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WESTERN BALKANS REGULAR ECONOMIC REPORT
No.14 | Fall 2018

Higher But Fragile Growth

Western Balkans
Regular Economic Report No.14

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WORLD BANK GROUP
Macroeconomics, Trade & Investment

Acknowledgements

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

The report is produced twice a year by a team led by Ekaterina Vostroknutova 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): Agim Demukaj, Sandra Hlivnjak (External section), Edith Kikoni (Fiscal section), Sanja Madžarević-Šujster (Labor section), Asli Senkal (Growth and Outlook sections), Lazar Šestović (Outlook section), Hilda Shijaku (Monetary section), Bojan Shimbov (External section), and Gunhild Berg (Financial sector section), and Christoph Ungerer (Financial Sector section and Spotlight). Additional contributions were from Michael Joseph Ferrantino, Maria Filipa Seara E Pereira, and Colin Christopher Ek (External section); Alena Kantarovich, Cevdet Cagdas Unal, Ruvejda Aliefendic, and Keler Gjika (Financial sector section); and Trang Van Nguyen, Monica Robayo, Ana Maria Oviedo, and Cesar Cancho (Labor section). The team is grateful for comments from David Gould, Stefanie Koettl-Brodmann, Josefina Posadas, and Maddalena Honorati.

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

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Higher But Fragile Growth

1. Overview

Growth in the Western Balkans has strengthened to an estimated 3.5 percent. In most of the region, growth projections for 2018 have been revised upward. Kosovo and Albania are expected to grow at 4 percent this year. At 3.8 percent, Montenegro's growth is projected to be 1 percentage point higher, although still lower than last year. Growth in Bosnia and Herzegovina continues to be stable at an estimated 3.2 percent. Serbia's economy has rebounded to 3.5 percent growth after last year's weather-related slowdown. Macedonia's growth also rebounded to 2.5 percent, as investor confidence was restored.

Growth was stimulated by higher public investment and consumption. Driven by tax reforms and faster growth, higher tax revenues created fiscal space, which some countries rushed to use for current spending and capital investment. Greater public investment is a welcome sign, but to be successful it must be supported by more efficient and effective public spending. The surge in untargeted social spending and public wages has had an immediate effect on growth rates in several countries through faster growth in consumption and household credit. But such effects are temporary and costly to sustain: in the longer term they heighten fiscal vulnerability.

Over 90,000 jobs were created in the first half of 2018, with new employment mostly in industry and services. But the overall labor market response to growth was slower than it could have been, reflecting the temporary nature of consumption-led stimuli as well as a rise in labor inactivity. In some countries, inactivity and emigration rather than new job creation explain the fall in unemployment. Structural distortions in labor markets find expression in high regional and gender disparities in outcomes. Improving incentives to participate in the labor force will help stimulate both job creation and growth.

Countries with higher growth rates boosted them mostly by investment and exports. Higher private investment led to higher economic growth. But to sustain growth, more investment is needed in tradable sectors. With competition between emerging markets fierce, investors will be attracted by political stability, a business-friendly regulatory environment, quality infrastructure, and a skilled labor force. Since credit is driven mostly by household borrowing, a more diversified and growth-friendly financial sector would also help to attract domestic and foreign investors.

Higher exports are also necessary for more secure long-term growth. External imbalances have been high but mostly stable. Bosnia and Herzegovina, Macedonia, and Serbia have all seen their exports grow fast. But growing consumption and large infrastructure projects have pushed up imports. Sustainably higher exports will help maintain macroeconomic stability, contribute to growth, and reduce poverty. Support could also come from regional integration: Because most exports of Western Balkan countries do not compete with each other, the benefits from regional integration into European Union value chains can be significant—and without trade-offs. The Multi-Annual Action Plan for building a regional economic area is a step in the right direction.

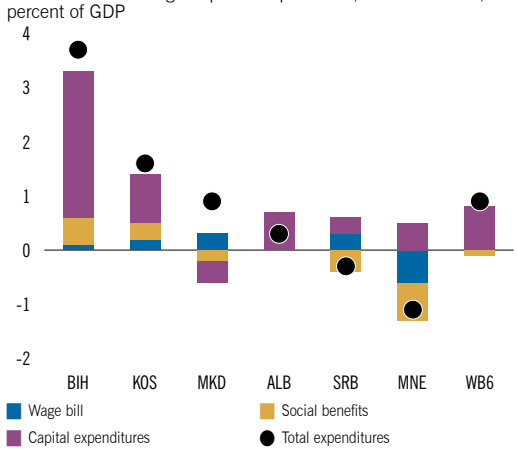
The risks clouding a positive growth outlook are both external and internal. A possible tightening of the financing conditions in international capital markets is a downside risk, especially in countries that have external and fiscal imbalances. With domestic sovereign bond markets often underdeveloped, Western Balkan countries are exposed to rises in global interest rates. Robust growth in the region also depends heavily on domestic and regional political stability, which define the speed of structural reforms. Mitigating these external and internal risks requires both a firm commitment to fiscal consolidation and acceleration of structural reforms.

Growth in the region strengthened...

Real GDP growth, percent

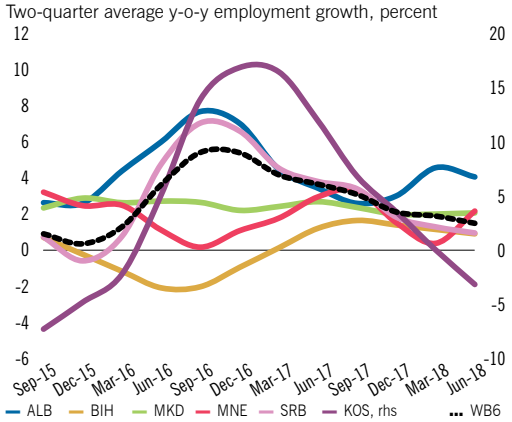
...due to higher public spending.

Contribution to change in public expenditure, 2018 estimate, percent of GDP



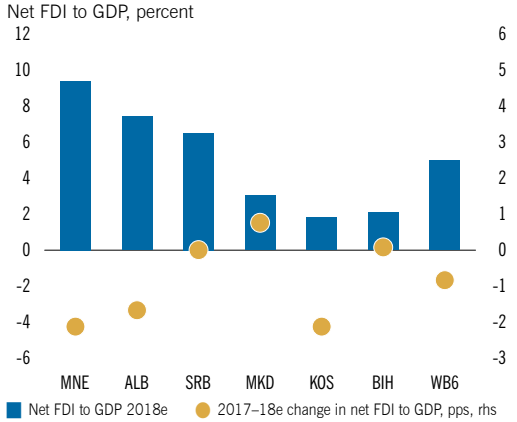
But limited private sector dynamism is reflected in the slow response of employment...

Two-quarter average y-o-y employment growth, percent



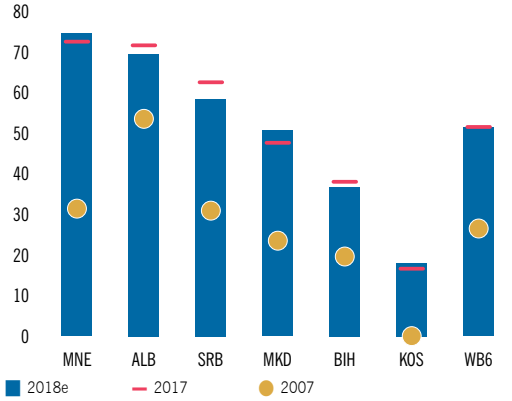
...and in low, stagnant FDI inflows.

Net FDI to GDP, percent



Instead, high and rising PPG debt is coupled with fiscal and external imbalances...

Public and publicly guaranteed debt, percent of GDP



...making the outlook vulnerable to tightening in financial markets, protectionism, and domestic politics.

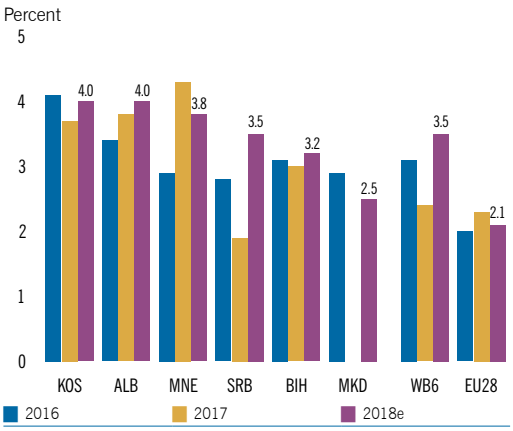
Growth rates, 2017–2020f, percent

	2017	2018e	2019f	2020f
Albania	3.8	4.0	3.6	3.5
Bosnia and Herzegovina	3.0	3.2	3.4	3.9
Kosovo	3.7	4.0	4.5	4.5
Macedonia, FYR	0.0	2.5	2.9	3.2
Montenegro	4.3	3.8	2.8	2.5
Serbia	1.9	3.5	3.5	4.0
WB6	***2.4***	***3.5***	***3.5***	***3.8***

2. Stronger growth, due to higher public spending

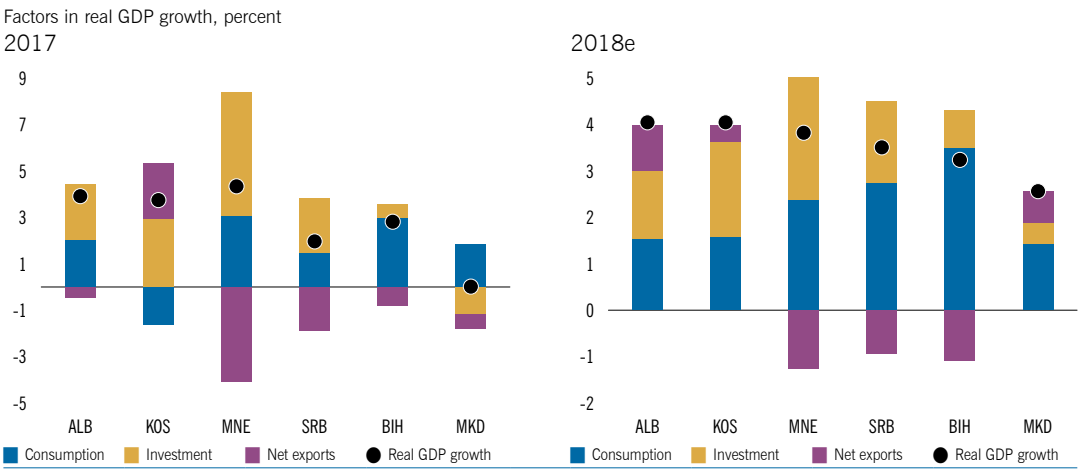
In the Western Balkans growth is projected to accelerate, reaching 3.5 percent for 2018 (Figure 2.1). In most of the region growth will be higher in 2018 than it was in 2017. The growth projection for Serbia, the largest economy in the region, has been revised upward to 3.5 percent, supported by a rise in both public and private investment. In Kosovo and Albania, growth is expected to reach 4 percent. In Kosovo, it is driven by a rebound in consumption, a rise in transport infrastructure investment, and higher exports of services. Albania is benefiting from a doubling in hydro energy production thanks to strong rainfall, a solid tourism season that boosted services exports, and a pick-up in manufacturing. In Bosnia and Herzegovina, growth continues to be a steady 3.2 percent, driven primarily by consumption and an increase in public investment. Growth in FYR Macedonia is expected to rebound to 2.5 percent, supported by improved investor confidence and rise in consumption and exports. Although growth in Montenegro is projected to be slightly lower than last year, it remains strong at 3.8 percent, 1 percentage point (pp) faster than projected earlier, due to energy and tourism investments and a speed-up in construction of the Bar-Boljare highway.

Figure 2.1. Growth is projected to pick up across the region in 2018.



Source: National statistical offices data; Eurostat; World Bank staff estimates.
Note: Data for WB6 and EU28 calculated as weighted average.

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



Source: National statistical offices; World Bank estimates.

In 2018 consumption continues to underpin economic activity, supported by growth in wages and employment (Figure 2.2). The increase in consumption has been supported by consumer borrowing, higher social transfers, public wages, and employment. For example, FYR Macedonia increased public support through the employment program and expanded pension spending. Bosnia and Herzegovina and Kosovo increased social spending and public wages. In 2017 Albania, FYR Macedonia, and Serbia increased the minimum wage. The rise in untargeted social spending may have spurred consumption in some countries, but it also raises fiscal sustainability concerns.

In all six countries higher public investment is expected to make a positive contribution to growth. Investment growth in general continues to be robust. It is projected to add 2.7 pp to growth in Montenegro, 2.1 pp in Kosovo, 1.7 pp in Serbia, and 1.5 pp in Albania. Investment growth is driven by higher public capital spending in all countries but FYR Macedonia. The increase in public investment is compensating for the decline in foreign direct investment (FDI) in Kosovo and in Albania, where FDI-financed energy projects are near completion. In Montenegro and Serbia, the rise in public capital spending is accompanied by an increase in private investment. In FYR Macedonia, by mid-2018 private investment in construction had also started to grow, after 12 consecutive months of decline.

The contribution of net exports to growth is projected to recover somewhat from last year, but it will still be minimal. Net exports are contributing most in Albania, where they are expected to add 1 pp, thanks to a weather-related spike in exports of hydroelectric power, a strong tourism season, and a slowing in imports as import-intensive FDI projects near completion. Although lower than last year, net exports are also expected to contribute 0.4 pp to growth in Kosovo, despite the halt in Ferronikeli production, due to higher tourism-related services. In FYR Macedonia also, the contribution of net exports is expected to be positive, adding 0.7 pp to growth in 2018, due to a solid performance by car industry suppliers. In Bosnia and Herzegovina and Serbia, fast growth in imports is overshadowing a solid increase in exports, so that net exports are projected to subtract about 1 pp from growth. Similarly, in Montenegro, net exports are expected to continue to subtract from growth as strong tourism and exports of electricity, aluminum, and steel are offset by higher imports of intermediate goods for the construction of the Bar-Boljare highway.

To speed up growth in the region and make it more sustainable will require both more investment and more exports. The higher pace of growth is much needed in the Western Balkans, but now it needs to be sustained. Higher public investment may be a welcome sign, but they must be supported by more efficient and effective public spending if public investment programs are to succeed. Stimulating growth through consumption and untargeted social spending may give temporary growth benefit but is hardly sustainable. Moreover, such an approach will raise fiscal and external vulnerability and may exacerbate the already high debt of Western Balkan countries. Private investment and increased export growth have elsewhere proved to be sure and sustainable drivers of long-term growth. But investment in the region, which averaged 23 percent in 2009–16, is far below the 31 percent average for upper-middle-income countries (UMICs).

As public investment grows, there is also ample room to push up private investment. Building up the financial sector to increase domestic savings and attract FDI to the tradable sectors of the economy would benefit the region by reinforcing the long-term sustainability of its growth. This will also require structural reforms (Box 2.1). While higher exports are doing more to support growth in most Western Balkan countries, their incomplete trade integration—average exports within the region are only about 40 percent of GDP—limits their growth potential (see the Spotlight discussion in Section 9).

Box 2.1. What kind of FDI for the Western Balkans?

FDI can facilitate economic growth through productivity spillovers, job creation, and upgrading of the export basket. Technology transfers through FDI to domestic suppliers, downstream sectors, or competitors are thought to have contributed considerably to technology adoption, structural change, and job creation in many East Asian economies, among them China, India, and Malaysia. Policymakers in developing economies often provide incentives to attract FDI in the expectation that it brings in not only capital but also new technologies, marketing techniques, and management skills. In fact, FDI is considered a major channel for transfers of technology to developing countries. Spillovers occur when local firms copy technologies either through observation or by hiring workers trained by companies with foreign parents. FDI in backbone service sectors has also been seen to raise the quality of the services offered.

But not all FDI are equally effective in speeding up growth. Analysis of sectors receiving FDI provides information about the productivity potential of technology spillovers through backward links to domestic suppliers or forward links to domestic industries. FDI in car manufacturing, for instance, has been shown over time to provide productivity spillovers to domestic suppliers of car parts. Similarly, productivity spillovers have been associated with FDI in backbone service sectors like ICT, finance, or hotels and tourism, and downstream in manufacturing. Investments in real estate and mining, however, have few links with the domestic economy, especially once construction ends, and little potential for productivity spillovers.

Foreign direct investment (FDI) in the Western Balkans is quite limited. The average FDI stock per capita in the Western Balkans (€2,600 in 2015) is less than half of the FDI stock per capita in Eastern European EU members, and just one-seventh of the EU average. Montenegro has the highest FDI stock per capita (€6,700), followed by Serbia (€3,700), which has enjoyed fast growth in greenfield FDI. FDI stock per capita of the other Western Balkan countries is at €2,000 or less.

In FYR Macedonia and Kosovo, except for a few exceptional years, net FDI flows have been mostly below 5 percent of GDP. In Albania, net FDI, mainly for hydropower projects, reached 9 percent of GDP in 2017. In Serbia, between 2009 and 2017 annual FDI inflows averaged 5 percent of GDP. In the same period, FDI in Montenegro, though quite volatile, averaged 15 percent of GDP but mainly targeted tourism and real estate.

Greenfield FDI in the Western Balkans has mainly originated from EU-28 countries like Italy, Austria, Germany, Slovenia, and the Netherlands, but also contributing were investors from Russia, the United Arab Emirates, the USA, and Turkey. Similarly, when all FDI stock is considered,

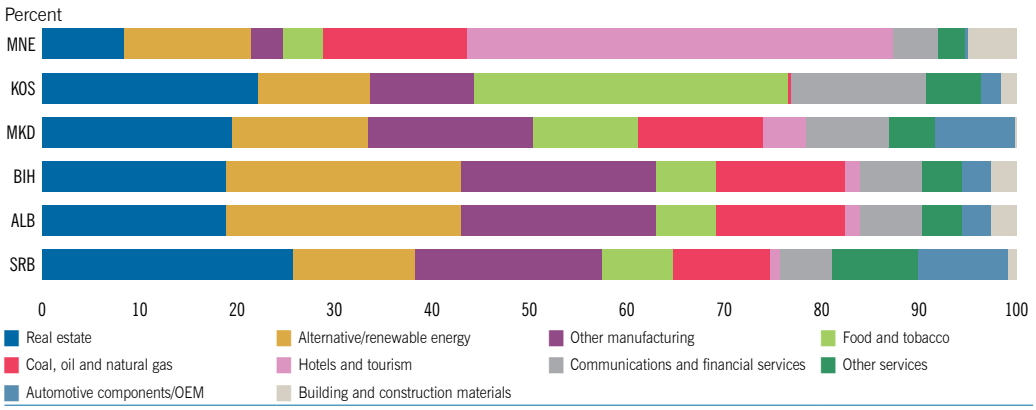
Box 2.1 continued

most originates in the Netherlands, Austria, Cyprus, Greece, Italy, and Switzerland. Intra-regional FDI is quite limited, which suggests that there is room for regional integration.

The concentration of Western Balkans FDI in real estate and energy extractives suggests that in the region FDI contributes little to productivity growth, technology adoption, or formal job creation. Real estate accounted for 20 percent of greenfield investment in the Western Balkans, followed by renewable energy (16 percent), and coal (14 percent). Automotive components and original equipment manufacturing, which have greater productivity spillover potential, account for only 6 percent of FDI. Because FYR Macedonia and Serbia receive the largest shares of manufacturing FDI, which goes into areas like automotive components and food products, they are better positioned to benefit from long-term productivity spillovers from foreign companies to domestic suppliers.

Among factors that foreign investors consider in their investment decisions are political stability and security, a business-friendly legal and regulatory environment, infrastructure quality, labor talent and skill, and low costs for labor and inputs. But, while some Western Balkan countries make extensive use of tax holidays to attract FDI, these are typically not among the top five considerations of foreign investors in the region—only one in five investors considers that the absence of investment incentives as critically important. There is, however, evidence that countries can maximize the benefits of FDI only if they have well-developed financial markets. And investors strongly value the quality of local suppliers. The availability of human capital is central to repatriating the benefits of FDI. Improving the business environment and investing in human capital are thus a priority for attracting and maximizing the benefits from FDI in the Western Balkans.

Figure B2.1.1. The composition of greenfield FDI inflows by country.



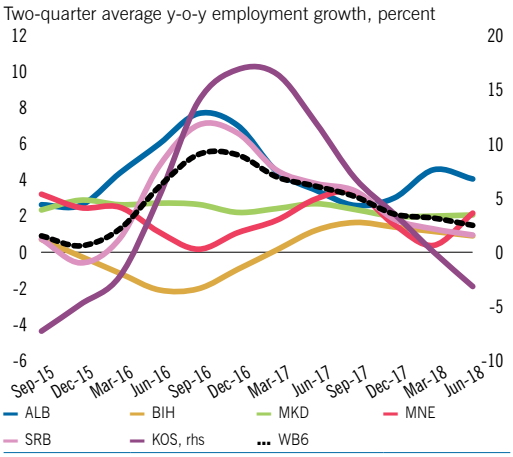
Source: FDImarkets and World Bank staff calculations. See also Arnold, J., B. Javorcik, M. Lipscomb, and A. Mattoo, 2012, "Services Reform and Manufacturing Performance - Evidence from India," Policy Research Working Paper 5948, World Bank, Washington, DC; Javorcik, B., 2004, "Does Foreign Direct Investment Increase the Productivity of Domestic Firms? In Search of Spillovers through Backward Linkages", *American Economic Review* 94 (3): 605-627; and Rodrik, Dani, 2008, "Normalizing Industrial Policy," Commission on Growth and Development Working Paper 3, World Bank, Washington, DC; Jirasavetakul, L. F., J. Rahman, 2018, "Foreign Direct Investment in New Member State of the EU and Western Balkans: Taking Stock and Assessing Prospects", WP/18/187International Monetary Fund, Washington DC.

3. In most countries, job creation has slowed

Employment rose in all countries except Kosovo but more slowly than in 2017. Only 91,400 new jobs were created in the Western Balkans in the first half of the year, compared to 214,000 a year ago. Looking at the half-year y-o-y changes, employment growth slowed in all countries except Albania, which gained from higher female participation in the labor market. In Montenegro, 2.2 percent employment growth was led by construction and tourism, reaching 48.1 percent in June 2018. In Kosovo, employment contracted by 3.1 percent in the first half of 2018, after steep increases in 2016 and 2017. At 48.6 percent, Serbia registered a historically high employment rate in June 2018, as employment grew by 0.9 percent y-o-y in the first half of 2018. Employment growth was about the same in Bosnia and Herzegovina and led the employment rate to rise to 34.3 percent in 2018. In FYR Macedonia, employment grew by 2.1 percent, supported by the employment subsidy program. With across-the-board improvements in the labor market, by June 2018 Albania had employment growth of 4.1 percent y-o-y. It also had the highest employment rate in the Western Balkans at 52 percent, up by 2 pp from a year earlier, and the lowest youth unemployment.

