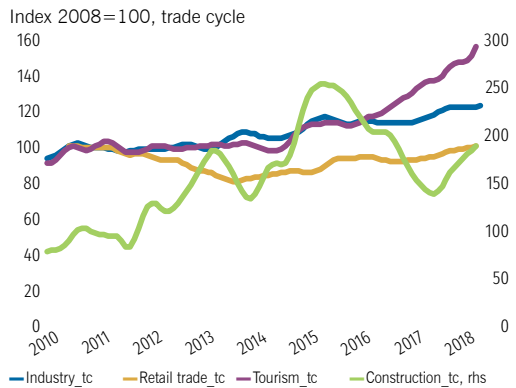
Source: National Bank.

Corporate lending recovered in 2018.



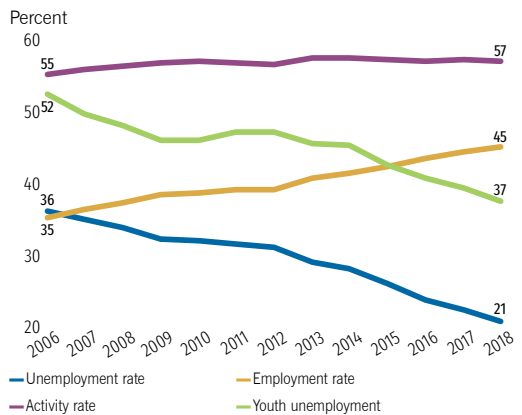
Source: National Bank.

...and was broad-based.



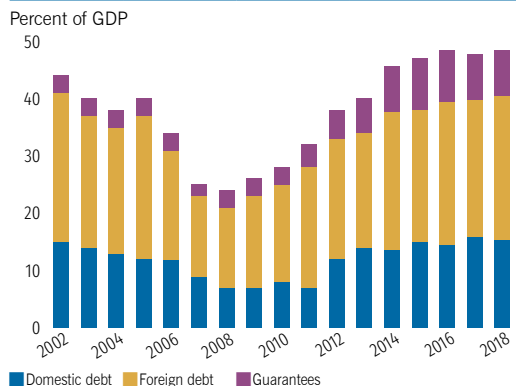
Source: State Statistics Office and World Bank calculations.

A brighter labor market brought unemployment to a historic low.



Source: State Statistics Office.

Although the deficit declined, public debt went up slightly.



Source: Ministry of Finance and World Bank estimates.

NORTH MACEDONIA	2014	2015	2016	2017	2018	2019f	2020f
Real GDP growth (percent)	3.6	3.9	2.8	0.2	2.7	2.9	3.2
Composition (percentage points):							
Consumption	2.1	3.5	2.0	0.1	3.2	1.9	1.6
Investment	2.8	2.9	3.9	0.7	-2.2	1.1	1.3
Net exports	-1.3	-2.5	-3.2	-0.5	1.7	0.0	0.2
Exports	7.3	4.2	4.7	4.5	9.1	5.0	5.7
Imports (-)	8.6	6.7	7.9	5.0	7.4	5.0	5.5
Consumer price inflation (percent, period average)	-0.2	-0.3	-0.2	1.3	1.5	1.8	1.9
Public revenues (percent of GDP)	29.7	31.0	30.6	31.0	30.2	32.2	32.2
Public expenditures (percent of GDP)	33.9	34.4	33.2	33.9	32.0	35.2	34.5
Of which:							
Wage bill (percent of GDP)	7.0	7.0	6.8	6.6	6.4	6.6	6.4
Social benefits (percent of GDP)	14.9	14.8	15.0	15.4	15.2	15.9	15.6
Capital expenditures (percent of GDP)	4.2	4.2	3.8	4.2	2.5	4.3	4.3
Fiscal balance (percent of GDP)	-4.2	-3.4	-2.7	-2.7	-1.8	-3.0	-2.4
Overall Fiscal Balance with the Public Enterprise for State Roads*	-5.3	-4.1	-3.8	-3.5	-2.3	-3.5	-2.9
Primary fiscal balance (percent of GDP)	-3.2	-2.3	-1.5	-1.5	-0.6	-1.6	-1.0
Public debt (percent of GDP)	38.0	38.1	39.8	39.5	40.5	44.2	45.3
Public and publicly guaranteed debt (percent of GDP)	45.8	46.6	48.7	47.7	48.4	53.4	54.4
Of which: External (percent of GDP)	32.1	31.6	34.2	32.0	32.9	36.1	35.8
Goods exports (percent of GDP)	32.5	33.6	36.5	40.7	45.5	47.5	49.2
Goods imports (percent of GDP)	54.2	53.7	55.3	58.5	61.6	64.9	66.6
Net services exports (percent of GDP)	4.5	3.8	3.5	3.8	3.3	3.5	3.8
Trade balance (percent of GDP)	-17.2	-16.2	-15.2	-14.1	-12.8	-13.9	-13.6
Remittance inflows (percent of GDP)	2.4	2.3	2.0	1.9	1.9	1.9	1.9
Current account balance (percent of GDP)	-0.5	-2.0	-2.9	-1.0	-0.3	-1.4	-1.8
Net foreign direct investment inflows (percent of GDP)	2.3	2.2	3.3	1.8	5.8	4.4	4.6
External debt (percent of GDP)	70.0	69.3	74.7	73.6	77.4	80.4	81.0
Real private credit growth (percent, period average)	8.6	9.5	4.3	1.2	5.0	n.a.	n.a.
Nonperforming loans (percent of gross loans, end of period)	10.8	10.3	6.3	6.1	5.1	n.a.	n.a.
Unemployment rate (percent, period average)	28.0	26.1	23.7	22.4	20.7	19.4	18.0
Youth unemployment rate (percent, period average)	53.1	47.3	48.2	46.7	45.4	n.a.	n.a.
Labor force participation rate (percent, period average)	57.3	57.0	56.5	56.8	56.9	n.a.	n.a.
GDP per capita, PPP (current international \$)	22,002	22,514	22,998	23,493	23,998	24,514	25,041
Poverty rate at US\$5/day, PPP (percent of population)	24.8	23.2	21.9	21.0	20.7	20.5	20.5

Sources: Country authorities, World Bank estimates and projections.

Note: *The general government balance as presented by the government with the state road agency finances included. Poverty rates are based on the North Macedonia survey on income and living conditions (SILC).

Serbia

- Growth in 2018, estimated at 4.2 percent,¹⁰ was stronger than projected but began to slow late in the year.
- As the labor market responded to higher growth, unemployment fell.
- A surplus of 0.5 percent of GDP in the general government budget helped reduce public debt.
- Because growth was to a large extent consumption-driven, the current account deficit went up by 8.4 percent (in euro terms).
- The recent slowdown of the economy could be exacerbated if external conditions for emerging markets tighten, EU growth slows, and local and regional political uncertainty worsens.

Recent Economic Developments

The Serbian economy expanded by 4.2 percent in 2018, well above the projected 3.5 percent.¹⁰ Investment rose by an estimated 11 percent in real terms, contributing 2.3 percentage points (pp) to GDP growth. Consumption increased by 3.4 percent in real terms, adding 2.9 pp to growth. The negative net contribution of foreign trade to growth subtracted about 1 pp. Economic growth was noticeably stronger in the first half of the year, reaching 4.9 percent year-on-year (y-o-y), but slowed in the second half to 3.7 percent; the contributions of all components of GDP began to wane, led by a slowdown in private investment and lower-than-expected export growth as economic activity slowed in Serbia's major trading partners, particularly Italy.

Services were the main drivers of growth. All services contributed in 2018, but the leaders were trade, transport, and tourism, which together added 1.1 pp to GDP growth. Agriculture also did well, with real growth of

output estimated at 15.6 percent, adding about 1 pp to growth.

The labor market continues to improve. According to Labor Force Survey data, unemployment again declined, to an estimated annual average of 12.7 percent, and employment rose by 0.9 percentage points compared to 2017, which suggests that 38,275 more jobs were created in 2018. As a result, employment among the population over 15 years old reached a record high of 47.6 percent.¹¹ In 2018, too, average wages went up by 4.4 percent in real terms.

The 2018 consolidated general government budget showed a surplus of 0.5 percent of GDP by year-end. However, although there was a strong increase in revenues from all sources, expenditures also went up significantly, leading to a smaller surplus than 2017's 1.1 percent of GDP. Total revenues increased by 6.7 percent in nominal terms but social security contributions went up by 9.2 percent, explaining nearly half of the total revenue increase. Public spending rose by 7.9 percent in nominal terms, corresponding to an increase of 152 billion dinars or (corresponding to 3 percent of GDP),

9 During the process of preparing this report the Statistic Office of Republic of Serbia issued a new set of estimates of national accounts for 2018. Based on those preliminary estimates growth in 2018 reached 4.3 percent.