Most of the new jobs are in industry or services. As structural change continues, the availability of jobs in agriculture is declining across the region. In Albania and Bosnia and Herzegovina, employment growth originated in services and industry. Similarly, most new jobs in FYR Macedonia were in manufacturing, food, and accommodation services, followed by the recovering construction sector. The gains in manufacturing were largely in FDI companies, which benefit from tax exemptions, employment subsidies, and other government support. In Montenegro, not only manufacturing and construction but also tourism and the public sector were significant contributors to employment growth. Employment in Kosovo declined in manufacturing, agriculture, accommodations, and mining but rose in trade, information and communication technology (ICT), and the public sector.

Figure 3.1. Employment has responded slowly to growth.

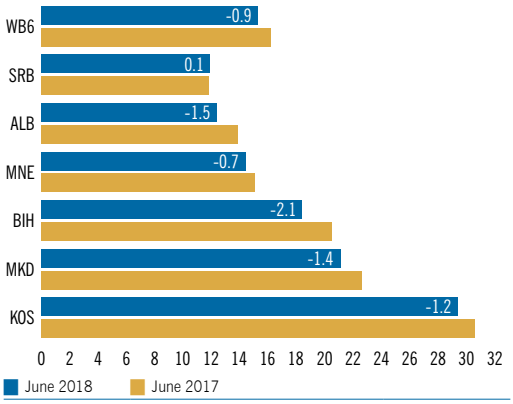


Source: National statistics offices and World Bank staff estimates.

In most Western Balkan countries, unemployment hit a new low, and a total of 9,000 unemployed young people found jobs. By June 2018, unemployment declined to historical lows of 21.1 percent in FYR Macedonia, 14.4 percent in Montenegro, 12.4 percent in Albania and 11.9 percent in Serbia. Although by June there was an overall y-o-y decline in unemployment in Kosovo (by 1.2 pp) and Bosnia and Herzegovina (2.1 pp),

Figure 3.2. In all Western Balkans countries except Serbia, unemployment declined in 2018.

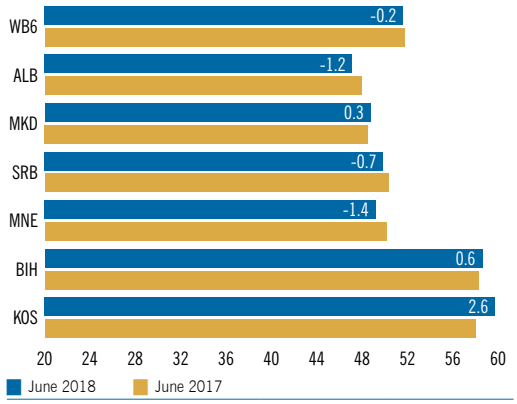
Unemployment rate, 15+ years, percent, and 2017–2018 change, pp



Source: National statistics offices and World Bank staff estimates.

Figure 3.3. Inactivity is not only high but has even increased in several countries.

Inactivity rate, 15+ years, percent, and 2017–2018 change, pp



Source: National statistics offices and World Bank staff estimates.

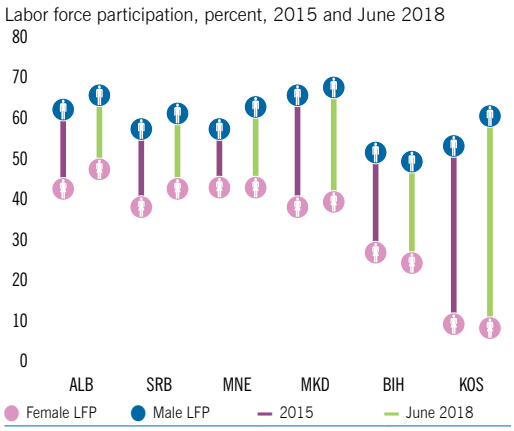
this was mainly due to lower participation rates. By mid-2018 youth unemployment in the region had also declined to a historic low, 35.9 percent. It was lowest in Albania at 22.6 percent, followed by Montenegro at 23.9 percent. Elsewhere in the Western Balkans, youth unemployment ranged from 27 percent in Serbia to 55 percent in Kosovo. Youth unemployment actually rose, however, in Kosovo and FYR Macedonia. In Montenegro, even with unemployment at an all-time low, more than half of Montenegrins of working-age still have no jobs. Despite recent improvements, and suggestive of pervasive structural constraints in the labor market, over 70 percent of the unemployed have been looking for a job for over a year in Kosovo, about 78 percent in FYR Macedonia, and 80 percent in Bosnia and Herzegovina.

Except in Albania and Serbia, the decline in unemployment was partly due to a rise in inactivity. In June 2018, the inactivity rate in the Western Balkans was still a high 46 percent, despite years of growth and direct attempts to support job creation. In most of the region inactivity recently increased, suggesting that more people transitioned from unemployment to inactivity than found jobs (Figures 3.2 and 3.3). In contrast to the regional trend, in Albania and Serbia sustained growth supported job creation and encouraged labor force participation. The overall participation rate for the Western Balkans improved to 54.4 percent in June 2018, up by 1.2 percentage points from a year earlier, with participation in Albania rising above 59 percent. In some countries, emigration might have also played a role in reduction of the labor force.

Despite some improvement, labor force participation of women continues to be low across the region. In Albania the participation of women in the labor force shot up to 51.4 percent in June 2018 (Figure 3.4). For Albanian women aged 25–54 it has improved to 75 percent, narrowing the gender gap to 15 pp. Serbia and Montenegro also have female participation rates above the regional median of 46 percent. In Montenegro, the gender

gap is narrowest—14 pp; now that lifetime benefits to mothers of three or more children have been abolished, over the medium term the female participation rate is likely to rise. In Bosnia and Herzegovina, however, by mid-year female labor force participation had fallen to 31.4 percent.

Figure 3.4. Female labor participation is about 25 percent lower than male.



Source: National statistics offices and World Bank staff estimates.

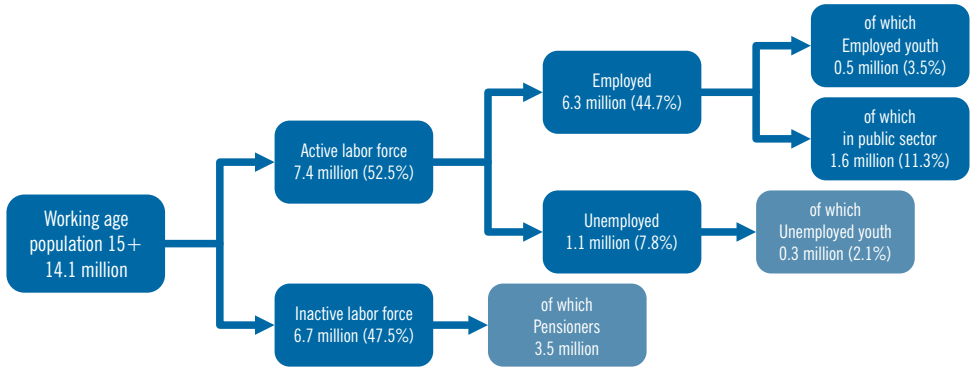
High inactivity among the working-age population means that a large share of factors of production and sources of income remains untapped, slowing economic growth. The working-age dependency ratio in the Western Balkans is extremely high—2.24 in 2017; this means that on average a working adult supports 2.24 dependents of working-age (Figure 3.5). The high dependency ratio places a greater burden on workers and the government to support the unengaged. It also exacerbates the existing disincentives to work and, given aging, implies a shrinking labor force. Oversized public sectors in some countries, plentiful options for early retirement, and high social benefit disincentives for engaging in the labor market keep labor force participation rates low. All these preclude the emergence of the skilled and adaptable labor force that the region desperately needs and thus reduce potential growth rates.

With inflation still low, growth, job creation, and wage growth have been lifting people out of poverty. In 2017, the average poverty rate for Albania, Kosovo, FYR Macedonia, Montenegro, and Serbia dropped by an estimated 1 pp from a year earlier, to a projected regional poverty rate of 23.1 percent. But rising inflation, especially in food and energy prices, is starting to affect lower-income households where food consumes more of the household budget. In this regard, moderate minimum wage increases that keep up with productivity growth and inflation, such as a 4.3 percent increase in Serbia, have been helpful in supporting the poor. In Albania, the increase in the minimum wage and higher capacity utilization in labor-intensive agriculture and construction pushed up wages. In the first quarter of 2018 real wages increased by 2.3 percent; they went up faster for women than for men, narrowing the gender gap. In FYR Macedonia, in the first half of the year net wages grew nominally by 5.5 percent y-o-y—and by over 10 percent in low-wage labor-intensive sectors. While this has likely helped reduce poverty, labor-intensive industries, such as textiles, have asked the government to subsidize costs to avoid layoffs. In other words, about 134,000 people escaped poverty during 2016–17.[1] To sustain recent welfare improvements, countries across the region will need to continue creating jobs to sustainably boost labor earnings. For the minimum wage to remain a functioning instrument of labor market policy, to avoid a surge in informal employment, and to maintain

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

Figure 3.5. Higher spending supported consumption and investment growth in 2018.

Structure of the working age population aged 15+ in the Western Balkans



Source: National statistical offices and World Bank staff estimates.

cost competitiveness, minimum wage policy should be informed by the degree of labor productivity in the sectors where it mostly applies.

Since employment has not consistently tracked growth, the Western Balkans need to address structural rigidities that affect the labor market and delay formalization. In the last decade in several countries, the elasticity of employment growth to GDP growth was minimal. Past GDP growth was not highly correlated with subsequent employment growth in Bosnia and Herzegovina, FYR Macedonia, and Montenegro. The fact that labor-intensive sectors like tourism and construction drove growth in Montenegro could reflect low labor mobility or weak links between tourism and domestic suppliers of services and goods (Box 3.1). Clearly, it is necessary to dismantle both barriers that prevent the domestic working-age population from taking formal jobs and regulatory barriers to firm entry and competition in high-growth sectors and their suppliers.

Box 3.1. Higher mobility, within as well as between countries, could help reduce unemployment.

Regional differences in unemployment are significant not only between Western Balkan countries but also within each. Unemployment ranges from 11.9 percent in Serbia to about 29 percent in Kosovo. But within country differences are even starker: for instance, in Montenegro unemployment ranges from 3.2 percent in the coastal region to close to 30.8 percent in the north (Figure B3.1.1).

Unemployment in the Montenegrin north is thus 11 times higher than in coastal areas; even the central region, which is within commuting distance of the coast, has triple the coast unemployment rate. Yet although tourism employment is growing, internal migration is too low to fill all the jobs. In FYR Macedonia, the closer a district is to Greece and Bulgaria, the lower the unemployment rate. In Serbia, unemployment is worse in the south and east than in the north. Meanwhile, Belgrade has labor shortages in transport and construction.

Low labor mobility exacerbates frictions in the labor market, and such frictions could become increasingly more binding, making it difficult for value chains (between, e.g., services and manufacturing) to function properly and thus potentially holding back long-term industry-level productivity increases and overall economic growth.

Figure B3.1.1. Unemployment hot spots.

Unemployment rates, percent, June 2018 or the latest available

Source: National statistical offices.

4. If it is to be redirected to growth, spending must be better managed

Though past and recent fiscal consolidation has borne fruit in most countries, Kosovo's fiscal balance is succumbing to spending pressures. In Montenegro, after a decisive fiscal consolidation—which abolished mothers' benefits, partially froze public-sector wages, and hiked excise duties and VAT—the fiscal deficit fell from 5.4 percent of GDP in 2017 to a projected 2.2 percent in 2018. FYR Macedonia is also expected to lower its deficit, from 2.8 percent in 2017 to 2.6 percent, and while much of the improvement is attributable to the higher revenues accompanying the economic rebound, it is also a result of continued compression of capital spending. In contrast, in Kosovo the fiscal position has worsened, partly due to a growth-enhancing rise in capital spending, but mainly because current spending is surging as the government ramps up untargeted social spending and public wages. Similarly, Bosnia and Herzegovina has moved from surplus to deficit; a 2.4 percent of GDP rise in spending, partly related to looming elections, is expected to push the fiscal deficit to 0.5 percent of GDP. Serbia's fiscal position remains in surplus as interest payments and activated guarantees decline and revenue performance is strong. In Albania, the fiscal balance is forecast to remain unchanged this year.

Revenues continue to grow, driven by tax reform and heightened economic activity. Revenue-to-GDP ratios are projected to increase in Montenegro (2.1 pp of GDP), FYR Macedonia (1.1 pp), and Bosnia and Herzegovina (0.8 pp), with smaller gains in Kosovo and Albania. In Serbia, although healthy economic activity is supporting nominal revenue gains, there has been a slight decline in the revenue-to-GDP ratio (see Figure 4.2). Government revenue in

Figure 4.1. Fiscal consolidation has substantially reduced the deficit in Montenegro.

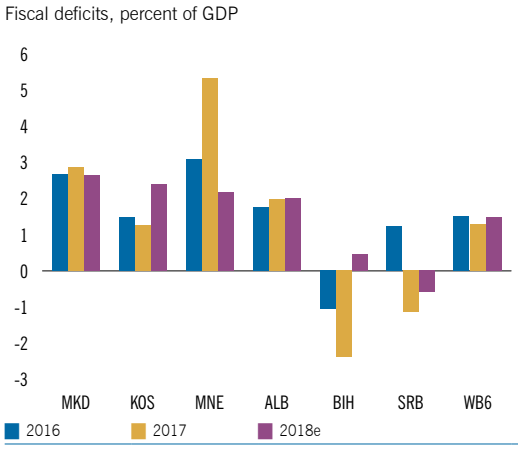
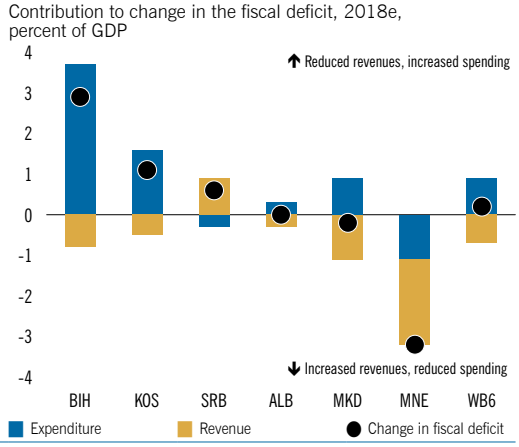


Figure 4.2. Revenue gains helped finance higher spending in most of the region.



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

Note: Data for FYR Macedonia presented in this section excludes finances of the Roads Agency (which average 1.7 percent of GDP in spending and 1 percent in revenue annually) the agency was taken off-budget in 2013. Unless otherwise specified, the regional average as calculated is not weighted.

Montenegro continues to benefit from 2017's comprehensive tax reforms, among them raising the VAT rate, reducing exemptions and excise taxes, and introducing a new excise on coal. Similarly, in Bosnia and Herzegovina the February 2018 increase in excise taxes on oil derivatives and introduction of a road tax and a tax on liquid gas have together boosted government revenues. In Albania, projected 2018 revenue gains of 0.3 percent of GDP result from higher social security contributions and national tax revenues, which compensate for lower than expected VAT revenues and delays in introducing the new property tax. In January FYR Macedonia raised excises on diesel and heating oil.

Nearly all countries have increased capital spending but only Montenegro and Serbia have also scaled back total spending as a share of GDP (Figures 4.3 and 4.4). Higher revenues have expanded the fiscal space, and all regional economies except Serbia and Montenegro have seen total spending rise as a share of GDP. Despite a significant increase in capital spending dominated by construction of the Bar-Boljare highway and transfers to the health sector, consolidation reforms in Montenegro continue to lower total spending. In Bosnia and Herzegovina, this year's higher spending mainly reflects accelerated work on capital infrastructure and other investment projects, the financing of which had been delayed in 2017; it also reflects recent rises in wages and social transfers. In Kosovo, higher spending on capital investment would be welcome except that pensions and benefits to war veterans have been rising unsustainably. Higher spending in FYR Macedonia has been largely directed to health, pensions, subsidies, and social assistance, with capital spending declining.

Though acceleration of large public investment projects is welcome, more is not always better. Under-investment, public as well as private, is an impediment to growth in all Western Balkan countries. Each has established a single pipeline of public investment projects to identify priorities and seek financing for

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

Contribution to change in public spending, 2018e, percent of GDP

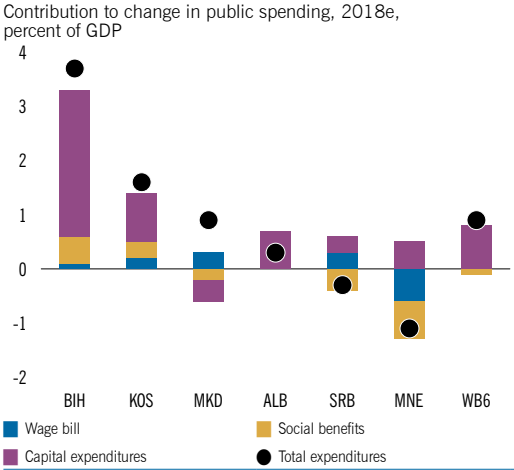
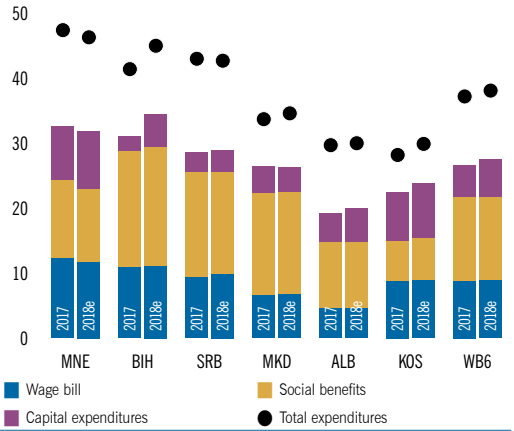


Figure 4.4. Spending remains dominated by public wages and social programs.

Estimated public spending, 2017 and 2018e, percent of GDP



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

projects to tackle infrastructure gaps. The scale and focus of national project pipelines vary significantly but improving transport infrastructure—especially roads and railways—and upgrading energy-generation capacity are popular goals throughout the region. The total cost of priority projects is also reported to vary substantially, from about 7 percent of GDP in Serbia to 20 percent in Bosnia and Herzegovina and 70 percent in Montenegro. However, the Western Balkan countries need to address the legacies not only of severe underinvestment but also of neglected maintenance and poor project selection and construction. The findings from Public Investment Management Assessments (PIMAs) and Public Expenditure and Financial Accountability (PEFAs) carried out for Western Balkan countries illuminate the significant need for better management of public investments (Box 4.1). Also needed are rigorous and transparent arrangements for appraisal, selection, and approval of investment projects and reinforcement of the institutions that fund, manage, and monitor projects. On average, public investment management in the Western Balkans is only about 70 percent of that in transition economies that are now EU members. Structural reforms to increase the efficiency and productivity of public investment are vital.

In countries where consolidation is mature, debt continues to fall; in the others, public and publicly-guaranteed (PPG) debt has edged up (Figure 4.5). The combination in 2017 and 2018 of economic growth, fiscal consolidation, and active debt management reduced the share of PPG debt in Serbia, Albania, and Bosnia and Herzegovina; in Serbia, fiscal surplus, economic recovery and

Box 4.1. Findings of the Public Investment Management Assessment.

Reports of Public Investment Management Assessments (PIMAs) indicate that there is considerable room for improvement to heighten the efficiency and productivity of public investment in all Western Balkan countries. For instance:

- Public institutions are fragmented, with overlapping mandates and little coordination.
- Project selection criteria are not systematically applied and are often waived.
- Project pipelines, primarily used for Western Balkans Infrastructure Framework–funded projects, are often not part of the medium-term budget, leaving room for a proliferation of other projects in the budget that are not yet ready for work to begin.
- Because there is little coordination between central government and municipalities, allocation of capital spending is distorted.
- Although public procurement laws, including e-procurement, are well-designed and procedures are competitive and transparent, compliance is rare.
- Monitoring and disclosure of the financial performance, investment plans, and fiscal risks of state-owned enterprises (SOEs) are limited or nonexistent.
- There are substantial gaps in government budgets, largely because they do not cover the capital spending of SOEs.
- Governments generally do not undertake ex post assessments and audits of projects, or do so only infrequently, for donor-funded projects.

Source: Based on IMF PIMA reports for Albania (June 2016), Kosovo (April 2016 and June 2017), and Serbia (April 2016).

exchange rate dynamics have helped to reduce public debt as a share of GDP from 62.5 to the 58.4 percent projected by yearend. Based on an April liability management operation, Montenegro's total PPG debt, pushed up by financing for highway construction, is projected to reach 74.6 percent by yearend. In FYR Macedonia, due to a new Eurobond issue PPG debt rose from 47.6 to a projected 50.6 percent of GDP. Kosovo's PPG debt, though the lowest in the region (16.6 percent of GDP in 2017), has continued to go up due to higher social benefits and improved execution of public investment projects; it is dominated by an increase in domestic debt.

External PPG debt ratios have risen in countries that took advantage of benign conditions in international financial markets (Figure 4.6). Montenegro issued a €500 million Eurobond and took a €250 million syndicated loan to refinance debt totaling €360 million that will come due in 2019–21 and also to cover its financial needs for the rest of 2018 and 2019. Its external PPG debt is expected to rise to 59 percent of GDP. In FYR Macedonia, issuance of a €500 million Eurobond has pushed up the general government external debt-to-GDP ratio, which is projected to rise past 36 percent of GDP. External PPG debt has declined in other Western Balkan countries. In Albania, exchange rate appreciation is expected to keep the external debt-to-GDP ratio slightly lower than last year, though external financing is expected to increase by yearend. The decline in external PPG debt as a share of GDP in Kosovo is attributed to weak execution on capital projects on loans financed by international financial institutions (IFI) and continued repayment of IBRD debt inherited from the former Yugoslavia. However, as IFI and US$-loan financing of capital and highway projects picks up in 2019, external PPG debt is expected to rise with possible appreciation of the US dollar.