10 World Bank databases now include revised data on national accounts from the Serbian Statistics Office.

11 Looking at quarterly data, the peak in employment was in Q3 2018 when employment rate stood at 49.2 percent.

despite the fact that there were savings of about 0.5 percent of GDP on interest payments and activated guarantees. The main drivers of higher spending were capital investments (up 48.9 percent), wages (up 10 percent), and goods and services (up 13.9 percent). The fiscal surplus and GDP growth helped reduce PPG debt as a share of GDP from 60.1 percent in 2017 to an estimated 55.5 percent in 2018.¹²

Inflation was generally quite stable throughout 2018, peaking in August at just 2.6 percent. The recovery in food and oil prices pushed up CPI inflation in the second half, but by year-end inflation had stabilized, bringing down the 2018 average to 2 percent. With inflationary pressures low and the inflation outlook stable, the central bank (NBS) lowered its policy rate to 3.25 percent in March and to 3 percent in April. In 2018, the dinar held steady in nominal terms. The NBS intervened regularly in the foreign exchange market to smooth excessive short-term exchange rate volatility. For the year it was a net purchaser of foreign currency, buying €1.6 billion. Foreign currency reserves reached €11.3 billion by year-end, up €1.3 billion y-o-y.

Credit activity recovered in 2018 but its structure is somewhat unfavorable. Credit grew by 7.6 percent, with most of the increase in the household sector (12.5 percent); loans to private businesses were up by 6.9 percent. A high proportion of household loans were short-term “cash” loans to individuals. The stock of those loans is 18.7 percent higher in euro terms than a year ago; loans to private enterprises were just 6 percent higher than loans to households.

The banking system is still performing well. Gross nonperforming loans (NPLs) declined considerably, from 9.8 percent in December 2017 to 5.7 percent at year-end 2018.¹³ Banks have been more aggressive, writing off bad loans or selling them to specialized investors. NPLs total about €1.1 billion, of which about €500 million is owed by active businesses and €200 million by enterprises now in bankruptcy proceedings. The value of household NPLs is about €400 million. The number of NPLs is expected to continue down over the medium term, although probably not as fast as in the past two years.

The current account deficit (CAD) did not change. Exports of goods rose by 7.7 percent in euro terms in 2018; but imports went up by 12.6 percent, from a much higher base. Consequently, the trade in goods deficit reached 12.2 percent of GDP. The surplus in trade in services rose in euro terms by 13 percent, countering the CAD impact of the widening goods trade deficit. It is estimated that the CAD, as in 2017, was still 5.2 percent. In 2018 net FDI was much higher, by 31.8 percent, and was sufficient to finance the CAD. Total external debt started to go up in nominal terms, reaching €26.5 billion in the third quarter, but continued to decline as a share of GDP, reaching an estimated 61.3 percent at year-end.

Outlook and Risks

Growth is expected to be slightly lower in 2019 but to recover to about 4 percent over the medium term. Economic activity in 2019 is projected to grow by only 3.5 percent because external developments are less favorable and

¹² Total public debt includes nonguaranteed debt of local governments.

¹³ Preliminary figures.

the one-off effects from higher consumption are exhausted. The medium-term projections are based on the assumptions that consumption will keep growing at about 3–4 percent annually and that investment will have annual growth of 5–6 percent in real terms. That would bring the share of investment in GDP to about 23 percent—still below the levels of other fast-growing Central and Eastern European countries. Net exports are projected to regularly make a small negative contribution to growth of about 0.3 pp a year.

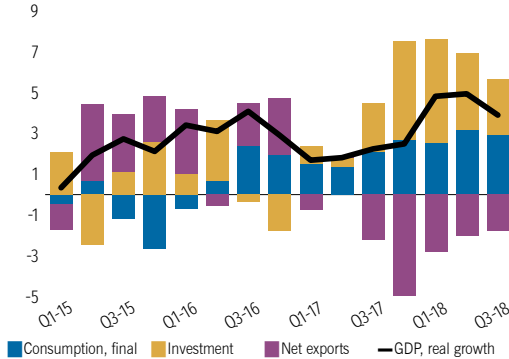
The medium-term growth projections depend heavily on the pace of structural reform. Serbia has a large unreformed public sector with inefficiencies in the SOEs sector. The sub-optimal performance of SOEs directly affects growth of the economy through lower than planned investment and occasional disruption in operations which leads to increase in imports. The lack of reforms not only has high fiscal costs but also makes Serbia less competitive (for example because of a slow pace of reforms in the energy, transport and other infrastructure sectors).