These developments highlight the importance of sound fiscal policy in the region to create the fiscal space necessary to be able to respond to adverse economic

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

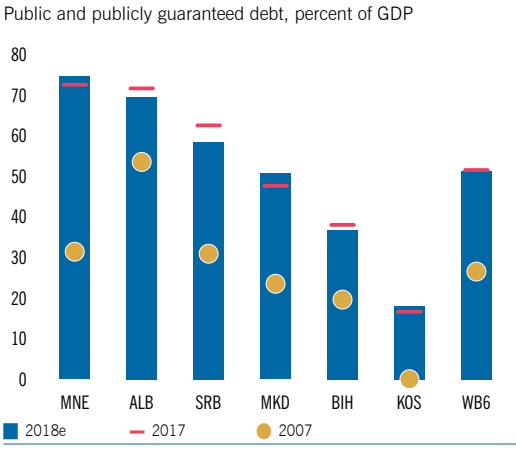
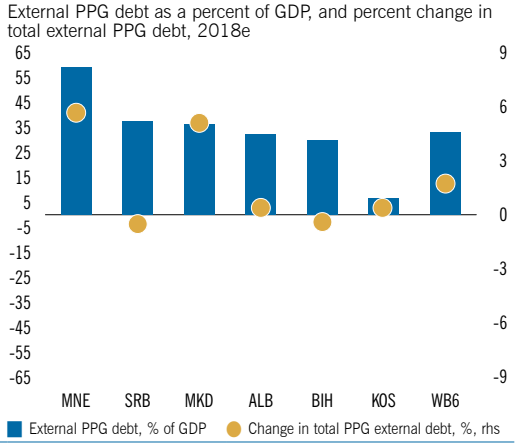


Figure 4.6. External PPG debt increased in countries with Eurobond issues, decreased in some others.



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

shocks and to navigate high external risks. The possibility of the tightening of financing conditions in international capital markets and the Western Balkan's high external imbalances call for timely measures to reduce public debt. Increasing pressures from citizens across the region demanding higher-quality public services further call for measures to create the necessary fiscal space to finance better public services. Addressing these fiscal challenges depends on adoption of medium-term fiscal consolidation strategies, increasing the efficiency of public spending, strengthening public financial management systems, and making public finances more transparent and accountable.

5. Inflation slowly rises due to higher tax rates and prices for imported food and energy

Inflation picked up between January and July 2018, mostly tracking the prices of imported food and energy. Contributing factors were tax-related price hikes and the build-up in domestic demand (Figure 5.1). Yet core inflation is relatively stable, which suggests that long-term inflationary pressures are being contained (Figure 5.2). Inflation in Montenegro was the highest in the region, driven by a higher VAT rate and excises. In Bosnia and Herzegovina and in FYR Macedonia higher global energy prices and higher excise duties pushed up prices for fuel and imported food. In Serbia and Albania, appreciation of the national currencies and subdued food prices in the first quarter of the year helped ease inflationary pressures. Driving inflation in Kosovo was the rise in food and transport prices, although housing, energy, clothing, and communications prices declined.

Monetary policy continues to be accommodative. In Albania and Serbia, which have floating exchange rates and inflation targeting, and FYR Macedonia, which has a de facto pegged exchange rate, the central banks cut interest rates and intervened in the markets to smooth excessive short-term fluctuations in the exchange rate and to ease the impact of appreciation on domestic prices (Figure 5.3). In Serbia, after two cuts in 2017 the key policy rate was again lowered in March and April to 3 percent. Similarly, in Albania, lower than expected inflation associated with exchange rate appreciation triggered a cut in the policy rate by 25 basis points (bps) to a new minimum of 1 percent. In FYR Macedonia, reflecting prices still stagnant given the negative output gap and the improved external position, the central bank in two steps lowered the key interest rate by 25 bps. In Bosnia and Herzegovina,

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

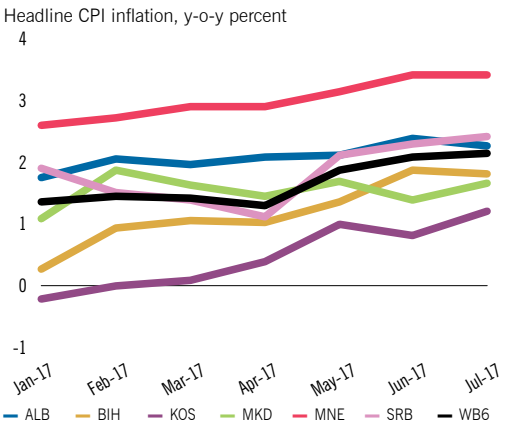
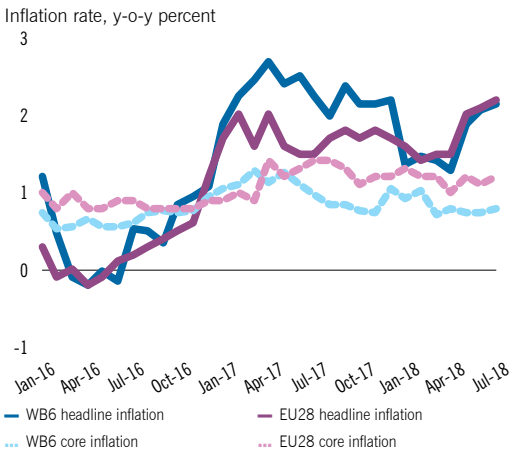


Figure 5.2. Food and energy prices have been mainly driving inflation in the first half of 2018.



Source: Central banks and World Bank estimates.
Note: Food and energy prices are included in headline but not core price indexes. Data for WB6 and EU28 calculated as weighted average.

the currency board also continues to support monetary policy.

Most exchange rates appreciated. Strong foreign currency inflows from exports, plus several one-off factors, drove up appreciation against the euro in Albania and Serbia (Figure 5.4). Although reflecting higher demand for these countries' exports, currency appreciation might not last, as emerging markets may be headed for a period of increased volatility (see Section 8).

Figure 5.3. Monetary policy further eased in the economies using inflation targeting…

Official policy interest rates, percent

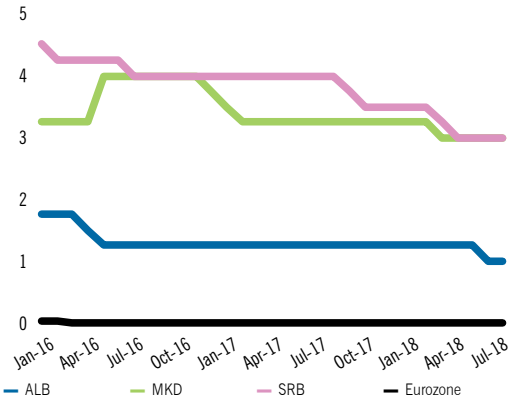
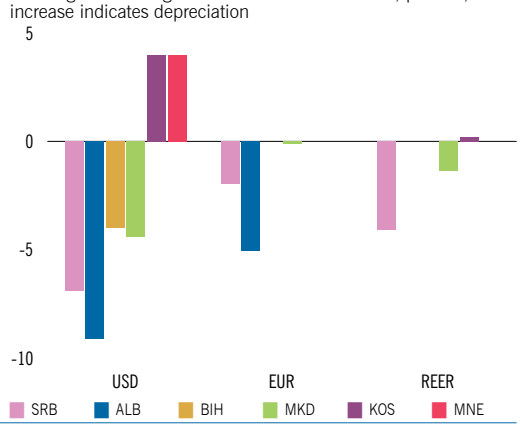


Figure 5.4. …as their currencies appreciated.

Exchange rate changes June 2017 to June 2018, percent; increase indicates depreciation



Source: National authorities and World Bank staff estimates.
Note: Kosovo and Montenegro are unilateral euro adopters.

6. Lending to households drives credit growth; despite lower NPLs, corporate lending is sluggish

Credit outstanding[2] continued to rise in most Western Balkan countries, reflecting recent reforms. Kosovo continued to show the strongest growth of credit outstanding to the private sector at over 11 percent in July 2018 (y-o-y), thanks to improving credit terms, reforms to firm up contract enforcement, and less bank aversion to risk (Figure 6.1). In Montenegro, accelerating growth in credit to the private sector exceeded 9 percent as asset quality continued to improve and deposits, a major source of funding for local banks, grew substantially. At 5 to 7 percent, lending also remained robust in Bosnia and Herzegovina, FYR Macedonia, and Serbia. Headline credit outstanding fell in Albania, partly reflecting the recent exchange rate appreciation, which reduced the value of loans denominated in foreign currency. Despite general progress in credit market deepening across the Western Balkans, domestic credit to the private sector continues to significantly lag behind levels in the European Union.

Lending to households continues to drive credit growth, mirroring the importance in the region of private consumption in driving GDP growth. Lending to corporations is more uneven, with write-offs of NPLs still suppressing credit growth (Figure 6.2). The regional average for growth in credit outstanding between July 2017 and 2018 was 9.1 percent for household loans and 3.2 percent for corporate loans (compared to 8.7 and 3.3 percent in December 2017).

De-euroization strategies are pushing up lending in domestic currencies, which reduces currency risk for unhedged borrowers. The central banks in FYR Macedonia and Serbia continue to work to de-euroize banks' balance sheets, keeping reserve requirements for foreign exchange-linked deposits higher than for the local currency and in the case of Serbia also assigning higher risk weights to unhedged borrowers. After some efforts to reduce lending in foreign currencies, in January 2018 the Bank of Albania launched a comprehensive strategy to reduce the use of foreign currency. Progress in de-euroization has been gradual; outstanding loans in foreign currencies still range from below 45 percent of total loans in FYR Macedonia to over 60 percent in Serbia and 50 percent in Albania.

Although NPLs are still high in most countries, improving asset quality is helping drive credit growth. NPLs burden bank balance sheets, undermine profits, and erode capital . High NPLs make it harder for banks to use the credit channel to support economic growth. Kosovo has the lowest NPLs in the region. Although NPLs are heading down in other countries, they are still high (Figure 6.3). FYR Macedonia and Kosovo had less exposure to international markets before the crisis and thus less need for reforms, likely a reason their NPLs are below pre-crisis levels. Albania, Montenegro, and Serbia continue to write off and sell old NPLs, and have reduced NPLs considerably

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

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

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

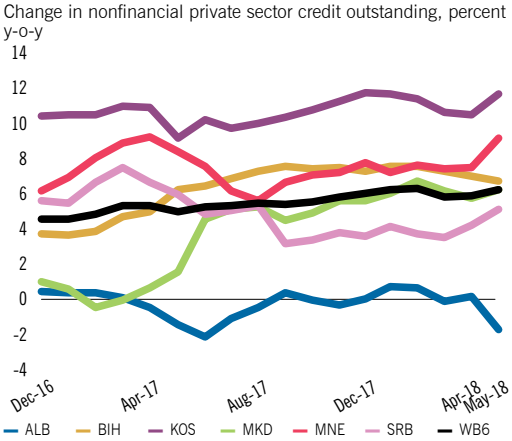


Figure 6.2. Credit to households grew; credit to firms dwindled.

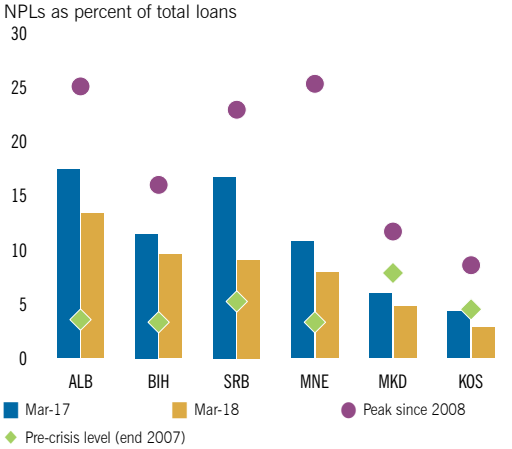
Change in credit outstanding, percent y-o-y in July 2018

Source: IMF IFS, central banks.

Note: Consistent data on private sector credit growth in Albania, Bosnia and Herzegovina, Macedonia FYR, and Serbia are from the IMF *International Financial Statistics* (IFS), which is currently available through May 2018. 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.

Figure 6.3. Nonperforming loans are declining.

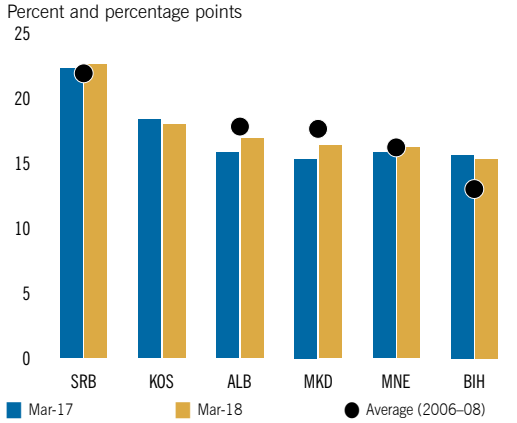
NPLs as percent of total loans



Source: IMF FSIs, National central banks.

Figure 6.4. Banks are adequately capitalized.

Percent and percentage points



Source: IMF FSIs, National central banks.

since 2017, especially Serbia. New insolvency laws are in place in Albania and the Bosnia and Herzegovina entity Republika Srpska. Albania is preparing to introduce a system for voluntary out-of-court restructuring. Montenegro has expanded coverage of the credit registry to enhance the capacity of lenders to assess credit risk and is working to redefine and reclassify NPLs and revise its capital requirements in compliance with the EU Capital Requirements Directive. As of March 2018, the regional NPL average was 8 percent of total loans. While NPLs in Albania have steadily declined from over 20 percent at peak to 13.3 percent as of June, that is still the highest in the region; at 2.8 percent, Kosovo has the lowest NPLs.

Banks in the Western Balkans remain well-capitalized, though further bank consolidation is still expected. As of March, bank capital adequacy averaged 17.6 percent (Figure 6.4). Profitability, though low, is on the rise, with a regional average return on assets of 1.8 percent as of March 2018. However, domestic bank vulnerabilities continue to raise concerns about asset quality and the health of specific banks. In Serbia, despite improvements in the banking system as a whole, the quality of state-owned bank assets is a source of risk. Structural changes in the banking sector continue with the planned sale of some foreign-owned subsidiaries as parent banks realign country exposures and smaller domestic institutions merge in Albania, Bosnia and Herzegovina, FYR Macedonia, and Serbia. Considering the size of Western Balkan economies and their financial sectors, there is room for further consolidation, the entrance of reputable players, and banking efficiency gains.

Diversifying financial systems is important to open up access to financing and the availability of term financing to foster investments—and ultimately economic growth. Financial systems in the Western Balkans are dominated by banks, which hold on average 85 percent of assets; there is very little capital market activity (stock market cap-to-GDP ratios average 19 percent and government securities-to-GDP 29 percent); penetration of insurance products is negligible; and nonbank financial institutions are generally insignificant. Bank liquidity, while ample, tends to be short-term, limiting the financing available for firms to invest and grow. Access to finance thus continues to be a challenge for firms in the region, especially micro, small, and medium enterprises. About 15 percent of these firms consider access to finance their biggest obstacle in doing business, compared to just 7 percent of large enterprises.[3] For smaller businesses, identifying alternative sources of funding could help drive innovation and long-term growth.

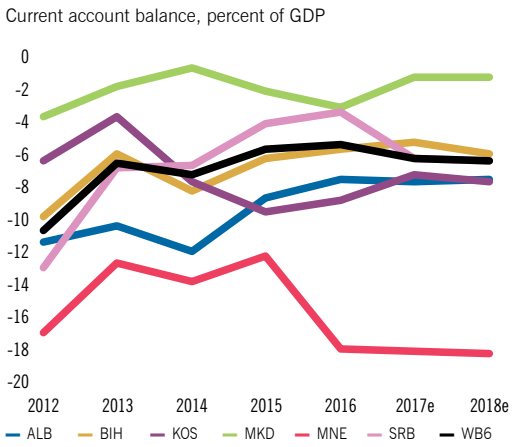
3 Based on World Bank Enterprise Survey data.

7. In most countries, despite export growth external deficits are still high

External deficits are expected to remain stable but elevated in most countries (Figure 7.1). In Montenegro the current account deficit (CAD) is expected to amount to 16.4 percent of GDP—about the same as in 2017 but by far the largest in the region. The elevated external imbalance is a potential threat to Montenegro's external sustainability given its dependence on FDI and foreign financing, but it also reflects high investment-related imports during the construction of the Bar-Boljare highway. Albania and FYR Macedonia have both improved their trade deficits and are expected to have slightly lower CADs, 6.8 percent of GDP for Albania and 1.2 percent for FYR Macedonia. Serbia's CAD is expected to hold at the 2017 level, 5.7 percent of GDP, because rising imports of equipment and intermediate goods were neutralized by a surplus in trade in services and higher net transfers. In Bosnia and Herzegovina, the current account deficit is expected to go up moderately, from 4.8 percent of GDP in 2017 to 5.3 percent because of a rising goods trade deficit. Kosovo's is projected to reach 6.9 percent of GDP; its deficit in trade of goods is rising because of higher imports of intermediate goods used for investment and lower exports because production of the Ferronikeli plant has halted.

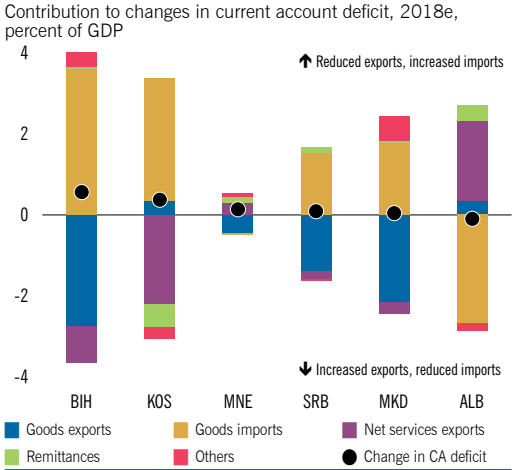
Goods and services exports continued to grow, but so did imports (Figure 7.2). Higher demand from the EU—the region's main trading partner—and higher prices for commodities resulted in higher exports for most Western Balkan countries. However, because the exports of those countries depend heavily on imports of intermediate goods, as do infrastructure construction, consumption, and energy supply, imports also increased

Figure 7.1. External deficits in the region have held steady.



Source: Data from central banks and national statistical offices; World Bank estimates.
Note: Data for WB6 calculated as weighted average.

Figure 7.2. Trade in goods drove the change in CADs, helped in some countries by new services exports.



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

substantially, attenuating the gains in the trade balance. Albania is projected to have the largest improvement in the goods trade balance in 2018, 2.2 percent of GDP, as a result of higher energy exports. However, its positive services trade balance is projected to decline significantly, resulting in only marginal improvement in the goods and services trade balance of 0.3 percent of GDP. The pattern is similar in Montenegro: in June exports of both goods and services had surged by 21.4 percent y-o-y, led by steel, aluminum, mineral fuels, wood, and tourism, but they were partially offset by rising imports of cars, furniture, electric machinery and equipment, iron, and steel. On the other hand, goods trade balances are expected to deteriorate by 3.4 percent in Kosovo, due to a disruption in the production of the Ferronikeli plant, and by 0.9 pp in Bosnia and Herzegovina as import growth surpassed export growth. In both countries, the trade deficit in goods was partly compensated for by a surge in services exports, particularly in Kosovo due to higher tourist income (largely diaspora travelers) and in Bosnia and Herzegovina to increases in transport and tourism services. In FYR Macedonia and in Serbia, the goods and services trade balances improved because of solid exports, driven in Serbia by foreign firms and ICT services and in FYR Macedonia due to higher exports in the auto parts industry. Complementarity of the export baskets of the countries in the region should create incentives for regional integration, which is a stepping stone toward higher volumes of exports (Box 7.1).

Despite high export growth, the share of exports in GDP remains low. Low exports represent a missed opportunity to speed up growth and improve external balances. High external imbalances make countries vulnerable to sudden stops in capital inflows or increasing costs of external financing. Especially for small countries, high stable growth is impossible without deeper trade integration; it boosts the size of accessible markets for successful domestic firms and makes countries exploit comparative advantages and economies of scale. Regional integration is a stepping stone to global integration and global value chain participation (see also the Spotlight on regional integration at the end of this report).

Stable FDI and remittances helped finance external imbalances (Figure 7.3 and Figure 7.4). Total FDI in the region is expected to reach 5 percent of GDP, slightly lower than in 2017 because it declined in all countries except Bosnia and Herzegovina and FYR Macedonia. The inflow of remittances in the Western Balkans is comparable to that of FDI, estimated at between 1.9 percent of GDP in FYR Macedonia and 11.9 percent in Kosovo. Despite new fiscal measures to attract FDI in 2018, Kosovo saw the biggest decline in FDI, from 4.0 to 1.9 percent of GDP between 2017 and 2018, though it was partly covered by strong growth in remittances. As in previous years, Montenegro is expected to have the highest inflow of FDI as a share of GDP, reaching 9.3 percent and covering about 60 percent of its CAD. Investments in Serbia are expected to total 6.5 percent of GDP (at the same level as in 2017), also aided by robust 20.6 percent y-o-y growth in remittances that were in total about 6.5 percent of annual GDP. In Bosnia and Herzegovina both FDI and remittances are expected to continue to grow steadily; FDI growth of about 2.1 percent of GDP and remittance inflows of about 8.2 percent are helping to balance the external account. In FYR Macedonia, a rebound in FDI—to an estimated 3 percent—is driven by

investments in services, primarily finance and insurance, and manufacturing, primarily motor vehicles.

The slight rise in external debt in 2018, in most countries from an already high base, implies that some countries continue to depend on external financing. Even though Western Balkan countries had been registering growing exports and FDI, which are improving their trade balance and external positions, in most there are risks associated with the persistence of high CADs, especially when external debt-to-GDP ratios are not only high but increasing. Still, in 2018 the ratio of external debt to GDP is projected to remain elevated for the Western Balkans at 80.5 percent of GDP. Currently, FDI finances a considerable part of the CADs. A sudden stop in foreign investments or an increasing reliance on imports, especially for consumption goods, would amplify dependence on external financing and may jeopardize foreign currency reserves (see Section 8). In 2018, however, all Western Balkan countries are projected to maintain reserves exceeding 4 months of imports.

Figure 7.3. Stable FDI helped finance most CADs…

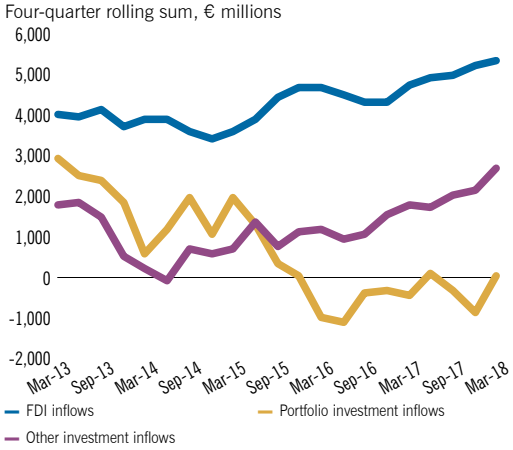
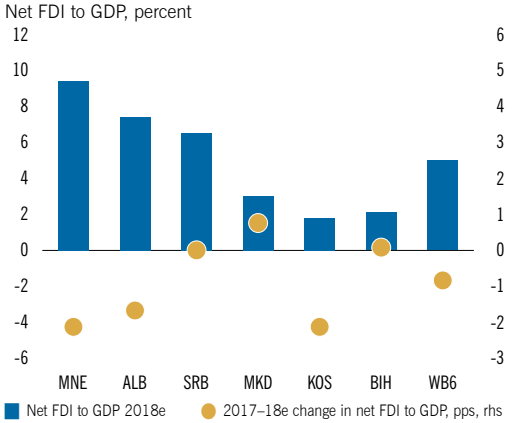


Figure 7.4. …but overall, FDI inflows stagnated at low levels.