The downside risks are mainly political: The constant public expectation of early elections; increasing public discontent; unstable work on resolving relations with Kosovo; slower than expected opening of chapters of the *acquis* for EU accession; and deterioration of indicators of the rule of law and governance¹⁴, all suggest that growth could have been faster if these issues had been resolved.

¹⁴ Recent rankings by international think tanks and NGOs.

Growth began to slow.

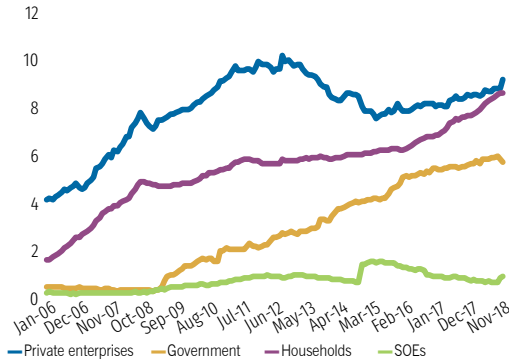
Contribution to GDP growth, percentage points



Source: Statistics Office of Serbia.

Credit recovered, mainly because loans to households increased.

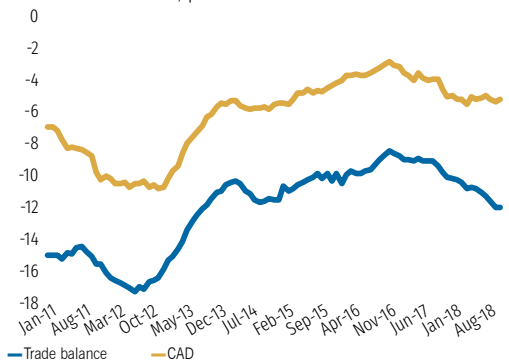
€ billion



Source: National Bank of Serbia.

Though the trade deficit widened, the CAD is under control.

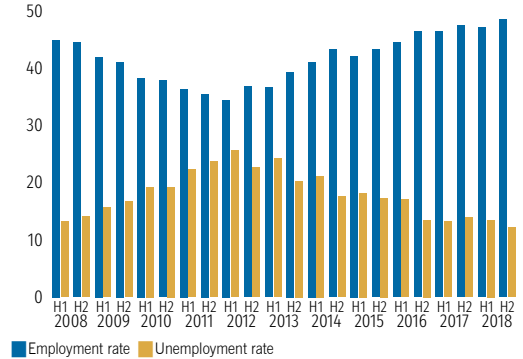
12-month cumulative, percent of GDP



Source: National Bank of Serbia.

However, the labor market improved.

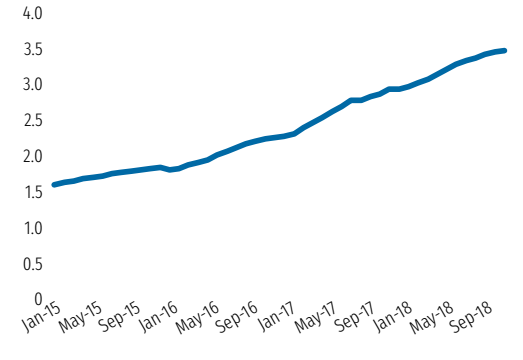
Percent



Source: Statistics Office of Serbia.

Short-term loans may be rising too fast.

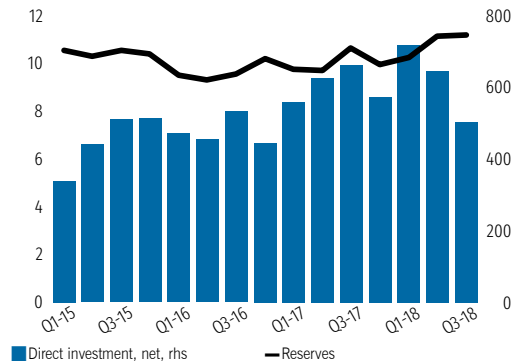
Stock of loans, € billion



Source: National Bank of Serbia.

High FDI is helping to push up reserves.

€ billion



Source: National Bank of Serbia.