Source: Data from central banks and national statistical offices; World Bank estimates.
Note: Dynamics of net FDI inflows in the Western Balkans closely track that of FDI.

Box. 7.1. Potential for value chain integration for Western Balkan exports to the EU.

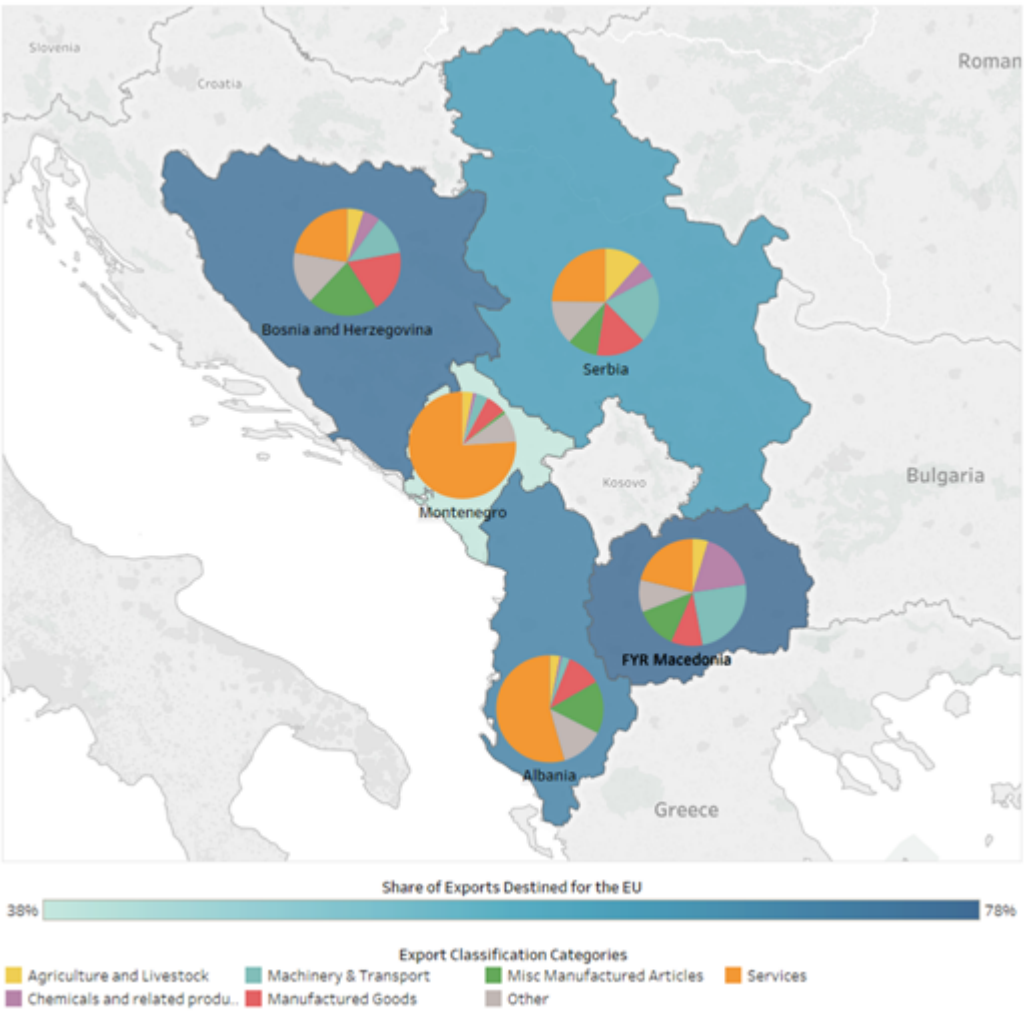
The main market for all Western Balkan exports is the EU (Figure B7.1.1). But the products exported to the EU are far from uniform, despite the historical ties of the region to the former Yugoslavia. Instead, there are substantial differences in export specializations. For Bosnia and Herzegovina, miscellaneous manufactured articles like apparel and footwear and manufactured goods like aluminum struts dominate its exports to the EU. FYR Macedonia and Serbia both specialize in exporting to the EU machinery and transport goods, such as auto parts. But Serbia has also specialized in exporting food products and FYR Macedonia chemical products to the EU. Exports

Box 7.1 continued

from Montenegro and Albania are dominated by services, especially tourism, and their goods exports are dominated by other manufactured products.

The different specialization patterns for exports to the EU are even more apparent when the categories are broken down into detail. The only top-three export products (SITC 4-digit level) to the EU that are exported by more than one country are footwear (Albania and Bosnia and Herzegovina), electric current (Bosnia and Herzegovina and Montenegro), and insulated electrical wiring (FYR Macedonia and Serbia). While footwear companies from Albania and Bosnia and Herzegovina compete in the EU market, most of the major export products of other Western Balkan countries do not necessarily compete for EU market shares.

Figure B7.1.1. Western Balkans Export Composition and Destinations.



Box 7.1 continued

The export specialization patterns suggest opportunities for cooperation through efficiency-enhancing activities like value chain integration. For example, Serbia exports cars to Italy mostly from the massive Fiat Chrysler plant while suppliers in FYR Macedonia specialized in exporting insulated electrical wiring, which is very important in automobile production and may thus open up opportunities for mutual trade.

Unlike export products, which offer opportunities for countries with similar specializations to compete, in some services sectors exports are by nature complementary. Because popular tourist destinations in the Western Balkans are not far apart, for instance, countries like Albania and Montenegro may be able to benefit more from the vitality of each other's tourism by bundling travel packages between famous sights in both (Table B7.1.1). Moreover, tourism sectors in both countries offer opportunities for local sourcing of necessary services or goods, such as food, reinforcing trade links between Western Balkan countries. Similarly, ICT firms in Belgrade can benefit from working with programmers or web designers based in Sarajevo, Skopje, or other cities in the region.

Table B7.1.1. Composition of Western Balkan services exports.

	Share of Each Service Category to GDP, percent			
Country	**ICT**	**Transport**	**Tourism**	**Total**
Albania	6	2	13	**20**
Bosnia and Herzegovina	3	2	4	**9**
FYR Macedonia	8	3	2	**14**
Montenegro	4	5	20	**29**
Serbia	7	3	3	**12**

Although most Western Balkan countries were formerly parts of a single country, their baskets of exports to the EU are quite different. They are therefore not necessarily competing directly with each other for the same EU markets or for FDI from the same EU firms. Rather, the differences in product specialization offer opportunities for more regional integration, including integration into value chains in such sectors as food, automobiles, or tourism. Given the different strengths and weaknesses of each country, there is room for mutual gains from economic cooperation throughout the Western Balkans.

Source: WB staff calculations the Observatory of Economic Complexity data, MIT.

8. The growth outlook is positive, but fragile

Medium-term growth in the Western Balkans is projected to solidify its upward trend, reaching 3.5 percent in 2019 and 3.8 percent in 2020 (Table 8.1). In FYR Macedonia, investment is expected to continue to recover because of the improving political climate, higher external demand, and investments in transport infrastructure. Growth in Serbia is expected to pick up to 4 percent by 2020, supported by higher exports and investment. Kosovo is projected to grow by 4.5 percent in 2019–20, the highest growth in the region, as consumption recovers and two large transport infrastructure projects are launched. Supported by domestic demand, growth in Bosnia and Herzegovina is expected to accelerate, reaching 3.9 percent by 2020. In contrast, growth in Albania and Montenegro is projected to taper off slightly: Economic activity in Montenegro is slacking off as fiscal consolidation advances and investment in public transport declines. In Albania it is projected to slow somewhat as private investment decelerates after two large FDI-financed energy projects are completed.

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

Percent

	2017	2018e	2019f	2020f
Albania	3.8	4.0	3.6	3.5
Bosnia and Herzegovina	3.0	3.2	3.4	3.9
Kosovo	3.7	4.0	4.5	4.5
Macedonia, FYR	0.0	2.5	2.9	3.2
Montenegro	4.3	3.8	2.8	2.5
Serbia	1.9	3.5	3.5	4.0
WB6	***2.4***	***3.5***	***3.5***	***3.8***

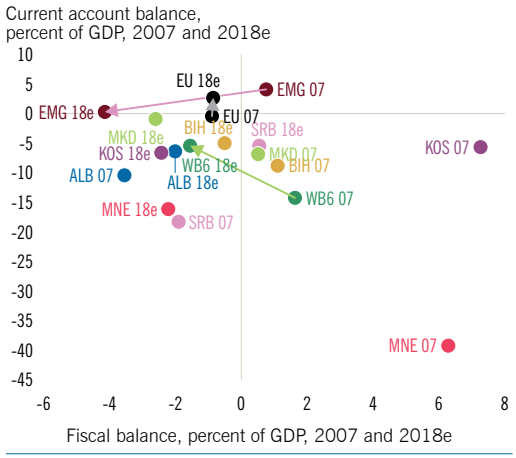
Source: Central banks and national statistics offices; World Bank estimates and projections.

A possible surge in external and domestic risks clouds the positive growth outlook. On the external front, the main risk is tightened financing conditions for emerging markets related to normalization of monetary policy in Europe, crises in a number of leading emerging markets, and uncertainty related to global protectionism. In addition, political stability in the region, current debates in the EU, and questions about the robustness of economic growth in the EU not only raise concerns but also elevate domestic uncertainties within the region. These stem primarily from the potential for delay or derailment of structural or fiscal consolidation reforms caused by the elections on the horizon in several countries and other political events. Other factors, such as any unmitigated risks of natural disasters (especially floods and droughts, see RER#13 for a full discussion) and political risks, also heighten the general uncertainty.

A potential tightening of the financing conditions in international capital markets is a downside risk, especially in countries with external or fiscal imbalances. As reported above, PPG debt increased sharply after the global financial crisis and remains high in several Western Balkan countries (see Figure 4.5). Although external deficits have generally improved since before the global financial crisis, only Serbia and Albania have lowered both external and fiscal imbalances. While external deficits have often declined somewhat, in 2018 fiscal vulnerability has increased compared to 2007 (Figure 8.1). Elevated twin deficits, external and fiscal, presage coming refinancing needs. With domestic sovereign

bond markets often underdeveloped, Western Balkan countries are heavily exposed to global interest rate increases. The tightening of external financing conditions—from a contagion of emerging markets due to events in Turkey or Argentina or from normalization of monetary policy in the developed world—could trigger the need for major fiscal consolidations, which could have severe adverse impacts on economic activity (Box 8.1). The effects of possible contagion from emerging markets to Western Balkan countries could be small, given minimal financial sector links and high share of FDI investment, but deterioration in the cost or availability of external financing is a worrying risk that could be exacerbated by exchange rate movements, such as the appreciation of the U.S. dollar.

Figure 8.1. The combination of external and fiscal deficits heightens regional vulnerability to rising costs for financing.



Source: National statistical offices, World Bank staff calculations, IMF World Economic Outlook.

Note: EMG refers to the IMF's Emerging and Developing economies classification of countries.

Box. 8.1. Impact of the situation in Turkey on the Western Balkans.

Turkey has been experiencing intense market volatility and economic stress. The value of the Turkish lira reached an all-time low in August 2018, having lost 87.5 percent of its value against the U.S. dollar since the beginning of the year. This situation was caused by a combination of overheating in the economy, changes in economic institutions, and a tightening in the external finances. Turkey is coping with problems related to the high current account deficit (CAD) and other external economic relations and its external financing needs, which are nearly 30 percent of GDP. Moreover, inflation has been persistently high—in August 2018 it was 17.9 percent, year-on-year.

Turkey is a key economic partner of the Western Balkans: (1) It is an important trading partner: Turkey accounts for between 1 percent (Albania) and 6 percent (Montenegro) of exports. The Western Balkans mainly export metals, oil seeds, and cereals to Turkey. Textiles, apparel, and electronics dominate imports from Turkey, which account for between 3 percent (Montenegro) and 10 percent (Kosovo) of the total imports. (2) Turkish banks are present in all six Western Balkan countries. Although they hold 0.1 percent of the market share in Serbia and 1.3 percent in Montenegro, they hold 22 percent of total banking sector assets in Kosovo and 28 percent in Albania. (3) Turkish investment is of particular importance in Kosovo (10.2 percent of total FDI) and in Albania and FYR Macedonia (about 5 percent).

The risk of contagion is manageable, with the main channel of potential impact through capital flows into emerging markets. The risk of contagion through the banking system is small. Should there be a risk through Turkish private sector borrowing from European banks, the banks are well-capitalized, with access to funds still easy. However, like other emerging markets, Western Balkans

Box 8.1 continued

countries are vulnerable to contagion from the capital markets. Although the high presence of Turkish banks in Albania and Kosovo is an additional risk, these operate as separate legal entities and are subject to national monitoring and safeguards. The main risk is the contagion through investor aversion to emerging markets, which may prompt them to sell riskier assets as investors search for yield in the low interest rate environment.

Table B8.1.1. Channels for transmission of Turkish market volatility to Western Balkan countries.

	Export of G&S (Exports to Turkey as percent of the total export)	Import of G&S (Import from Turkey as percent of the total import)	FDI inflow (Turkey's share of the total)	Banking sector (number of Turkish banks)	Banking sector (Share of Turkish banks in total assets)	Banking sector (credit in Turkish Lira)
Albania	0.8	7.5	5.0	1	27.9	n.a.
Bosnia and Herzegovina	3.9	4.2	3.1	1	3.5	0
Kosovo	1.9	9.6	10.2	3	22.0	n.a.
Macedonia, FYR	1.6	4.8	5.3	1	9.2	0
Montenegro	6.0	3.1	3.6	1	1.3	0
Serbia	1.8	3.7	0.7	1	0.1	0

Note: 2017 data, except for FDI for FYR Macedonia and Bosnia and Herzegovina where the stock data is used.

Source: World Bank staff calculations.

Notes: 2017 data, except for FDI for FYR Macedonia and Bosnia and Herzegovina where the stock data is used.

Uncertainty related to a possible escalation of trade disputes could delay or deter investment. The risks of disruption to trade flows are added to those of trade negotiations on NAFTA and between the EU and the UK. As uncertainty rises, investors become more cautious, especially about entering industries like automobile production. New U.S. tariff hikes may worsen uncertainty and market volatility. So far, import costs are limited to U.S. tariffs on steel and aluminum, U.S. tariffs on certain goods from China, and, in response, tariffs by Canada, China, the European Union, India, Mexico, and Turkey on a variety of U.S. goods (Box 8.2). As long as current tariff actions are targeted against a single country, there may be an opportunity for exports of Western Balkan countries to partially substitute for targeted goods previously imported from the U.S. or China. But further tariff surcharges, currently under official study, pose significant risks, especially when they are expanded to include the car industry. That is, even with uncertainty of repercussions through the value chains, new U.S. tariffs on cars from the EU are likely to have significant adverse effects on FDI inflows and exports of the Macedonian and Serbian car and car parts industries—which are significant to the economies of both countries. An escalation of the trade conflicts might trigger a general global decline in investor confidence that would have major repercussions for all Western Balkan economies.

Stronger economic growth in the EU has major upside potential. Favorable external

demand from the EU would support export growth and the inflow of remittances into Western Balkan countries. Although global growth has eased slightly, it remains robust enough to reach a projected 3.1 percent in 2018 and 2.9 percent in 2020.[4] While growth is expected to decelerate in other advanced economies, it is expected to accelerate somewhat in the Euro Area relative to 2017. Robust external demand is expected to drive goods exports in FYR Macedonia and Serbia and services exports in Albania and Montenegro. Moreover, stronger private investment financed by FDI in Kosovo, FYR Macedonia, and Serbia is tied to robust growth projections in the EU.

Robust growth in the region depends on domestic and regional political stability. Political stability strengthens both investor confidence and private consumption; investment uncertainty heightened by political instability is a major downside risk to the positive growth outlook in the region. In the EU, as the European Central Bank starts to moderate its quantitative easing program, some countries struggle with high borrowing costs and high debt, and growth projections vary widely depending on assumptions about the potential impact of tightening, or a more disorderly interest rate adjustment, on some vulnerable EU economies. Industrial production declined in the EU in the first half of the year. Combined with other political events, these internal challenges may distract attention from EU enlargement and reduce the pressure for structural reforms in the Western Balkans. Political tensions in the Western Balkans may also have an impact, including the relationship between Serbia and Kosovo, and FYR Macedonia's agreement with Greece on its name. On the domestic front, risks are primarily related to upcoming elections in several countries and the resulting slowdown in carrying out structural reform programs.

Mitigating these risks requires both staying committed to fiscal consolidation, and giving impetus to structural reforms. In the short term, launching credible medium-term fiscal consolidation strategies is thus necessary to reduce deficits to create fiscal space to finance higher-quality public services and build buffers against adverse economic shocks. These strategies need to be based on making public spending more efficient so that better public services can be delivered more effectively. But they also need to emphasize strengthening public financial management and making public finances more transparent and accountable. To sustain higher growth, the growth strategies of Western Balkan countries must move away from reliance on unsustainable transfers to individual groups or firms and toward structural reforms that generate formal private sector jobs by boosting human capital, firm productivity, and innovation. This requires leveling the playing field for firms by removing regulatory barriers to firm entry, reinforcing the mandate—and the power—of competition authorities, making state aid programs more transparent, ensuring that public procurement is transparent and competitive, removing barriers to trade and FDI in services sectors, enhancing the independence and efficiency of commercial courts, and reducing the costs related to hiring formal employees. And it also requires boosting the quality of public services, including education more responsive to market needs, reforming pension, social assistance, and health care systems to overcome their structural

4 World Bank, 2018, "Global Economic Prospects, June 2018: The Turning of the Tide?" Washington, DC: World Bank. doi: 10.1596/978-1-4648-1257-6.

and demographic challenges. The success of these reforms, beyond mere adoption of general laws, is critical to both mitigate external and domestic risks and to enhance Western Balkan growth potential and thus incomes region-wide.

Box 8.2. Impact of global trade tensions on the Western Balkans.

The current round of trade disputes, involving the United States, China, and U.S. trading partners, may create both opportunities and risks for the Western Balkans.

What has happened: In 2018, in unusual circumstances several countries introduced import tariff surcharges on a variety of goods. These included U.S. tariffs on steel and aluminum from almost all countries (March 2018), U.S. tariffs on certain goods from China valued at about $50 billion, Chinese tariffs on certain goods from the U.S. valued at about $50 billion (July/August 2018), and tariffs by Canada, China, the European Union (EU), India, Mexico, and Turkey on a variety of U.S. goods, in response to the U.S. tariffs on steel and aluminum (April–July 2018). Officials are studying further tariffs, among them U.S. tariffs on another $200 billion of imports from China, Chinese tariffs on another $60 billion of imports from the U.S., and U.S. global tariffs on imports of autos, auto parts, and uranium. The recent U.S. actions and the counter-actions of U.S. trading partners are now subjects of disputes at the World Trade Organization.

Channels of influence: Tariff surcharges on U.S. imports of particular categories of goods, to the extent that they are global or near-global, could reduce U.S. imports from the Western Balkans to the extent that Western Balkan countries actually export any of these goods to the U.S. At present, this applies to the steel and aluminum tariffs. Additional U.S. tariffs on consumer goods could further disrupt global value chains by reducing demand for upstream goods or services supplied to targeted industries. The U.S., for example, is currently considering imposition of import tariffs on autos worldwide. This would most likely reduce the volume of US imports of cars from the main European producers and thus, in turn, reduce their demand for auto part imports, which would attenuate exports—and possibly FDI into the Western Balkan auto parts industry.

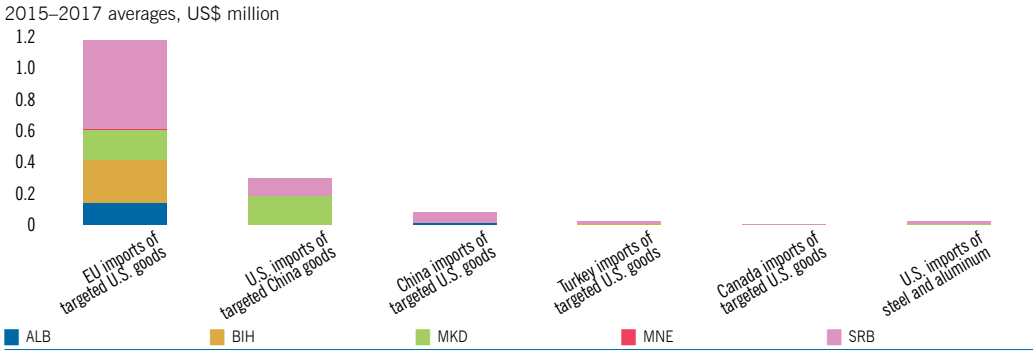
The current tariff actions, however, are targeted against specific countries. In these cases, there might also be an opportunity for Western Balkan exports to increase because they might partially substitute for targeted goods previously imported from the U.S. or China. Model-based estimates indicate that tariff surcharges imposed due to the U.S.-China trade dispute would have a small positive impact on exports of most other regions of the world but a negligible impact on their GDP. However, if escalation of trade conflicts and accompanying uncertainty leads to a significant global decline in investor confidence, all regions of the world would be harmed.

Potential impact on the Western Balkans: Figure B.8.2.1 shows the value of Western Balkans exports that appear on product lists in current trade disputes. At the moment, goods exposed to the potential for export expansion substantially outweigh in value goods facing new tariff barriers. U.S. imports of targeted steel and aluminum from the Western Balkans amount only to about $21 million a year. However, imports of specific goods on targeted product lists are much larger, amounting to

Box 8.2 continued

about $1.2 billion for EU imports of targeted U.S. goods, $296 million of U.S. imports of targeted China goods, $77 million of China's imports of targeted U.S. goods, $21 million of Turkey's imports of targeted U.S. goods, and $5 million of Canada's imports of targeted U.S. goods.

Figure B8.2.1. Imports of Western Balkan goods affected by recent trade actions



Source: World Bank staff calculations using UN Comtrade dataset. See also Freund, Caroline, Michael Ferrantino, Maryla Maliszewska, and Michele Ruta, July 2018, "Impacts on Global Trade and Income of Current Trade Disputes," *Macroeconomics, Trade and Investment MTI Practice Notes* No. 2, World Bank Group. Washington, DC.

Potential impact on specific Western Balkan exports: The U.S. imports primarily certain hot-rolled steel products from Serbia and FYR Macedonia. These exports to the U.S. will likely decline. They amount to 4.5 percent of current Serbian exports to the U.S. and 2.8 percent of current Macedonian. EU imports from the Western Balkans of goods targeted from the U.S. are dominated by iron, steel and, aluminum products, apparel, furniture, and cereals. The share of all EU imports from the Western Balkans that appear on the targeted list is significant, ranging from 4.1 percent for FYR Macedonia to 10.7 percent for Albania. U.S. imports from the Western Balkans of goods targeted from China, on the other hand, are dominated by motor vehicles, electric motors, circuit boards, and miscellaneous electrical and mechanical capital and intermediate goods. These originate primarily in Serbia and FYR Macedonia.

Western Balkan exports of auto parts to the main European countries that export cars and trucks to the U.S. (Germany, Italy, Norway, Slovakia, Spain, Sweden, and the U.K.) averaged €243 million from 2015–17—the most important auto parts exports are ignition wiring sets (€114 million) and motor vehicle seats (€54 million). The share of these parts used in autos produced for the U.S. rather than other markets is unknown. Serbia's exports of auto parts of €101 million is the highest in the region and accounts for 2.4 percent of total Serbian exports to these countries, followed by FYR Macedonia (€63 million, 2.7 percent), Bosnia-Herzegovina (€62 million, 4.1 percent), and Montenegro (€3 million, 5.7 percent).

9. Spotlight: Greater regional economic integration means higher growth and more jobs

Few small countries in Europe and Central Asia have achieved high levels of income per capita without deep integration into the global economy. Economic integration can facilitate access to a larger consumer base, a greater pool of qualified workers, additional sources of financing, and new technologies. A larger market with an even playing field for both domestic and international firms can strengthen competition, shake up sclerotic industries, and encourage innovation. This is particularly important for small economies in Europe and Central Asia, where domestic markets alone are not large enough to justify development of complex value chains and where local closely connected political and business elites can sometimes prevent the emergence of domestic competition.[5,6]

While the Western Balkans have made major progress toward opening their economies, they continue to trail regional peers. For instance, while the average ratio of goods and services exports to GDP in the Western Balkans rose from about 30 percent in 2010 to about 40 percent in 2017, that is still behind levels achieved by regional peers like Latvia (about 60 percent), Cyprus (about 65 percent). and Estonia (about 80 percent)—all of which have significantly higher income per capita even with populations similar to or smaller than Western Balkan economies. In part, this reflects legacy factors in the Western Balkans—such as a relatively limited productive base that now needs to be gradually nurtured and a recent history of regional ethnic tensions that has limited both intra- and inter-regional trade. However, in part this situation also calls for further policy action.

In 2017, recognizing the growth opportunities that can come with economic integration, the Western Balkans initiated a joint Multi-Annual Action Plan (MAP) to develop a Regional Economic Area. This initiative promotes regional economic integration among the Western Balkan countries, but also aligns regional legal frameworks and infrastructure with the requirements for eventual EU accession, to help full integration into the EU value chains. The MAP covers four dimensions of economic integration: trade, investment, mobility, and digital integration. Much has already been achieved: For instance, the Central European Free Trade Association (CEFTA) Additional Protocol 5 on trade facilitation has entered into force, a Regional Investment Reform Agenda (RIRA) has been endorsed, and a Digital Reform Agenda has been launched.

Building on this momentum, the region now has a unique opportunity to move forward to greater regional and global economic integration. This requires decisive policy actions on all dimensions of the MAP:

5 As population increases, the link between trade openness and high income per capita weakens. Nonetheless, even for an economy of Serbia's population, following the development path of open economies like Hungary, Belgium, and the Czech Republic is a promising option.

6 Nonetheless, economic integration alone is unlikely to be sufficient to achieve high income per capita (see FYR Macedonia) and may not be the only pathway to high income in a small economy (see Norway).

- **Trade:** Besides upgrading physical infrastructure and aligning tariffs, nontariff obstacles to trade need to be brought down. National single windows can streamline documentation processing for traders. Automating the cross-border process can alone save 2 percent in trade costs.[7] Joint border crossings can reduce truck travel times. A risk-based approach to border controls can slash the time inspection and other procedures take, and thus the time to trade.[8] There is also much export volume and product diversification to be gained through reliable standards and certifications of quality that are harmonized with the EU.

- **Investment:** In 2017, across the region average investment was 23 percent of GDP, a third lower than the middle-income-country average.[9] Individual country initiatives to attract FDI have relied on blunt incentives like tax breaks and cash subsidies. Moreover, the type of FDI attracted has had limited spillover to the rest of the economy. Obviously, this is not a sustainable strategy. RIRA offers a coordinated approach to regional investment. In a World Bank worldwide survey, close to 90 percent of investors said that accessing new customers was a key motivation (World Bank Group 2018). With RIRA, the Western Balkans can offer seamless access to a regional market. A regional investment plan will reduce obstacles to investor entry, better protect investors, streamline policies for attracting investors, and, perhaps most important, better position the region for integrating into global supply chains. Now is the time to translate RIRA into concrete actions to align national investment frameworks.

- **Mobility:** To alleviate the brain drain and fill skills gaps, the Western Balkans need a more attractive value proposition for highly skilled workers. The region's skills gap is real. The 2018 Balkan Business Barometer reports that in the last 12 months 1 in 5 businesses have had difficulties filling vacancies. Businesses identified lack of skills as the reason two-thirds of vacancies went unfilled. The MAP foresees (1) making mobility simpler for researchers; (2) mutual recognition of professional qualifications, such as those of doctors, dentists, architects, and engineers, and (3) mutual recognition of academic qualifications. These initiatives can raise the value of acquiring and using skills; and together with national reforms of education, they can help tackle the regional skills gap.

- **Digital integration:** The Western Balkans can seize the opportunities created by the digital revolution. Already, in Kosovo, the startup *gjirafa* is an inspiring example. This company developed a search engine for the Albanian language. Using its success to raise capital in Silicon Valley, the business expanded by adding online content, such as digitizing bus schedules, video streaming services, and an online market place that today serves Albania,

7 Evdokia. Moïsé, and Silvia Sorescu, 2013. "Trade Facilitation Indicators: The Potential Impact of Trade Facilitation on Developing Countries' Trade," OECD Trade Policy Papers 144, OECD Publishing, Paris.

8 In Montenegro, a risk-based approach to customs reduced inspections of imported excise goods by 80 percent and the average release time for goods by 70%. http://www.worldbank.org/en/news/feature/2018/06/11/a-new-way-of-managing-risk-for-customs-in-montenegro.

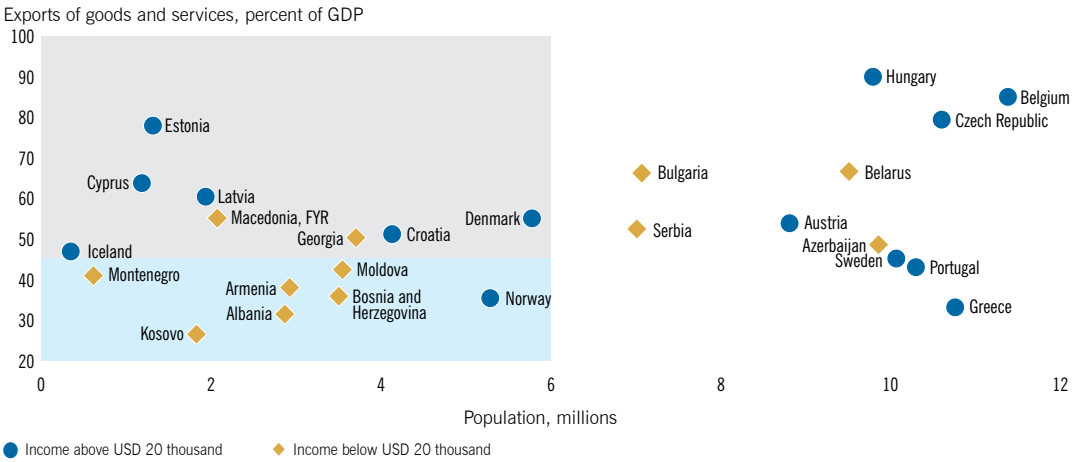
9 Simple average of GFC ratios; World Development Indicators (WDI).

Kosovo, and FYR Macedonia. The region has also attracted some big players, such as Microsoft, which has sited one of its five global development centers in Serbia. This has greatly stimulated the startup scene there. With the right enabling environment, this is just the start for realizing the IT potential of the Western Balkans. Doing so will include elimination of regional roaming charges, a unified approach to digital security and data protection, promotion of digital skills, and affordable and accessible high-speed broadband.

This comprehensive approach to regional integration is necessary to facilitate the transfers of knowledge and technology that are critical to sustained high economic growth and shared prosperity. Critical connections between the Western Balkan countries through trade, FDI, migration, telecommunications, and transportation, among others, complement each other. The internet and efficient transport links, for example, are both necessary to boost exports, in goods as well as services. And both are necessary for successful e-commerce to reap the benefits from the digital revolution. Moreover, technology transfers emerge from FDI linking domestic firms to global value chains, creating local knowledge spillovers. And they are greater from countries that themselves have strong links to third countries. Therefore, a balanced approach to increasing all dimensions of connectivity is desirable.[10]

The stakes are high, but economic integration may be the key to the higher living standards the Western Balkans aspire to. Income per capita in the Western Balkans is still only 28 percent of Germany's; at current growth rates, it will take five decades for the region to reach Germany's current standard of living and

Figure 9.1. Among small countries in Europe and Central Asia, high income per capita is closely correlated with trade openness.



Source: World Development Indicators 2017; European and Central Asia (ECA) economies with population less than 12 million; excluding Luxemburg; income is measured as GDP per capita, PPP (constant 2011 international $).

10 See Gould, David Michael. 2018. Critical Connections: Promoting Economic Growth and Resilience in Europe and Central Asia. Europe and Central Asia Studies. Washington, DC: World Bank.

eight decades to catch up with Germany.[11] New opportunities are needed to speed up growth—which means overcoming small and fragmented national markets. The process will be helped by the non-competing nature of countries' exports (see Box 7.1). With a shared vision to ensure macroeconomic stability, carry bold reforms beyond borders, and enhance economic integration, the Western Balkans can accelerate growth, improve living standards, and reap the benefits of the new global economy.

11 The calculations are based on WDI GDP per capita (PPP constant 2011 international dollars). The Western Balkans ratio is a simple average of GDP per capita in Western Balkans countries. Projections are based on extrapolating the ratios forward, based on the five-year historical average growth rate of the ratios.

Country Notes

Albania

- Growth for 2018 is projected to be 4 percent, supported by a weather-related spike in hydroelectric power production and a strong tourism season.
- Employment growth is helping to reduce poverty.
- The primary fiscal deficit and public debt are expected to decline.
- In the medium term, growth is expected to gradually moderate to about 3.5 percent. Risks to this outlook include international situation in emerging markets, growth in the EU, and the success of the fiscal consolidation and tax reform.
- Fiscal consolidation, more efficient public spending, and structural reforms are still critical to sustainable and equitable growth.

Main Developments and Trends

Annual GDP growth for 2018 is projected at 4 percent. Hydroelectric power production in the first half of 2018 nearly doubled from the same period last year, driven by heavy rains. Tourism is boosting growth of services exports. Improving employment, wages, and credit growth continue to drive private consumption. While private investment is decelerating with completion of two large energy projects financed by foreign direct investment (FDI), heavy government spending on infrastructure is supporting growth in total investment. Albania's economic recovery in the first half of 2018 is expected to carry through into the second half of the year.

Sustained growth has supported job creation and encouraged participation in the labor force. Employment grew by 4 percent in the first half, mostly in services and industry. The unemployment rate fell to 12.4 percent of the labor force. Increased capacity utilization in certain segments of the labor market is building up pressures on real wages, which grew by 2.3 percent in the first quarter, following a trend established in 2017. Real wage increases in agriculture and construction should help boost the incomes of workers in the bottom 40 percent of the income distribution, heightening the prospects for less poverty for the year.

In 2018 Albania's fiscal deficit is forecast to hold at 2 percent of GDP. Fiscal revenues are expected to go up by 0.3 percent of GDP. Higher social security contributions and national tax revenues compensate for lower than expected VAT revenues and delays in introducing the new property tax. Similarly, spending is forecast to increase by 0.3 percent of GDP, with capital spending going up by 22.5 percent, mainly for infrastructure, which will more than offset lower current transfers. The net fiscal balance is forecast to remain unchanged in 2018. In compliance with the fiscal rule, public debt is expected to decline from 71.6 percent of GDP in 2017 to 69.5 percent in 2018. Exchange rate appreciation is expected to keep the external public debt share on GDP at a slightly lower level than last year, even though external financing is expected to increase.

Following an appreciation of the exchange rate, the central bank intervened in the foreign

exchange market and further eased monetary policy. Strong foreign currency inflows from exports and several one-off factors combined to drive up the lek exchange rate in Spring 2018. With inflation expected to average 2.1 percent in 2018—below the 3 percent target—the central bank again lowered the policy rate by 0.25 percentage points (pp) to minimize the impact of the appreciation on domestic prices. With the banking system liquid, well-capitalized, and making progress in cleaning up nonperforming loans, the monetary easing is expected to further stimulate credit growth.

The current account deficit (CAD) is expected to reach 6.8 percent of GDP in 2018 as exports in both goods and services expand and outgrow imports. Stronger economic performance in the EU is also supporting remittances, which are expected to amount to 6.3 percent of GDP (in net terms). The CAD is fully covered by FDI. Meanwhile, foreign exchange reserves have held steady, covering the equivalent of 6½ months of imports of goods and services.

Outlook

Albania's economic growth is projected to slow to about 3.5 percent by 2019–20 as the increased economic dynamism gradually closes the output gap. Growth will rely increasingly on private consumption, fueled by labor income gains, and on net exports, supported by growing foreign demand and expanding market access. Investment—public and private—will also contribute to growth as the government continues to invest in infrastructure and the business environment improves.

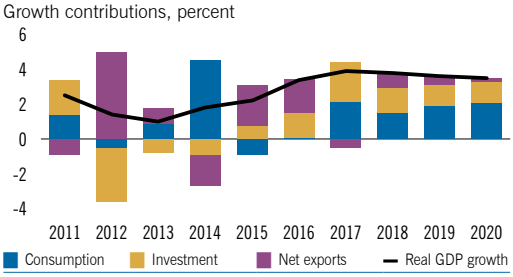
Given the strong performance of the labor market since 2017, poverty is expected to decline faster in the next two years. Based on the growth and consumption forecasts, poverty is projected to fall by more than 2 pp a year, reaching about 24 percent in 2020. However, the 9 percent minimum wage increase in 2017 could have an ambiguous effect on poverty, reducing the number of jobs created at the margin while increasing the wages of those already working.

The fiscal deficit is expected to fall to 1.2 percent of GDP by 2020. Based on the medium-term fiscal framework, fiscal consolidation is expected to continue until 2022, which should generate savings on public wages, goods and services, and current transfers to social insurance beneficiaries and local governments. At the same time, launch of the new property tax in late 2018 will increase revenues. Sustained capital expenditures of 5 percent of GDP are planned over the medium term, and later this year additional investments, financed through public private partnerships (PPPs), will be contracted. By 2022, gradual fiscal consolidation and continued economic growth are expected to lower the debt-to-GDP ratio to 60 percent.

Downside risks do threaten these positive economic prospects. External risks include a possible tightening of financing conditions for emerging markets, and EU growth and accession prospects which are also dependent on current discussions in the Union. On the domestic side, determined progress on fiscal consolidation and broadening of the tax base are necessary to preserve macro-fiscal stability as a foundation for growth. The government should also actively manage fiscal risks from PPPs and

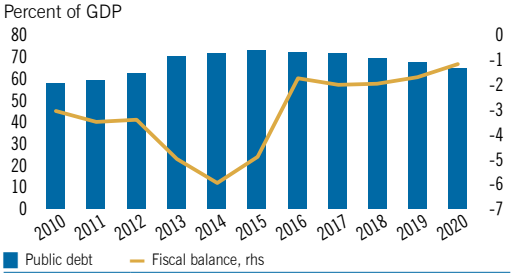
state-owned enterprises and continue to make public spending more efficient. Sustaining inclusive growth requires a commitment to tackling structural challenges related to the business environment, energy security, and human capital.

Investment and consumption are expected to drive growth in 2018.



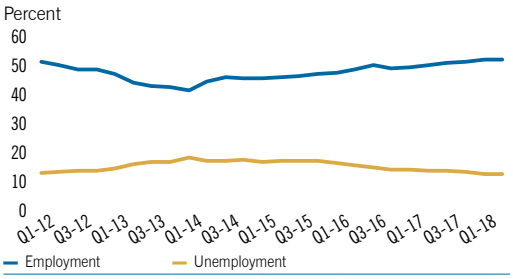
Source: INSTAT and World Bank.

Government debt is declining as the fiscal deficit narrows.



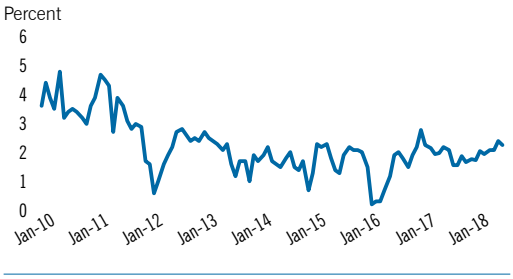
Source: Ministry of Finance and World Bank.

Growth is supporting sustained recovery in the labor market.



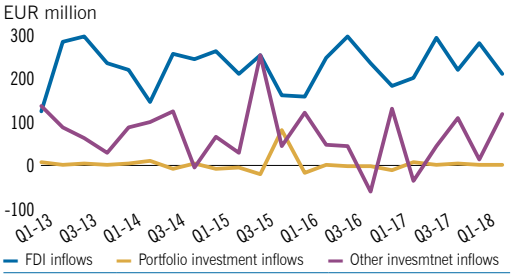
Source: INSTAT.

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



Source: INSTAT

Sustained non-debt-creating flows (FDIs) covered the current account deficit entirely.



Source: Central Bank and World Bank.

ALBANIA	2014	2015	2016	2017	2018[e]	2019[f]	2020[f]
Real GDP growth (percent)	1.8	2.2	3.4	3.8	4.0	3.6	3.5
Composition (percentage points):							
Consumption	4.5	-0.9	0.1	2.1	1.5	1.9	2.1
Investment	-0.9	0.7	1.4	2.3	1.5	1.2	1.2
Net exports	-1.8	2.4	1.9	-0.5	1.0	0.5	0.2
Exports	0.9	0.5	6.5	5.7	4.4	4.4	4.2
Imports (-)	2.7	-1.9	4.6	6.2	3.5	3.9	4.0
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	28.0	28.2	28.3
Public expenditures (percent of GDP)	32.3	31.5	29.4	29.7	30.0	29.9	29.5
Of which:							
Wage bill (percent of GDP)	5.1	5.1	4.6	4.7	4.7	4.7	4.6
Social benefits (percent of GDP)	9.9	9.9	10.3	10.2	10.2	10.2	10.1
Capital expenditures (percent of GDP)	4.3	4.4	4.0	4.4	5.1	5.0	5.0
Fiscal balance (percent of GDP)	-6.0	-4.9	-1.8	-2.0	-2.0	-1.7	-1.2
Primary fiscal balance (percent of GDP)	-3.1	-2.2	0.5	0.1	0.3	0.7	1.2
Public debt (percent of GDP)	66.1	69.1	68.7	67.8	65.5	62.7	61.7
Public and publicly guaranteed debt (percent of GDP)	72.0	72.7	72.3	71.6	69.5	67.2	64.8
Of which: External (percent of GDP)	29.6	34.2	32.6	32.4	32.3	32.1	31.7
Goods exports (percent of GDP)	9.3	6.8	6.0	6.7	6.3	6.4	6.5
Goods imports (percent of GDP)	31.6	27.0	27.9	29.7	27.1	26.8	26.6
Net services exports (percent of GDP)	3.2	2.9	5.1	7.9	5.9	6.2	6.4
Trade balance (percent of GDP)	-19.1	-17.3	-16.8	-15.1	-14.8	-14.2	-13.7
Remittance inflows (percent of GDP)	7.2	7.4	7.2	6.7	6.3	6.2	6.1
Current account balance (percent of GDP)	-10.8	-7.8	-6.8	-6.9	-6.8	-6.6	-6.1
Foreign direct investment inflows (percent of GDP)	8.1	8.0	8.7	9.0	7.3	6.5	6.1
External debt (percent of GDP)	69.6	73.6	73.6	73.6	73.6	73.6	73.6
Real private credit growth (percent, period average)	-1.4	-1.8	-2.1	-2.3	n.a.	n.a.	n.a.
Nonperforming loans (percent of gross loans, end of period)	22.4	18.2	18.3	13.2	n.a.	n.a.	n.a.
Unemployment rate (percent, period average)	17.5	17.1	15.2	13.8	n.a.	n.a.	n.a.
Youth unemployment rate (percent, period average)	32.5	33.2	29.0	25.9	n.a.	n.a.	n.a.
Labor force participation rate (percent, period average)	53.7	55.7	57.5	58.3	n.a.	n.a.	n.a.
GDP per capita, PPP (current international $)	10,645	10,926	11,276	11,693	12,114	12,526	12,964
Poverty rate at US$5.5/day, PPP (percent of population)	37.0	35.4	33.3	31.0	28.4	26.2	24.0

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

Bosnia and Herzegovina

- *Bosnia and Herzegovina (BiH) has maintained a stable 3 percent annual growth rate for the last few years. Growth in 2018 is projected at 3.2 percent, driven primarily by consumption. In the medium term it is expected to pick up as a new government is elected and structural reforms supported by new investment in infrastructure get underway.*
- *As a result of a planned increase in public investment, in 2018 the fiscal stance is expected to deteriorate, followed by gradual improvement over the medium term; this forecast assumes the success of reforms to reduce the public wage bill and shift jobs from the public to the private sector.*
- *Risks to this outlook are mostly on the downside. Externally, slow growth in the EU and accession prospects, possible tightening of financing conditions for emerging markets, as well as regional political situation are the main downside risks. Domestically, delays in forming the new government after the October general election could slow reform efforts and drag down growth.*

Recent Economic Developments

Growth in 2017 was an estimated 3 percent, rising to an estimated 3.2 percent in 2018. Consumption continues to be the dominant driver of growth, adding 3.5 pp, followed by investment (0.8 pp). Net exports, however, are expected to subtract 1.1 pp from growth. In the first half of the year, external demand helped push up export growth by 12 percent, but an 8 percent rise in imports offset export momentum. The main exports are mineral products, base metals, and machinery, which together contributed 69 percent to growth in exports. Growth in imports was broad-based and mainly driven by the same three categories, followed by chemical products, plastics, and rubber, which together explain 70 percent of the growth in imports.