SERBIA	2014	2015	2016	2017	2018e	2019f	2020f
Real GDP growth (percent)	-1.6	1.8	3.3	2.0	4.2	3.5	4.0
Composition (percentage points):							
Consumption	0.1	-1.0	1.1	1.9	2.9	2.4	2.9
Investment	-0.9	0.8	0.4	2.2	2.3	1.5	1.3
Net exports	-0.8	1.9	1.9	-2.1	-1.0	-0.3	-0.3
Exports	1.7	4.0	5.4	4.0	5.4	5.0	5.0
Imports (-)	2.5	2.0	3.5	6.1	6.4	5.3	5.3
Consumer price inflation (percent, period average)	2.1	1.4	1.1	3.2	2.0	2.6	3.0
Public revenues (percent of GDP)	39.0	39.3	40.8	41.5	41.1	39.9	39.7
Public expenditures (percent of GDP)	45.2	42.7	41.9	40.4	40.6	40.4	40.2
Of which:							
Wage bill (percent of GDP)	11.0	9.7	9.2	9.0	9.2	9.3	9.2
Social benefits (percent of GDP)	16.7	16.5	15.8	15.1	14.7	14.5	14.4
Capital expenditures (percent of GDP)	2.3	2.7	3.1	2.8	3.6	4.0	3.9
Fiscal balance (percent of GDP)	-6.2	-3.4	-1.2	1.1	0.5	-0.5	-0.5
Primary fiscal balance (percent of GDP)	-3.4	-0.4	1.7	3.6	2.6	1.4	1.6
Public debt (percent of GDP)	58.2	64.0	62.8	55.6	50.1	51.3	49.0
Public and publicly guaranteed debt (percent of GDP)	65.4	70.6	68.6	58.7	54.3	55.8	53.0
Of which: External (percent of GDP)	39.0	42.4	42.7	35.5	33.6	37.0	36.0
Goods exports (percent of GDP)	30.0	32.1	34.9	35.9	35.5	38.6	39.6
Goods imports (percent of GDP)	41.6	42.3	43.4	46.1	47.7	49.4	50.0
Net services exports (percent of GDP)	1.3	2.0	2.5	2.4	2.5	2.6	2.9
Trade balance (percent of GDP)	-10.3	-8.2	-6.0	-7.8	-9.7	-8.2	-7.5
Remittance inflows (percent of GDP)	5.3	5.8	5.1	5.2	5.9	5.1	5.1
Current account balance (percent of GDP)	-5.6	-3.5	-2.9	-5.2	-5.2	-5.1	-4.9
Net foreign direct investment inflows (percent of GDP)	3.5	5.1	5.2	6.2	7.4	5.7	5.5
External debt (percent of GDP)	72.4	73.5	72.1	68.9	61.3	57.4	53.2
Real private credit growth (percent, period average)	-3.8	-1.2	5.0	1.9	3.7	n.a.	n.a.
Nonperforming loans (percent of gross loans, end of period)	21.5	21.6	17.0	9.8	5.7	n.a.	n.a.
Unemployment rate (percent, period average)	19.2	17.7	15.3	13.5	12.7	12.5	11.5
Youth unemployment rate (percent, period average)	47.5	43.2	34.9	31.9	29.8	n.a.	n.a.
Labor force participation rate (percent, period average)	51.9	51.6	53.3	54.0	54.5	n.a.	n.a.
GDP per capita, PPP (current international \$)	13,398	13,454	13,773	15,000	15,942	16,925	18,020
Poverty rate at US\$5.5/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.

Note: Nonperforming loans show year-to-date actuals.

Key Economic Indicators

	2014	2015	2016	2017	2018e	2019f	2020f
Real GDP growth (percent)							
Albania	1.8	2.2	3.4	3.8	4.2	3.8	3.6
Bosnia and Herzegovina	1.1	3.1	3.1	3.2	3.0	3.4	3.9
Kosovo	1.2	4.1	4.1	4.2	4.2	4.4	4.5
North Macedonia	3.6	3.9	2.8	0.2	2.7	2.9	3.2
Montenegro	1.8	3.4	2.9	4.7	4.4	2.9	2.4
Serbia	-1.6	1.8	3.3	2.0	4.2	3.5	4.0
<i>WB6</i>	<i>0.4</i>	<i>2.6</i>	<i>3.3</i>	<i>2.6</i>	<i>3.8</i>	<i>3.5</i>	<i>3.8</i>
Consumer price inflation (percent, period average)							
Albania	1.6	1.9	1.3	2.0	2.1	2.5	2.9
Bosnia and Herzegovina	-0.9	-1.0	-1.6	0.8	1.4	1.1	1.1
Kosovo	0.4	-0.5	0.3	1.5	1.1	2.6	1.9
North Macedonia	-0.2	-0.3	-0.2	1.3	1.5	1.8	1.9
Montenegro	-0.7	1.5	-0.3	2.4	2.6	2.0	1.9
Serbia	2.1	1.4	1.1	3.2	2.0	2.6	3.0
<i>WB6</i>	<i>1.0</i>	<i>0.7</i>	<i>0.4</i>	<i>2.2</i>	<i>1.8</i>	<i>2.2</i>	<i>2.4</i>
Public expenditures (percent of GDP)							
Albania	32.3	31.5	29.4	29.8	29.0	29.4	29.2
Bosnia and Herzegovina	45.8	42.5	41.5	40.4	44.3	41.7	40.2
Kosovo	26.6	27.1	27.7	27.6	29.6	31.3	31.0
North Macedonia	33.9	34.4	33.2	33.9	32.0	35.2	34.5
Montenegro	47.7	48.8	45.3	47.0	46.2	45.4	41.6
Serbia	45.2	42.7	41.9	40.4	40.6	40.4	40.2
<i>WB6</i>	<i>38.6</i>	<i>37.8</i>	<i>36.5</i>	<i>36.5</i>	<i>37.0</i>	<i>37.2</i>	<i>36.1</i>
Public revenues (percent of GDP)							
Albania	26.3	26.6	27.6	27.7	27.2	27.2	27.1
Bosnia and Herzegovina	43.7	43.1	42.7	43.0	43.8	42.0	41.4
Kosovo	24.0	25.1	26.3	26.4	26.9	27.4	27.4
North Macedonia	29.7	31.0	30.6	31.0	30.2	32.2	32.2
Montenegro	44.6	41.5	42.5	41.4	42.5	42.5	41.8
Serbia	39.0	39.3	40.8	41.5	41.1	39.9	39.7
<i>WB6</i>	<i>34.5</i>	<i>34.4</i>	<i>35.1</i>	<i>35.2</i>	<i>35.3</i>	<i>35.2</i>	<i>34.9</i>

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

	2014	2015	2016	2017	2018e	2019f	2020f
Fiscal balance (percent of GDP)							
Albania	-6.0	-4.9	-1.8	-2.0	-1.8	-2.1	-2.1
Bosnia and Herzegovina	-2.0	0.7	1.2	2.6	-0.5	0.3	1.2
Kosovo	-2.6	-2.0	-1.4	-1.2	-2.7	-3.9	-3.6
North Macedonia	-4.2	-3.4	-2.7	-2.7	-1.8	-3.0	-2.4
Montenegro	-3.1	-7.3	-2.8	-5.6	-3.8	-3.0	0.2
Serbia	-6.2	-3.4	-1.2	1.1	0.5	-0.5	-0.5
WB6	-4.0	-3.4	-1.4	-1.3	-1.7	-2.0	-1.2
Public debt (percent of GDP)							
Albania	66.1	69.1	68.7	67.8	64.6	63.0	62.1
Bosnia and Herzegovina	42.0	41.9	42.4	36.1	35.1	34.0	33.2
Kosovo	10.4	12.7	14.1	15.6	16.9	18.6	20.0
North Macedonia	38.0	38.1	39.8	39.5	40.5	44.2	45.3
Montenegro	59.9	66.2	64.4	64.2	70.8	67.2	64.3
Serbia	58.2	64.0	62.8	55.6	50.1	51.3	49.0
WB6	45.8	48.6	48.7	46.4	46.3	46.4	45.7
Public and publicly guaranteed debt (percent of GDP)							
Albania	72.0	72.7	72.3	71.8	68.6	65.8	64.7
Bosnia and Herzegovina	43.1	43.2	43.3	38.0	36.7	35.6	34.8
Kosovo	10.6	12.8	14.4	16.3	17.7	19.3	20.7
North Macedonia	45.8	46.6	48.7	47.7	48.4	53.4	54.4
Montenegro	67.1	73.7	71.4	70.0	75.4	71.6	68.6
Serbia	65.4	70.6	68.6	58.7	54.3	55.8	53.0
WB6	50.7	53.3	53.1	50.4	50.2	50.2	49.4
Goods exports (percent of GDP)							
Albania	9.3	7.5	6.6	6.9	7.4	6.2	6.3
Bosnia and Herzegovina	25.0	25.2	25.7	29.8	29.9	31.2	32.1
Kosovo	5.8	5.6	5.1	5.9	5.6	5.7	5.7
North Macedonia	32.5	33.6	36.5	40.7	45.5	47.5	49.2
Montenegro	10.3	9.1	8.9	8.9	9.5	9.8	10.1
Serbia	30.0	32.1	34.9	35.9	35.5	38.6	39.6
WB6	23.8	24.5	26.0	27.6	28.1	29.7	30.5