The unemployment rate remains high, although the labor market has improved somewhat. The unemployment rate has fallen from 20.5 percent in 2017 to 18.4 percent, driven by rising demand for labor and a fall in the activity rate.[1] The employment rate has risen from 33.9 percent in 2017 to 34.3 percent this year, though that is still low for a Western Balkan country. Most of the jobs improvement originated in industry and services; in agriculture employment went down in absolute terms. The long-term unemployment rate decreased by 2 pp but is still 80 percent. Despite stable economic growth for the last three years, there have been only modest gains in employment. Addressing structural rigidities will be crucial if BiH is to accelerate and solidify gains in job creation.

Prices have picked up. In 2017 the consumer price index rose on average by 0.8 percent. A long winter, a rebound of global energy markets, and the increase in excise duties pushed up prices

1 2018 Labor Force Survey.

for fuel and imported food in the first half of the year; tobacco prices also went up. By June 2018 these had led to a 1.9 percent increase in consumer prices year on year (y-o-y). Given the limited growth in nominal salaries, in 2018 higher consumer prices will most likely reduce real incomes.

In 2018, a fiscal deficit higher by 0.5 percent of GDP is expected. The fiscal account has been in surplus for several years. A surplus of 2.4 percent of GDP is estimated for 2017, up from a 1 percent surplus in 2016.[2] This increase is mainly the result of higher collection of tax revenues, although combined with higher social spending and some recovery of capital spending. In 2018, both tax revenues and spending on wages, social transfers, and investment are expected to increase lending, causing a deficit of 0.5 percent of GDP. Reaching agreement on the Global Fiscal Framework for 2019–21 by midyear is an important milestone; it has created a positive precondition for timely adoption in this election year of the budgets for 2019. Total public debt in 2017 was 36.1 percent of GDP (of which external was 30.6 percent) and consisted largely of concessional debt to international financial institutions. The total external debt-to-GDP ratio is projected to remain at about 70 percent in 2018.

The banking sector is liquid and well-capitalized. Though still high, the system-wide nonperforming loan (NPL) ratio is heading down. At the end of the first quarter, the share of NPLs in commercial bank portfolios reached 9.7 percent of total loans, down from 10 percent at the end of 2017. Profitability has been improving—in the first quarter return on equity was 11.9 percent and capital adequacy was relatively stable at 15.4 percent. Capital buffers are within regulatory requirements.

The current account deficit (CAD) narrowed slightly in 2017 but is expected to widen in 2018. The CAD went from 5.1 percent in 2016 to 4.8 percent in 2017 based on strong growth in exports (up by 16.1 percent) and a somewhat slower rise in imports (up by 12.4 percent). In 2018, however, net exports are expected to subtract from growth, mainly because imports have started to pick up but exports of some commodities, such as fruit, are growing more slowly. For example, the export of apples to Russia was disrupted in January due to violation of a rules of origin agreement, but by mid-year the agreement was back in force. Other components of the current account, such as services surplus from transport, travel, construction, and remittances were almost unchanged and were sufficient to finance a significant part of the trade deficit. The rest is financed mainly by other investment and FDI. It is estimated that in 2018 FDI will cover 40 percent of the CAD, with the rest coming from new borrowing. A recent Debt Sustainability Analysis rated BiH as moderately indebted.

Outlook and Risks

Supported primarily by rising domestic demand, economic growth is projected to build from 3.2 percent in 2018 to 3.9 percent by 2020. As a new government is elected and reform activities accelerate, a moderate rise in growth is expected, with likely higher investment in infrastructure. A rise in exports is also expected, but strong demand for imports for infrastructure projects may outpace export

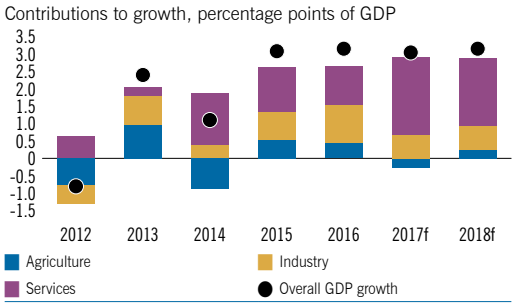
2 See BiH Global Fiscal Framework 2019–21.

growth. Remittances are likely to hold steady and support a gradual pickup in consumption. Investments will support job creation in energy, construction, and tourism. Real GDP growth is therefore projected to build gradually to 3.9 percent by 2020.

Achieving efficient and effective fiscal policy is still a major challenge as the country strives to address persistent unemployment. Although recently the fiscal account has been mostly in surplus, the high tax burden deters job creation, and public spending is inefficient. Despite good fiscal outcomes, continuing accumulation of arrears, structural rigidities on the spending side manifest in a high public wage bill and poor targeting of social assistance suggest that better public finance management could improve the efficiency of public spending. With elections forthcoming, this may be a key challenge for the new government.

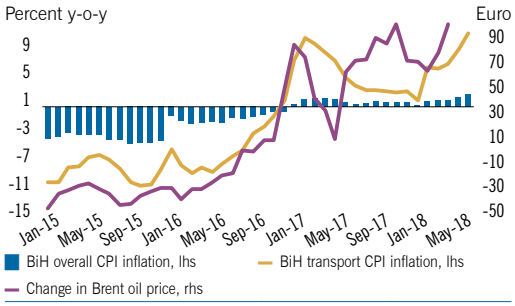
Both domestic and external risks persist. The main domestic risk may be the October general elections and the possibility of delays in forming the government. That might hold back the reform agenda. Progress toward becoming a WTO member, however, suggests that improvements in trade may boost growth. On a positive side, BiH is expecting to receive a ruling answer on its candidate status from the European Commission within the next calendar year. Externally, slow growth in the EU and accession prospects, possible tightening of financing conditions for emerging markets, as well as regional political situation are the main downside risks.

Annual GDP growth continued at 3 percent, led by services.



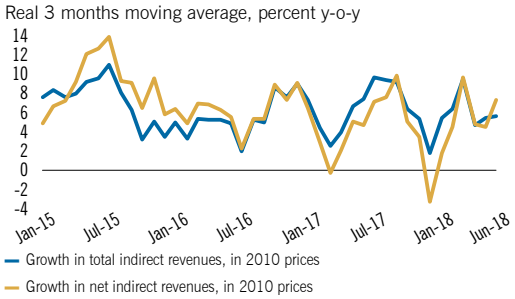
Source: BiH Agency for Statistics; World Bank staff estimates.

Consumer price inflation was moderate in 2018 but oil prices rose in the first half of the year.



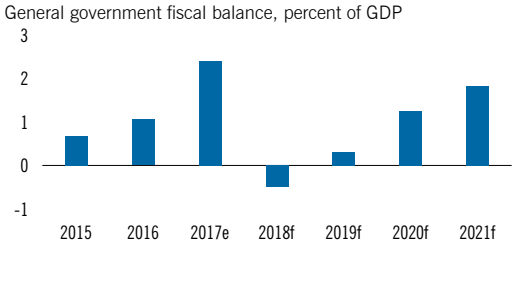
Source: BiH Agency for Statistics; World Bank staff estimates.

Collection of indirect tax revenues slowed at mid year.



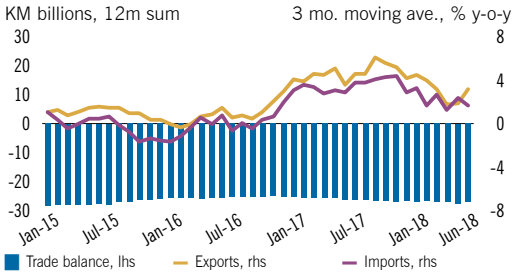
Source: BiH Indirect Tax Office; World Bank staff estimates.

The fiscal balance is expected to turn to deficit in 2018.



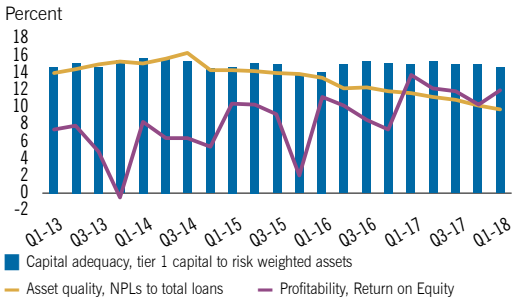
Source: Fiscal authorities; World Bank staff estimates.

The deficit in the goods trade continued to widen.



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

Nonperforming loans in commercial bank portfolios are high and deleveraging is still a risk.



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

BOSNIA AND HERZEGOVINA	2014	2015	2016	2017	2018e	2019f	2020f
Real GDP growth (percent)	1.1	3.0	3.1	3.0	3.2	3.4	3.9
Composition (percentage points):							
Consumption	n.a.	n.a.	n.a.	3.0	3.5	2.6	2.7
Investment	n.a.	n.a.	n.a.	0.6	0.8	1.0	0.8
Net exports	n.a.	n.a.	n.a.	-0.8	-1.1	-0.2	0.4
Exports	n.a.	n.a.	n.a.	4.2	1.7	1.7	1.3
Imports (-)	n.a.	n.a.	n.a.	5.1	2.7	2.0	0.9
Consumer price inflation (percent, period average)	-0.9	-1.0	-1.6	0.8	1.1	1.4	1.4
Public revenues (percent of GDP)	44.2	43.2	43.1	43.7	44.5	42.9	42.7
Public expenditures (percent of GDP)	46.2	42.5	42.1	41.4	45.0	42.6	41.5
Of which:							
Wage bill (percent of GDP)	12.1	11.5	11.0	11.0	11.1	10.9	10.6
Social benefits (percent of GDP)	17.2	16.5	17.7	17.8	18.3	17.1	16.7
Capital expenditures (percent of GDP)	4.3	2.0	2.4	2.3	5.0	4.3	4.1
Fiscal balance (percent of GDP)	-2.1	0.7	1.0	2.4	-0.5	0.3	1.2
Primary fiscal balance (percent of GDP)	-1.2	1.6	1.9	3.2	0.5	1.3	2.2
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)	25.1	25.2	25.7	28.5	31.2	33.9	35.2
Goods imports (percent of GDP)	53.9	50.3	49.3	52.3	55.9	59.1	60.8
Net services exports (percent of GDP)	6.1	6.4	6.4	7.1	8.0	8.3	8.4
Trade balance (percent of GDP)	-22.7	-18.8	-17.1	-16.7	-16.7	-17.0	-17.2
Remittance inflows (percent of GDP)	8.5	8.3	8.2	8.3	8.2	8.3	8.4
Current account balance (percent of GDP)	-7.4	-5.7	-5.1	-4.8	-5.3	-5.5	-5.6
Foreign direct investment inflows (percent of GDP)	2.9	1.7	1.6	2.1	2.1	2.2	2.3
External debt (percent of GDP)	77.1	72.2	71.0	70.3	69.3	68.8	68.8
Real private credit growth (percent, period average)	4.1	2.3	4.2	4.9	n.a.	n.a.	n.a.
Non-performing loans (percent of gross loans, end of period)	14.0	13.7	11.8	10.0	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)	62.9	62.2	54.5	45.8	n.a.	n.a.	n.a.
Labor force participation rate (percent, period average)	43.7	44.1	43.0	42.6	n.a.	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.
Notes: Non-performing loans show year-to-date actuals.

Kosovo[3]

- *Growth is projected to reach 4.0 percent in 2018, up from 3.7 percent in 2017 and driven by investment, services exports, and a recovery in consumption.*
- *The fiscal deficit is expected to reach 2.4 percent of GDP in 2018 as rapid growth in untargeted social spending and public wages and accelerated public investment outpace revenue growth.*
- *The outlook is positive, with growth averaging 4.5 percent for 2019–20, but the upturn is subject to major risks related to possible tightening of financial conditions for emerging markets and growth in the EU, domestic and regional political dynamics, the speed of execution of public investments, and the stability of metals production and prices.*

Main Developments and Trends

Growth is expected to reach 4 percent in 2018, up from 3.7 percent in 2017, driven mainly by public and private investment, services exports, and a recovery in consumption. Investment, both public and private, is projected to add 2.1 percentage points (pp) to growth. Private investment is expected to increase less this year than last because in the first half of 2018 FDI fell. Despite the fast rise in services exports, net exports are expected to add a mere 0.4 pp to growth, as Ferronikeli production has halted and imports related to investment have risen. Consumption has recovered in part after last year's unexpected negative contribution of 1.6 pp and is expected to contribute 1.5 pp. Expansion in services (accommodation, transport, financial activity, and construction) is expected to add 3.3 pp, up from 1.4 pp in 2017. As in the last two years, agriculture is expected to contribute just 0.3 pp, and industry only 0.1 pp, down from 0.6 pp in 2017 as base metal production slows.

Net job creation was negative in the first half of 2018, after fast pick-ups in employment in 2016 and 2017. In the first half of 2018, employment fell by 1.4 pp y-o-y. Unemployment also declined by 1.2 pp as labor force participation fell by 2.6 pp. Youth unemployment rose to 55 percent, up 4.1 pp y-o-y. Over 70 percent of those unemployed have been seeking a job for over a year, and at 28.5 percent of the working-age population, employment is low. It is not yet clear whether this trend will continue in 2018.

A fiscal deficit of 2.4 percent is expected in 2018, doubling from 1.2 percent in 2017 and driven by higher capital investment and growing untargeted social protection spending. Total spending is projected to grow by 9.2 percent, including 7.4 percent growth in current spending for higher transfers, goods and services, and wages; and 16.3 percent growth in capital spending. Social protection spending will increase by 7.8 percent: payments for war veterans will exceed budget as amendments

3 The note is based on the data made available as of the time of report's preparation, August, 2018 and GDP figures are based on the quarterly estimates. The current annual estimate for 2017 GDP growth based on September 2018 GDP data release is at 4.2 percent.

to the law to contain the costs were not implemented. New capital projects, fueled by additional funds from the Privatization Agency and commencement of railway and other IFI-financed projects, are likely to accelerate execution of the capital budget. Revenues are also expected to increase by 5.1 percent y-o-y in 2018. The projections are for indirect tax revenues to grow by 4.5 percent (VAT by 6.6 percent); non-tax revenues to be almost flat at 0.2 percent growth; and direct tax revenues to grow by 9.8 percent, driven by a 10 percent increase in corporate income taxes. By yearend, public and publicly guaranteed debt is projected at 18 percent of GDP, is growing fast due to higher primary budget deficits.

In the first half of 2018 investment and consumption rose due to higher credit growth. As in 2017, better market conditions and lower interest rates led to higher private credit (11.3 percent). Corporate loans grew by 11.2 percent, mostly to the service sector, namely wholesale and trade, construction, and other services, followed by manufacturing, while loans to households grew even faster at 11.9 percent. NPLs declined further to reach 2.7 percent of loans by end-July.

Average inflation is expected to moderate to about 0.7 percent. The main driver is the rise in food and transport prices—housing, energy, clothing, and communications prices declined.

The current account deficit (CAD) is expected to go up to 6.9 percent in 2018 due to an unexpectedly strong increase in imports and a halt in nickel production. Driven by tourism exports, financed by the diaspora, net exports of services contributed positively but were offset by an unexpected pick-up in services imports, a 3 percent decline in exports of goods (due to the shut-down of the Ferronikeli plant, the biggest exporter of base metals in Kosovo), and a 10 percent increase in imports, mainly for investment projects.

Surprisingly, net FDI fell by 40 percent y-o-y in the first half of 2018, though remittances again grew. Among reasons for the FDI decline were weaker performance by foreign firms and higher repatriation of profits for debt repayment, which reduced the scope for reinvestment of earnings. There were net FDI outflows in construction, mining, and manufacturing. Though still positive, net inflows in financial intermediation also declined. Strong growth in remittances supplemented FDI in covering the domestic savings shortfall.

Outlook

Economic growth in Kosovo is projected to reach 4.5 percent in the medium term, propelled by higher capital spending and a recovery in consumption. The government is preparing railway and regional road projects. The enhanced business climate, higher FDI, and optimism in the EU are likely to encourage private investment. Higher wages, social spending, remittances, and credit to households should lead household consumption and by 2020 add 1.6 pp to growth. Exports are likely to benefit from robust growth in the EU and higher prices for base metals, but net exports are expected to subtract 0.8 pp from growth because of higher imports for public investments.

In 2019, higher growth can stimulate creation of services, construction, and manufacturing jobs. However, if more people enter the labor market, unemployment might also rise.

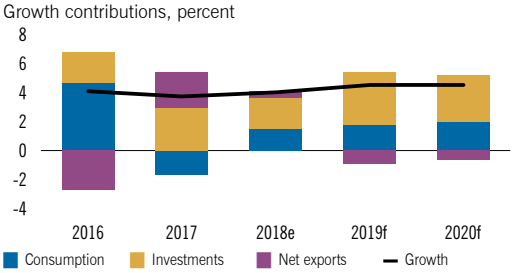
Higher current and capital spending is expected to raise the 2019 fiscal deficit to 2.9 percent. Collection of more revenues is expected to be offset by higher current and capital spending on IFI- and PAK-financed projects; higher costs for wages, goods, and services; and higher subsidies and transfers for veteran benefits and targeted social assistance. The deficit of 1.9 percent of GDP, excluding investment clause projects, will adhere to the fiscal rule.

In the medium term the CAD is expected to widen to about 9 percent of GDP as more investment goods are imported. Heightened demand for investment goods implies higher capital spending, but growth in FDI and remittances should cover the gap.

This positive outlook is vulnerable to risks related to domestic and regional political developments, lower production and prices of base metals, and lower than expected growth in Europe. Any delay in reforms, e.g., to cap war veteran benefits or to prevent rises in untargeted social benefits and unfunded early retirement options, plus uncertainties about the draft law on public wages and salaries, could increase fiscal pressures and reduce the potential for productive government spending. Project delays can also raise costs. The expansion of public investment may suffer from capacity constraints. Lower than expected growth in the Euro Area might reduce remittances and FDI, and exports and lower base metal prices and production might expand the CAD. Finally, the possible tightening of the financing conditions for emerging markets could impact Kosovo as well, including through spillovers from the region.

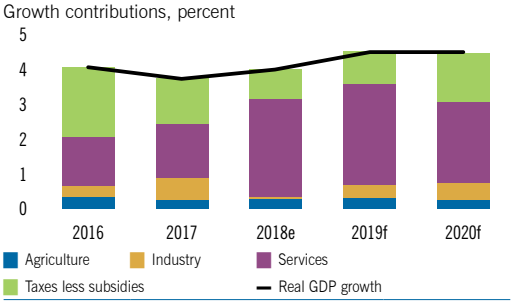
To counterbalance these risks, reforms should focus on preserving fiscal sustainability by avoiding unfunded increases in social protection spending and allocating spending to items that may increase output, shift resources to tradable sectors, increase productivity, engage and employ youth and women, address corruption, improve environmental sustainability, and address infrastructure constraints.

Investment and recovery in consumption were the main reasons behind higher growth in 2018.



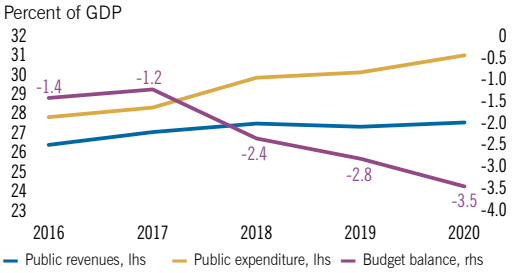
Source: Statistics Agency of Kosovo and World Bank.

Services are likely to continue to be the main engine of growth in 2018, and beyond.



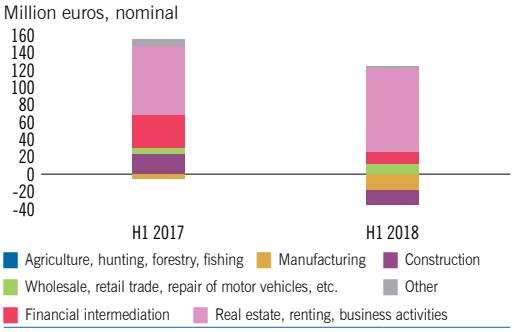
Source: Statistics Agency of Kosovo and World Bank.

Higher public investment, IFI-financed projects, and transfers will raise budget deficits.



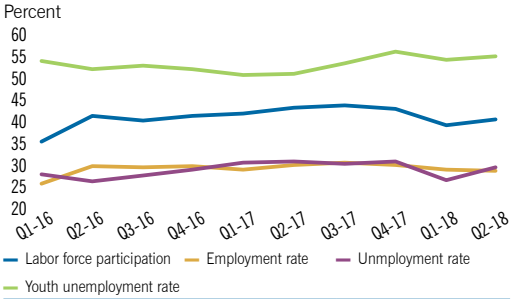
Source: Ministry of Finance and World Bank.

FDI outflows in manufacturing and construction led to a decline in FDI in the first half of 2018.



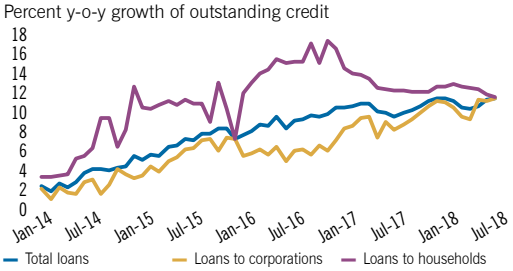
Source: Central Bank of Kosovo and World Bank.

Recent improvements in the labor market began to reverse in H1 2018, but that may not continue.



Source: Statistics Agency of Kosovo and World Bank.

Credit growth again supports growth in private investment and consumption.



Source: Central Bank of the Republic of Kosovo.