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

	2014	2015	2016	2017	2018e	2019f	2020f
Trade balance (percent of GDP)							
Albania	-19.0	-17.3	-16.8	-15.1	-13.5	-13.6	-13.3
Bosnia and Herzegovina	-22.7	-18.5	-16.7	-16.3	-16.2	-16.4	-16.6
Kosovo	-28.7	-28.5	-27.2	-26.1	-29.2	-29.4	-29.5
North Macedonia	-17.2	-16.2	-15.2	-14.1	-12.8	-13.9	-13.6
Montenegro	-19.8	-18.6	-22.5	-23.4	-24.1	-23.7	-21.9
Serbia	-10.3	-8.2	-6.0	-7.8	-9.7	-8.2	-7.5
WB6	-16.4	-14.4	-13.0	-13.3	-14.0	-13.5	-13.1
Current account balance (percent of GDP)							
Albania	-10.8	-8.6	-7.6	-7.5	-6.3	-6.4	-6.2
Bosnia and Herzegovina	-7.3	-5.3	-4.7	-4.7	-4.9	-5.3	-5.5
Kosovo	-6.9	-8.6	-7.9	-6.0	-8.4	-8.9	-10.3
North Macedonia	-0.5	-2.0	-2.9	-1.0	-0.3	-1.4	-1.8
Montenegro	-12.4	-11.1	-16.2	-16.1	-17.1	-17.1	-14.9
Serbia	-5.6	-3.5	-2.9	-5.2	-5.2	-5.1	-4.9
WB6	-6.4	-5.1	-4.9	-5.5	-5.5	-5.7	-5.7
External debt (percent of GDP)							
Albania	69.5	74.4	73.4	68.7	62.1	59.8	59.1
Bosnia and Herzegovina	77.1	72.2	71.0	67.6	70.5	67.4	66.7
Kosovo	31.2	33.3	33.2	32.6	33.9	34.2	34.8
North Macedonia	70.0	69.3	74.7	73.6	77.4	80.4	81.0
Montenegro	162.3	171.0	162.5	160.5	168.3	162.1	159.0
Serbia	72.4	73.5	72.1	68.9	61.3	57.4	53.2
WB6	80.4	82.1	81.0	78.9	80.7	78.6	77.2
Unemployment rate (period average, percent)							
Albania	17.5	17.1	15.2	13.7	12.3	n.a.	n.a.
Bosnia and Herzegovina	27.5	27.7	25.4	20.5	18.4	n.a.	n.a.
Kosovo	35.3	32.9	27.5	30.5	29.5	n.a.	n.a.
North Macedonia	28.0	26.1	23.7	22.4	20.7	19.4	18.0
Montenegro	18.0	17.6	17.7	16.1	15.2	15.4	15.0
Serbia	19.2	17.7	15.3	13.5	12.7	12.5	11.5
WB6	24.3	23.2	20.8	19.4	18.1	15.8	14.8

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

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1001 Windows
by Markel Capo

Capo is the author of different exhibitions that conjoin modern and traditional elements. His latest exhibition entitled "Ku(k)llat" is a tribute to the strength and values of women. The painting "1001 Windows", the winner of Albanian Contemporary Art Competition organized recently by the World Bank, is part of an ongoing project called "Wreath Stone", inspired by castles, stones, and Albanian women strength. In another ongoing project Capo paints Albanian national costumes on plates, jewelry, and wooden spoons.

Capo uses his art as a tool for communication, also using his art to raise awareness of people with Down syndrome. He volunteers with the foundation "Down Syndrome Albania", teaching young children how to paint. Capo has expressed his dedication for those who have what he calls the "Love Syndrome" through music and photography.

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.