KOSOVO	2014	2015	2016	2017	2018[e]	2019[f]	2020[f]
Real GDP growth (percent)	1.2	4.1	4.1	3.7	4.0	4.5	4.5
Composition (percentage points):							
Consumption	3.8	2.5	4.7	-1.6	1.5	1.8	2.0
Investment	-1.4	2.9	2.1	2.9	2.1	3.6	3.2
Net exports	-1.2	-1.3	-2.7	2.5	0.4	-0.9	-0.7
Exports	2.9	0.5	0.5	5.3	4.5	4.1	3.6
Imports (-)	4.1	1.8	3.2	2.8	4.1	5.0	4.3
Consumer price inflation (percent, period) average)	0.4	-0.5	0.3	1.5	0.7	1.5	1.6
Public revenues (percent of GDP)	24.0	25.1	26.3	27.0	27.5	27.4	27.7
Public expenditures (percent of GDP)	26.6	27.1	27.7	28.2	29.9	30.2	31.2
Of which:							
Wage bill (percent of GDP)	8.7	9.0	9.0	8.8	9.0	8.9	8.8
Social benefits (percent of GDP)	5.0	5.4	6.1	6.2	6.5	6.0	5.8
Capital expenditures (percent of GDP)	7.4	7.0	7.2	7.5	8.4	9.5	10.6
Fiscal balance (percent of GDP)	-2.6	-2.0	-1.4	-1.2	-2.4	-2.9	-3.5
Primary fiscal balance (percent of GDP)	-2.4	-1.7	-1.1	-1.0	-2.0	-2.5	-3.1
Public debt (percent of GDP)	10.4	12.7	14.1	15.9	17.2	18.6	20.1
Public and publicly guaranteed debt (percent of GDP)	10.6	12.8	14.4	16.6	18.0	19.3	20.8
Of which: External (percent of GDP)	5.8	6.2	6.2	6.8	6.7	6.9	7.3
Goods exports (percent of GDP)	5.8	5.6	5.1	6.0	5.6	5.6	5.7
Goods imports (percent of GDP)	42.8	41.9	42.8	45.3	48.2	50.3	51.8
Net services exports (percent of GDP)	8.3	7.9	10.5	12.8	15.0	17.3	19.4
Trade balance (percent of GDP)	-28.7	-28.5	-27.2	-26.4	-27.6	-27.4	-26.8
Remittance inflows (percent of GDP)	9.9	10.5	10.5	11.3	11.9	12.1	12.5
Current account balance (percent of GDP)	-6.9	-8.6	-7.9	-6.6	-6.9	-8.5	-9.0
Foreign direct investment inflows (percent of GDP)	2.2	4.7	2.9	4.0	1.9	3.2	3.6
External debt (percent of GDP)	31.2	33.3	32.7	33.4	34.4	34.6	35.2
Real private credit growth (percent, period average)	3.2	7.9	8.7	8.8	n.a.	n.a.	n.a.
Nonperforming loans (percent of gross loans, end of period)	8.5	6.5	4.9	3.1	n.a.	n.a.	n.a.
Unemployment rate (percent, period average)	35.3	32.9	27.5	30.4	n.a.	n.a.	n.a.
Youth unemployment rate (percent, period average)	61.0	57.7	52.4	52.7	n.a.	n.a.	n.a.
Labor force participation rate (percent, period average)	41.6	37.6	38.7	42.8	n.a.	n.a.	n.a.
GDP per capita (current US$)	4,055	3,745	3,698	3,876	3,982	4,297	4,473
Poverty rate at US$5/day, PPP (percent of population)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Sources: Country authorities, World Bank estimates and projections.

FYR Macedonia

- *Growth is projected to rebound to 2.5 percent in 2018, driven by consumption and an investment recovery based on investor confidence, which rose as political stability was restored.*
- *Labor market performance improved, and unemployment fell to a historical low. Although higher than in most Western Balkan countries, by EU standards employment and labor force participation rates are low.*
- *The fiscal deficit narrowed, largely due to the significant under-execution of capital spending. Nevertheless, by June 2018, public debt had gone up.*
- *Accelerating and sustaining growth without jeopardizing fiscal sustainability should be a priority. This will require a credible fiscal strategy to prevent more growth in public debt and structural reforms to bring about long-term employment gains through higher productivity, improved human capital, and enhanced quality of public services.*
- *Risks to the outlook are moderate. Externally, slow growth in the EU and accession prospects, possible tightening of financing conditions for emerging markets, as well as regional political situation are the main downside risks.*

Recent Economic Developments

In 2018 the Macedonian economy is rebounding from stagnation as exports, consumption, and investments recover. Manufacturing grew by 5.6 percent y-o-y in the first six month of 2018, largely in FDI-intensive sectors. Meanwhile, local industries like mining, apparel, metal, and non-metal products declined. Continuing its negative trend, construction fell by more than 25 percent y-o-y in real terms as road construction slowed. However, private investments (proxied by civil engineering works) started growing after 12 consecutive months of decline. Propelled by rising wages, pensions, and household lending, retail trade continued growing and tourism had a record-breaking year. With investment and consumption recovering, by year-end growth is projected to jump from zero in 2017 to 2.5 percent.

The labor market continued to improve, helped in part from employment subsidies. In the first half of 2018, employment grew by 2.1 percent y-o-y. Most of the jobs created were in manufacturing and food and accommodation services, followed by construction and professional services. The subsidies for the Employment Program, including for subsidizing the rise in minimum wages, almost doubled by July 2018 compared to the same period last year. Even though the employment rate improved to 44.9 percent in the second quarter, more than half of Macedonians of working-age are either still unemployed or are not looking for work. The unemployment rate fell to a historical low of 21.1 percent in June and is projected to decline further, to 20.4 percent, for the year. The share of long-term unemployed at 78 percent (81 percent in 2017) reflects structural issues in the labor market. Youth unemployment (age 15–

24) was 47.6 percent, up slightly from a year ago. Led by the rise of the minimum wage in September 2017, net wages rose by an average of 5.5 percent y-o-y. The largest increase, over 10 percent, was in low-earning labor-intensive sectors.

The fiscal deficit is expected to decline in 2018 as revenue grows and capital investment drops. By July 2018, revenues had gone up by 4.6 percent y-o-y, paced by social contributions, excises, and higher corporate and personal income tax receipts. Net VAT revenues also went up, despite a surge in VAT refunds to clear arrears to the corporate sector. Spending increased by only 1.3 percent y-o-y, largely driven by the drop in capital spending, despite an already low 2017 base. On the other hand, current spending increased by 5.7 percent y-o-y, led by social transfers and employment subsidies to firms to compensate for the rise in the minimum wage. The budget deficit declined to 2.1 percent of GDP (on a 12-month rolling basis) compared to 2.7 percent in 2017. The expected deficit for 2018 is 2.6 percent—or 3.2 when the finances of the Public Enterprise for State Roads are included.

Despite the lower deficit, new borrowing pushed up public debt. Public and publicly guaranteed (PPG) debt had risen from 47.6 percent in 2017 to 49.1 percent by June 2018. The increase is due to issuance of a new Eurobond—at the historically-best terms for a 7-year €500 million bond of 2.75 percent—that fully covers government borrowing requirements for 2018. On the other hand, guaranteed debt declined as a percent of GDP from 8.2 to 8 percent as disbursements of the Chinese loan for constructing highways slowed. PPG debt is expected to reach 50.6 percent of GDP by yearend.

Monetary policy has become even more accommodative. During 2018, the Central Bank lowered the key interest rate by 25 bps in two consecutive steps, bringing it down to 2.75 percent. The interest rate cut reflects favorable changes in the foreign exchange market, led by an improved external position, a rise in deposits, and economic stagnation in early 2018 despite the positive expectations of economic agents. Inflation has risen in 2018, reaching 1.5 percent y-o-y by July, as prices went up for food, beverages, and energy (including oil). Core inflation was still low at 1.3 percent y-o-y in July, which suggests that economic activity is still below potential.

Credit grew in 2018, mostly targeted to households. By July household credit had grown by 10 percent y-o-y; with the economy still recovering, corporate lending grew by 2.6 percent. Recent improvements in bank assets, with corporate nonperforming loans (NPLs) having declined from 9.8 percent in 2017 to 7.8 percent in July 2018, while all NPLs dropping from 6.2 to 5.1 percent, which helped spur lending. The survey of credit activity reports lower credit requirements and higher credit demand from companies.

The external balance is still stable. The current account deficit (CAD) is expected to decrease marginally from 1.3 percent of GDP in 2017 to 1.2 percent. The solid performance of car-parts exports, along with iron and steel, furniture, and tobacco, left the goods and services trade deficit largely unchanged, even though imports have risen by double digits. Net private inflows went up sufficiently to cover the entire goods and services trade deficit. The deficit in the primary income balance widened marginally due to interest payments and repatriated profits.

FDI is projected to increase from 2.3 percent of GDP in 2017 to 3.0 percent in 2018.

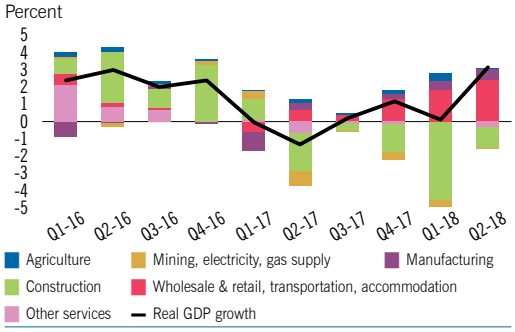
Outlook and Risks

The economic outlook is positive, and it is expected that, by 2020, growth will have gradually risen to 3.2 percent. Spurred by recovering investments, an improved political climate, and the end of technical difficulties that interrupted the construction of two highways, construction is expected to recover. Manufacturing is also expected to grow, propelled by external demand. Private consumption is projected to rise with higher wages and employment, rising credit to households, and also, as the new authorities indicated, a rise in social transfers. This baseline scenario is conditional on the success of the agreement with Greece on resolution of the country's name dispute and revival of the NATO and EU membership processes. Externally, slow growth in the EU and accession prospects, possible tightening of financing conditions for emerging markets, as well as regional political situation are the main downside risks.

Political stability and related business optimism give policymakers an opportunity to tackle critical longer-term development priorities. The current government, in office since June 2017, has embarked on a new reform program and has already made progress in implementing a Public Financial Management Reform Strategy, making public finances more transparent and deregulating the energy sector. However, EU accession negotiations will require a broad-based reform effort if FYR Macedonia is to catch up with the frontrunners.

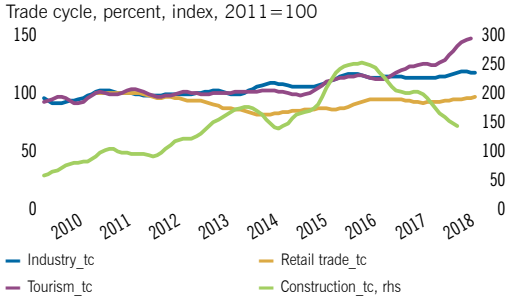
Accelerating and sustaining growth without jeopardizing fiscal sustainability is critical. Credible medium-term fiscal consolidation is necessary to reduce the fiscal deficit and stabilize the public debt-to-GDP ratio. The country's growth strategy must move away from reliance on fiscal stimulus to support individual firms and make structural reforms that produce long-term job gains by boosting human capital and firm productivity. To mitigate medium- and long-term demographic pressures, reforms of pensions and health care are needed to overcome the structural challenges both systems must deal with. Finally, public spending must be made more efficient so that better public services can be delivered more effectively.

Economy started recovering by mid-2018…



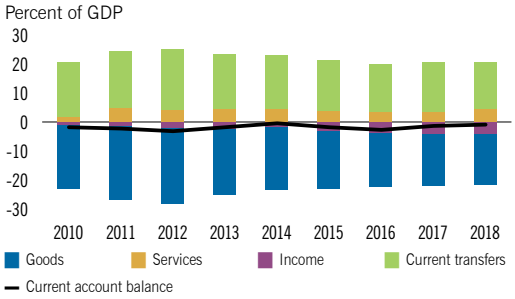
Source: State Statistics Office.

…and should further strengthen as suggested by high-frequency indicators.



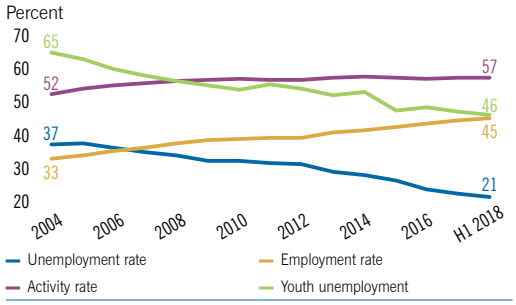
Source: State Statistics Office and World Bank estimates.

External deficit narrowed due to surge in exports.



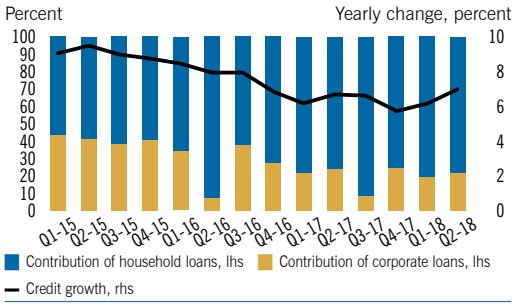
Source: National Bank data.

Labor market improved, with unemployment at a historic low.



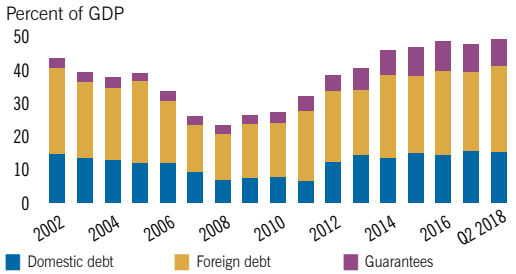
Source: State Statistics Office.

Continued credit expansion is mainly targeted to households.



Source: National Bank data.

Although the deficit declined, public debt resumed growth.



Source: Ministry of Finance and World Bank estimates.

FYR MACEDONIA	2014	2015	2016	2017	2018[e]	2019[f]	2020[f]
Real GDP growth (percent)	3.6	3.9	2.9	0.0	2.5	2.9	3.2
Composition (percentage points)							
Consumption	2.0	3.7	2.5	1.8	1.4	1.2	1.0
Investment	2.9	2.6	4.4	-1.1	0.4	1.5	2.1
Net exports	-1.3	-2.5	-4.0	-0.7	0.7	0.2	0.1
Exports	7.3	4.2	4.2	5.0	5.0	4.9	4.9
Imports	8.7	6.7	8.3	5.7	4.3	4.7	4.8
Consumer price inflation (percent, period average)	-0.2	-0.3	-0.2	1.3	1.6	2.0	2.0
Public revenues (percent of GDP)	29.7	31.0	30.3	30.9	32.0	32.7	32.8
Public expenditures (percent of GDP)	33.9	34.4	33.0	33.7	34.6	35.3	35.4
Of which:							
Wage bill (percent of GDP)	7.0	7.0	6.8	6.6	6.9	6.9	6.7
Social transfers (percent of GDP)	15.3	15.3	15.3	15.8	15.7	15.8	15.8
Capital expenditures (percent of GDP)	4.2	4.2	3.8	4.1	3.7	4.1	4.3
Fiscal balance (percent of GDP)	-4.2	-3.4	-2.7	-2.8	-2.6	-2.6	-2.6
Overall Fiscal Balance with the Public Enterprice for State Roads included	-5.3	-4.1	-3.8	-3.4	-3.2	-3.1	-3.1
Primary fiscal balance (percent of GDP)	-3.2	-2.3	-1.5	-1.5	-1.2	-1.1	-0.9
Public debt (percent of GDP)	38.1	38.1	39.6	39.3	42.4	43.5	44.2
Public and publicly guaranteed debt (percent of GDP)	45.7	46.6	48.4	47.6	50.6	55.7	58.3
Of which: External (percent of GDP)	32.1	31.6	33.9	31.9	36.3	43.1	44.7
Goods exports (percent of GDP)	32.5	33.6	35.7	40.4	42.7	44.6	46.3
Goods imports (percent of GDP)	54.2	53.7	54.3	58.2	60.3	62.3	63.8
Net services exports (percent of GDP)	4.5	3.8	3.6	4.0	4.3	4.6	4.9
Trade balance (percent of GDP)	-17.2	-16.2	-15.0	-13.9	-13.3	-13.1	-12.5
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	-2.7	-1.3	-1.2	-1.4	-1.5
Net foreign direct investment inflows (percent of GDP)	2.3	2.2	3.3	2.3	3.0	3.1	3.2
External debt (percent of GDP)	69.6	68.5	72.0	72.7	77.4	78.2	78.9
Real private credit growth (percent, period average)	8.5	9.4	7.8	4.2	n.a.	n.a.	n.a.
Non-performing loans (percent of gross loans, end of period)	11.1	10.6	6.4	6.2	n.a.	n.a.	n.a.
Unemployment rate (percent, period average)	28.0	26.1	23.7	22.4	20.4	19.4	18.0
Youth unemployment rate (percent, period average)	53.1	47.3	48.3	46.8	n.a.	n.a.	n.a.
Labor force participation rate (percent, period average)	57.5	57.2	56.8	57.2	n.a.	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.
Notes: Poverty rates are based on FYR Macedonia survey on income and living conditions (SILC).

Montenegro

- *The 2018 growth projection was revised upward to 3.8 percent as both private and public investments surged, and tourism recorded another historical high.*
- *Employment growth resumed in mid-2018, led by tourism, construction, and trade, and helped reduce administrative unemployment by double digits.*
- *Medium-term refinancing pressures subsided with the successful Eurobond issuance as Montenegro's credit outlook improved to stable.*
- *While tax increases led the fiscal consolidation, spending restrictions have been delayed despite the high deficit and high public debt. Fiscal vulnerability, although declining, is still high, calling for public administration and social sector reforms to accelerate.*
- *Risks to the outlook are mostly on the downside. Externally, slow growth in the EU and accession prospects, possible tightening of financing conditions for emerging markets, as well as regional political situation are the main downside risks. Domestically, the pace of fiscal consolidation and ability to reduce debt are key risks.*

Recent Economic Developments

Montenegro's economy again grew robustly in 2018. The growth projection for the year has been revised upward as both private and public investment surged, and exports of goods and services expanded. Investment contributed most to growth in the first quarter as energy and tourism investments were accompanied by the speed-up in construction of the Bar-Boljare highway. Supported by growth in employment and wages, consumption also grew but decelerated after nine quarters of consecutive growth. Although net exports continued to subtract from growth, strong tourism and exports of metal goods in response to higher EU demand have offset still-high growth in imports. Tourism, retail trade, and construction were again drivers of growth in 2018, but have been supplemented by manufacturing and energy, which has doubled production after investments in new capacity in recent years.

Higher growth has stimulated job creation in the private sector. After slowing in the second half of 2017, by mid-2018 employment growth had picked up again. Employment grew by 1.6 percent y-o-y by June 2018, led by manufacturing, construction, tourism, and the public sector. The administrative unemployment rate finally declined after 5 years of continuous growth but is still above 20 percent, with youth unemployment about double the national average. However, by June 2018 the survey-based unemployment rate had declined to a historic low of 15.6 percent (on a four-quarter basis), suggesting that informality is still high. The survey-based employment rate grew to 46.4 percent as both female and male employment grew. The activity rate stagnated, however, suggesting that more Montenegrins transitioned from unemployment to inactivity than acquired new jobs.

Despite robust growth, at mid-2018 the external deficit was unchanged. The current account deficit (CAD) of 16.4 percent of GDP by June 2018 (on a four-quarter basis) was similar to the revised 2017 annual data. Imports of goods had gone up by 12.9 percent y-o-y, led by the high import-dependence of investments in infrastructure and tourism. Rising imports of cars, furniture, electric machinery and equipment, and iron and steel, however, have been offset by a 21.4 percent surge in exports of both goods and services, led by steel, aluminum, mineral fuels, wood, and tourism. The surplus in the income account declined due to the rise of both dividend payouts and interest payments on rising debt, and the transfer account surplus grew as both remittances went up and government disbursement of EU funds accelerated. Net FDI inflows declined to 9.3 percent of GDP (on a four-quarter basis), which still covered two-thirds of CAD financing. Given the rise in external public debt so far in 2018, the external debt-to-GDP ratio will likely grow to exceed 163 percent.

Driven by tax rate hikes, in 2018 inflation rose. Consumer prices had increased by 2.4 percent in 2017 and by August had risen to 2.8 percent y-o-y, tracking the rise in the VAT rate and higher excises on tobacco, alcohol and sugary drinks. and transportation. By July producer prices were up by 2.1 percent, led by a higher cost for oil and higher excises.

Poverty reduction slowed in 2018. The poverty headcount is estimated to have declined in the past few years as economic growth picked up and social transfers surged. In 2018, however, it will be difficult to significantly reduce poverty, given withdrawal of the mothers' benefit and the rise in indirect taxes. Also, led by public sector wage dynamics and the rise in the VAT rate and inflation, real gross wages have declined this year. Poverty (measured as consumption below the standardized middle-income-country poverty line of $5.5/day 2011 PPP) slid from 8.7 percent in 2012 to an estimated 4.8 percent for 2018.

Growth in credit to the private sector resumed with the reduction in nonperforming loans (NPLs), growth in deposits, and lower lending costs. By July 2018 credit to the private non-financial sector had grown by 9.4 percent, driven by household lending; however, corporate lending had also recovered by 7.1 percent. Continuing the trends, by midyear deposits had grown by 15.2 percent y-o-y, suggesting that incomes has risen more robustly than the wage statistics implied. With lending growing, NPLs fell to 7.1 percent, even after application of the stricter international financial reporting standards (IFRS9) that the banking system transitioned to in January 2018. The banking system remained well-capitalized, although some domestic banks continue to show weaknesses and may require resolution.

The fiscal consolidation launched in 2017 has started yielding benefits in terms of higher revenues, lower spending on social benefits, and a slowdown in growth of the public wage bill. The general government deficit declined from 2.5 percent of GDP in the first seven months of 2017 to 1.6 percent in the same period of 2018. However, capital spending doubled and transfers to the health sector shot up; as the system still faces structural deficit. Issuance of the €500 million Eurobond and the syndicated €250 million loan supported by the World Bank guarantee, enabled the government to pre-finance some

debt (€320 million by June) due in 2019–21 and ease its medium-term refinancing needs. By yearend public and publicly guaranteed debt is expected to rise to 75 percent, up from 72.5 percent in 2017, as the government builds up deposits for 2019 financing through the liability management operation.

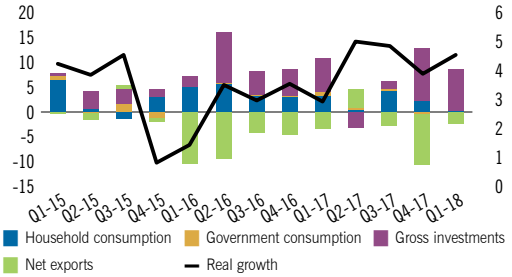
Outlook and Risks

The economic outlook is positive, but despite moderation downside risks are still high. The economy is expected to grow by an average of 2.6 percent in 2019–20 because of declining transport investments and personal consumption. As investment slows, so will economic growth, unless productivity gains and new private sector investments unlock Montenegro's full growth potential. Poverty (at $5.5/day 2011PPP) is expected to again decline in 2019, to an estimated 4.6 percent, subject to improvements in private sector employment and earnings. Externally, slow growth in the EU and accession prospects, possible tightening of financing conditions for emerging markets, as well as regional political situation are the main downside risks.

The large fiscal deficit and growing public debt call for sustained implementation of the fiscal consolidation. The 2018 budget revision delayed for a year the initial objective of reaching a balanced budget by 2019 and bringing public debt down to 60 percent by 2020. However, despite easing the 2019–21 refinancing needs, the possibility of tightening financing conditions at international capital markets calls for prompt action to reduce public debt and country's external imbalances; these are likely to stay high, given the import dependence of Montenegro's current growth pattern. Enhancing policy predictability and accelerating structural reforms is required to reduce downside risks and assure the continued improvement of growth and labor market prospects.

Investments led robust growth in 2018.

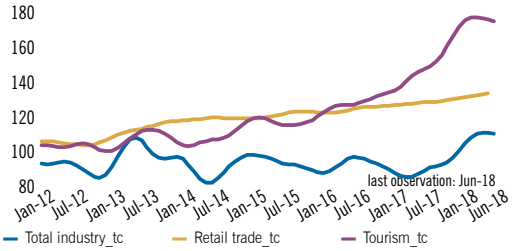
Contribution to growth, percent



Source: MONSTAT data.

Increased energy and tourism capacity contributed to growth.

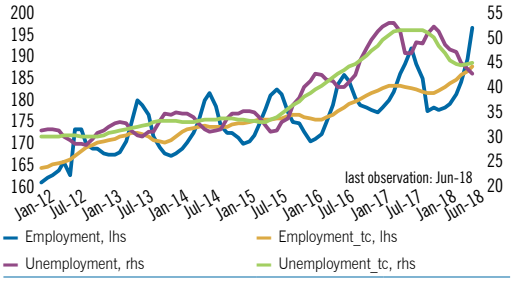
High-frequency data, trend-cycle, 2013–18



Source: MONSTAT.
Note: Tc = Trend cycle.

The labor market improved…

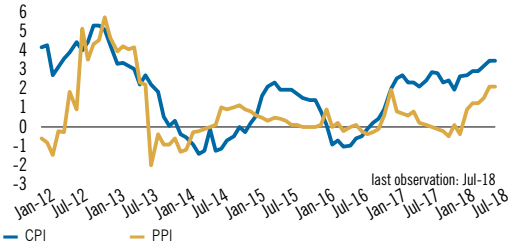
Administrative data, thousands, 2013–18 In thousands



Source: MONSTAT data.

…and inflationary pressures have begun to subside.

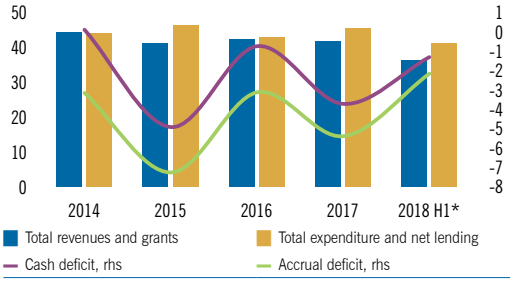
2013–18, annual growth rates



Source: MONSTAT data.

Public finances remain fragile…

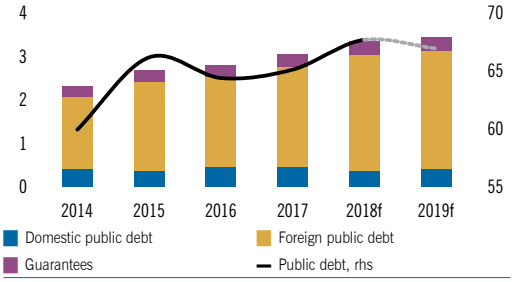
Percent of GDP, 2014–18



Source: MOF and MONSTAT data.
Note: 2018 data show central government only.

…and public debt is set to grow further.

2014–19, EUR billion 2014–19, percent of GDP



Source: MoF, CBCG and MONSTAT data.

MONTENEGRO	2014	2015	2016	2017	2018[e]	2019[f]	2020[f]
Real GDP growth (percent)	1.8	3.4	2.9	4.3	3.8	2.8	2.5
Compositioin (percentage points):							
Consumption	2.6	2.2	4.5	3.1	2.4	2.3	2.9
Investment	0.5	1.9	6.1	5.3	2.7	1.0	0.0
Net exports	-1.3	-0.7	-7.6	-4.1	-1.3	-0.5	-0.5
Exports	-0.3	2.2	2.4	2.2	2.2	2.3	2.1
Imports (-)	1.0	2.9	10.0	6.3	3.5	2.7	2.6
Consumer price inflation (percent, period average)	-0.7	1.5	-0.3	2.4	3.1	2.1	1.6
Public revenues (percent of GDP)	44.6	41.5	42.5	42.0	44.1	43.9	43.0
Public expenditures (percent of GDP)	47.7	48.8	45.6	47.4	46.3	45.6	39.2
Of which:							
Wage bill (percent of GDP)	13.3	13.1	12.9	12.4	11.7	11.5	11.1
Social benefits (percent of GDP)	14.3	13.3	12.9	12.0	11.3	11.1	11.5
Capital expenditures (percent of GDP)	5.8	9.0	4.3	8.3	8.8	9.6	4.5
Fiscal balance (percent of GDP)	-3.1	-7.3	-3.1	-5.4	-2.2	-1.8	3.8
Primary fiscal balance (percent of GDP)	-0.9	-4.9	-1.0	-3.0	-0.1	0.4	5.6
Public debt (percent of GDP)	59.9	66.2	64.4	65.1	67.6	66.8	60.6
Public and publicly guaranteed debt (percent of GDP)	67.1	73.7	71.4	72.5	74.6	73.5	67.0
Of which: External (percent of GDP)	47.9	55.7	52.8	54.2	59.2	57.8	51.5
Goods exports (percent of GDP)	10.3	8.9	8.7	9.0	9.5	9.8	10.3
Goods imports (percent of GDP)	50.1	48.9	50.6	52.9	52.9	53.2	53.5
Net services exports (percent of GDP)	20.0	21.6	19.4	20.1	19.8	20.6	21.4
Trade and services balance (percent of GDP)	-19.8	-18.5	-22.5	-23.8	-23.6	-22.8	-21.9
Remittance inflows (percent of GDP)	4.3	4.1	3.8	3.8	3.6	3.5	3.3
Current account balance (percent of GDP)	-12.4	-11.0	-16.2	-16.3	-16.4	-15.7	-15.1
Foreign direct investment inflows (percent of GDP)	10.2	16.9	9.4	11.4	9.3	8.9	7.6
External debt (percent of GDP)	163.3	162.2	160.9	161.7	163.4	159.9	159.2
Real private credit growth (percent, period average)	-1.6	0.0	4.0	4.9	n.a.	n.a.	n.a.
Nonperforming loans (percent of gross loans, end of period)	15.9	12.5	10.3	7.3	n.a.	n.a.	n.a.
Unemployment rate (percent, period average)	18.0	17.6	17.7	16.1	15.8	15.5	15.0
Youth unemployment rate (percent, period average)	36.3	38.5	36.1	32.0	n.a.	n.a.	n.a.
Labor force participation rate (percent, period average)	52.7	53.7	54.5	54.7	n.a.	n.a.	n.a.
GNP per capita, Atlas (current international $)	15,410	16,050	16,195	16,389	16,586	16,785	16,986
Poverty rate at US$5.5/day, PPP (percent of population)	4.8	4.6	4.2	4.4	4.8	4.6	4.4

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

Serbia

- *After sluggish growth in 2017, the economy rebounded in the first half of 2018, bringing projected growth for 2018 to 3.5 percent.*
- *Responding to faster growth, by the second quarter of 2018 unemployment had fallen to 12.5 percent of the working-age population, down 2.9 percentage points in the second quarter of 2018 compared to the first quarter.*
- *Both central and general government budgets were in surplus through June, putting them on course to end 2018 with the surplus of 0.6 percent of GDP.*
- *Though political developments to some extent overshadowed economic reforms, by yearend Serbia is still expected to finish reforms of some of the largest state-owned enterprises and banks.*
- *The main concerns now are the recent widening of the external deficit and the implications for external debt, a risk that could be exacerbated by potential tightening of the external conditions for emerging markets, slower growth in the EU and accession prospects, as well as regional political dynamic.*

Recent Economic Developments

Economic growth is projected to rise to 3.5 percent in 2018, up from an earlier forecast of 3 percent. Growth in the first quarter of 4.9 percent year-on-year[4] was broad-based, paced by 26.4 percent growth in construction. Although it is too early to assess how agriculture will perform for the full year, its production is expected to out-do 2017. As for spending, higher investment was the most important driver of growth, contributing 5 percentage points (pp) in the first half of the year. Both public and private investment went up. In the first half of 2018 consolidated public capital spending rose by 44 percent in nominal terms compared to the first half of 2017 (mainly on transport infrastructure). Net exports are expected to subtract 3.2 pp from 2018 growth; since 11 percent real growth of imports overshadowed the solid 8.2 percent increase in exports. Most of the import increase is explained by machinery and equipment imports, which were up 17 percent through June as investment recovers.

The labor market continues to improve. Labor Force Survey data suggest that in the first half of the year about 1 percent more Serbian citizens were employed.[5] Unemployment for the working-age population was 12.5 percent in the second quarter[6]; unemployment for all of 2018 is expected to be about 13 percent. Low internal mobility has started to create frictions, for example, with unemployment at 15.6 percent in South-East Serbia and 10.2 percent in Vojvodina but with increasingly pronounced labor shortages in construction and other fast-growing sectors in Belgrade. Lower unemployment was accompanied by

4 All percentages are year-on-year unless otherwise stated.

5 Registered employment was up by about 3.7 percent through June.

6 Unemployment of workers over 15 years of age fell to 11.9 percent.

increase in activity rate which reached a record high 68.5 percent in the second quarter. Average wages went up by 4.2 percent in real terms—a progression expected to continue through 2018.

In the first half of 2018 the budget had a surplus of 0.7 percent of annual GDP; a surplus is also projected for the full year. Revenues are expected to decline slightly, from 44.2 percent of GDP in 2017 to 43.3 percent. Nominal revenue collection was strong in the first half, helping to offset higher spending. The net result was a surplus of 32.8 billion dinars—11 billion less than in the first half of 2017. Nominal revenues were up 4.9 percent, notably in social insurance contributions (up by 0.5 percent of annual GDP) and the VAT on imports (up by 0.4 percent of annual GDP).[7] Collection of the VAT on imported goods reflects the increase in imports, and higher social contributions track the growth in formal employment. Solid growth of revenues is also projected for the remainder of the year. Thus in 2018 total revenues should be about 4 percent higher than in 2017. While government spending is expected to decline in GDP terms in 2018, nominal spending on wages, goods and services, and capital projects has gone up in the first half of the year. However, in the last few years an active debt management and stricter control of financial support to utility companies and SOEs, have resulted in lower interest payments and activated guarantees, saving about 0.3 percent of GDP more in the first half of 2018 compared to 2017. Spending for all of 2018 is projected to go up by 5.4 percent in nominal terms compared to a year earlier—which would still bring down the share of total spending in GDP from 43 percent in 2017 to 42.7 percent. Consolidated general government is projected to close the budget year with a surplus of 0.6 percent of GDP, down from 1.2 percent in 2017. The fiscal surplus, nominal growth of GDP and favorable dollar/euro and dinar/euro exchange rates have helped to reduce public debt as a share of GDP from 62.5 percent in 2017 to a projected 58.4 percent at yearend.[8]

Appreciation of the dinar helped manage inflationary pressures. Inflation peaked at 2.6 percent in August 2018, after hitting a low of 1.1 percent in April (partly due to last year's base effect). The recovery in food and oil prices has pushed up the CPI over the recent months. Due to the low inflationary pressures and stable inflation outlook, the central bank (NBS) lowered its policy rate to 3.25 percent in March 2018, and to 3 percent in April. Between January and August 2018 the dinar had appreciated by 0.2 percent in nominal terms against the euro. The NBS intervened regularly in the foreign exchange market to smooth excessive short-term exchange rate volatility. In 2018 the NBS has been a net purchaser of foreign currency, buying a total of €1.6 billion by the end of August. Foreign currency reserves reached €11.4 billion at the end of July (equal to 6.5 months of imports), the highest level since March 2013. Net foreign currency reserves[9] peaked at €9.5 billion in July.

Credit activity recovered somewhat in the second quarter, but its structure is

7 Data for the first half of 2018 show a significant drop in revenues from domestic VAT (down by 28 percent compared to the same period in2017).

8 Here total public debt includes nonguaranteed debt of local governments.

9 Total foreign currency reserves less foreign-denominated bank balances on account of required reserves and liabilities related to repayment of IMF loans.

unfavorable. Sluggish 3.7 percent growth in total loans by the end of July was mainly driven by more lending to households (up 9.6 percent) and the government (up 4.8 percent). There was a spike in short-term loans ("cash loans") to individuals, which at the end of July were 21.4 percent higher than a year ago (July data, in euro terms). As a result, the stock of cash loans is now higher than the volume of mortgages, although the latter are also growing. In July the stock of loans for housing was 5.8 percent higher than a year ago (in euro terms). On the other hand, business lending went down by 1 percent in nominal terms, to a large extent because of a significant write-off and sale of NPLs (81 and 41 billion dinars, respectively, over the previous twelve months) and partially because loans to SOEs were down 23.3 percent, as those improved performance and due to stricter control by the government over their borrowing.

Banking sector performance remains solid. Gross nonperforming loans (NPLs) again edged down, from 9.8 percent in December 2017 to 6.7 percent at the end of July, as banks were more aggressive in writing off bad loans or sold them to specialized investors. More than 70 percent of all NPLs are with businesses (their value is about €1 billion, of which 300 million is owed 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 at not as fast as in the previous 18 months.

Although the trade deficit continues to widen, in the first half of 2018 the current account deficit (CAD) was generally unchanged in euro terms. The trade deficit went up by 26.5 percent, compared to the same period of 2017, reaching 5.7 percent of annual GDP; for the full year it is expected to reach 11 percent. The surplus in trade in services rose in euro terms by 23.2 percent and in net transfers by 14 percent, thus compensating for the impact of the widening trade deficit on the CAD, which went down only 1.4 percent. As for services exports, ICT services went up a significant 26.2 percent. Remittances continued to grow robustly, by 20.2 percent, reaching 3.2 percent of annual GDP. Net FDI increased by 8.6 percent to reach €1.3 billion, on target to reach €2.6 billion for the year. Chinese investment was part of the higher FDI. Shanding Linglong, which produces car tires, announced a greenfield investment of about US$1 billion in Zrenjanin Free Zone, to be completed in three phases through 2025. The Chinese Zijin mining company won a tender for a 65 percent equity stake with a combined US$550 million in investment for a capital increase and to clear arrears in RTB Bor, the largest Serbian copper and gold producer (a debt-ridden pre-bankruptcy SOE). Total external debt continues to decline (down €668 million in the first quarter compared to the same quarter of 2017) despite an increase in the CAD and despite the increase in cross-border loans (up by €29 million in the first quarter compared to the same quarter of 2017).

Outlook and Risks

Growth of the Serbian economy over the medium term is expected to be a healthy 4 percent or so. Growth in 2018 is likely to be faster than currently projected, and the momentum should continue into the medium term with investment and exports as the main drivers. Exports are projected to grow by about 9.5 percent annually in real terms; and

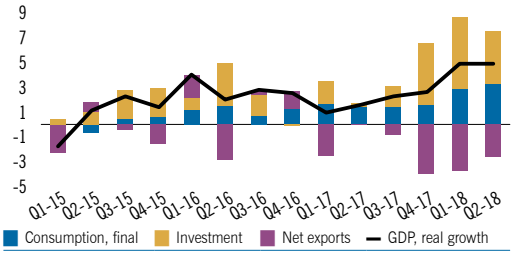
investment should rise by about 6.5 percent each year for the next three years. Announced increases in public wages and expected increases in employment and wages generally will also drive up consumption. It is not yet clear how much of this will spill over to imports, however, and worsen external imbalances.

The medium-term growth projections crucially depend on the pace of structural reforms and progress with EU accession. It is vital that Serbia deals with its unsustainable SOEs. Recent efforts to resolve some of the main loss-makers are encouraging. Privatization of state-owned financial institutions should be accelerated. Meanwhile, expected fast growth in the EU, Serbia's main trading partner and investor, is favorable. Speeding up the EU accession process is important because it will both strengthen institutions and send a positive signal to investors. In addition, the work on regional projects, mainly dealing with connective infrastructure like roads and railways, would help Serbian exporters and stimulate growth of the economy in general.

The downside risks are mainly political. Although Serbia's growth of 4.9 percent in the first half of 2018 is aligned with the results of other Central European countries,[10] the constant threat of early elections; the recent resignation of the Minister of Finance; work on resolving relations with Kosovo; slower than planned opening of chapters of the acquis for EU accession; a gap in formal IMF engagement; and some deterioration in the country's governance and rule of law indicators—all suggest that growth could have been faster. In addition, the uncertainty created by regional political developments, the potential tightening of financing conditions for emerging markets in general, as well as concerns about the speed of EU growth, is making both local and foreign investors more cautious. This in turn delays completion of some important projects related to both infrastructure and the real sector.

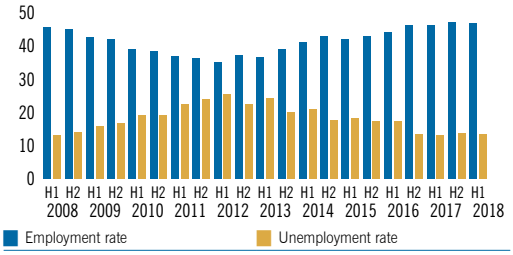
10 Based on preliminary estimates for Q2, the simple average for growth in this group (Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania, Slovakia, and Slovenia) was about 4 percent.

Growth in H1 2018 was broad-based.



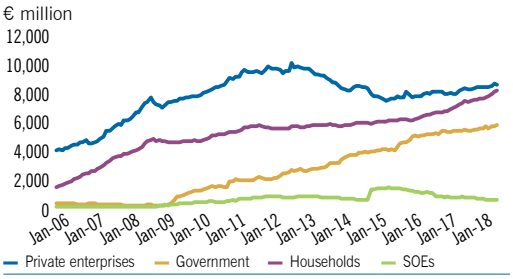
Source: Statistics Office of Serbia.

The performance of the labor market improved.



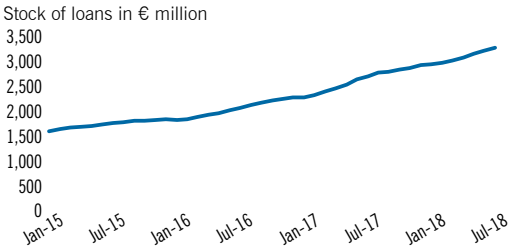
Source: Statistics Office of Serbia.

Credit activity recovered, mainly because loans to households increased.



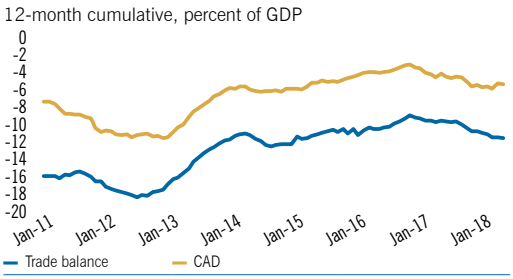
Source: National Bank of Serbia.

Cash loans may be increasing too fast.



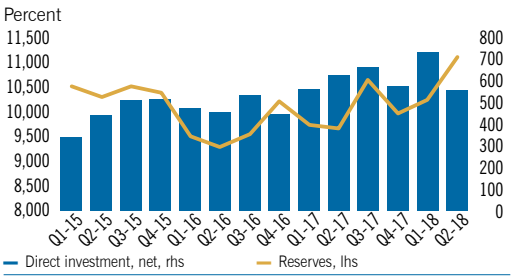
Source: Ministry of Finance; World Bank staff calculations.

The trade deficit widens, but the CAD is under control.



Source: National Bank of Serbia.

High FDI is helping push up reserves.



Source: National Bank of Serbia.

SERBIA	2014	2015	2016	2017	2018[e]	2019[f]	2020[f]
Real GDP growth (percent)	-1.8	0.8	2.8	1.9	3.5	3.5	4.0
Composition (percentage points):							
Consumption	-1.1	0.1	1.1	1.5	2.7	2.6	3.6
Investment	0.0	1.6	1.5	2.3	1.7	1.7	1.4
Net exports	-0.7	-0.9	0.2	-1.9	-1.0	-0.8	-1.0
Exports	2.3	4.5	5.8	5.2	5.9	5.5	5.6
Imports (-)	3.0	5.4	5.6	7.1	6.8	6.3	6.5
Consumer price inflation (percent, period average)	2.1	1.4	1.1	3.2	1.6	2.6	3.0
Public revenues (percent of GDP)	41.5	41.9	43.2	44.2	43.3	42.2	42.0
Public expenditures (percent of GDP)	48.1	45.6	44.5	43.0	42.7	42.7	42.5
Of which:							
Wage bill (percent of GDP)	11.7	10.4	9.8	9.5	9.9	9.7	9.7
Social benefits (percent of GDP)	17.8	17.6	16.7	16.1	15.7	15.6	15.5
Capital expenditures (percent of GDP)	2.5	2.8	3.3	3.0	3.3	3.6	3.6
Fiscal balance (percent of GDP)	-6.6	-3.7	-1.3	1.2	0.6	-0.5	-0.5
Primary fiscal balance (percent of GDP)	-3.7	-0.5	1.8	3.9	2.8	1.8	1.9
Public debt (percent of GDP)	64.2	68.8	67.8	57.7	53.8	51.3	49.0
Public and publicly guaranteed debt (percent of GDP)	71.9	75.9	73.0	62.5	58.4	55.8	53.0
Of which: External (percent of GDP)	41.5	45.2	45.9	38.0	37.0	37.0	36.0
Goods exports (percent of GDP)	31.9	33.9	37.0	38.3	39.7	41.3	42.5
Goods imports (percent of GDP)	44.3	45.8	46.0	49.1	50.7	51.8	53.0
Net services exports (percent of GDP)	1.4	2.2	2.6	2.6	2.7	2.8	2.6
Trade balance (percent of GDP)	-10.9	-9.8	-6.4	-8.2	-8.2	-7.7	-7.9
Remittance inflows (percent of GDP)	5.8	6.4	5.6	5.8	5.7	5.5	5.5
Current account balance (percent of GDP)	-6.0	-3.7	-3.1	-5.7	-5.7	-5.5	-5.3
Foreign direct investment inflows (percent of GDP)	3.7	5.4	5.5	6.6	6.5	5.9	5.7
External debt (percent of GDP)	77.1	78.3	76.5	72.0	65.2	61.0	56.7
Real private credit growth (percent, period average)	-3.8	-1.2	5.0	1.9	n.a.	n.a.	n.a.
Non-performing loans (percent of gross loans, end of period)	21.5	21.6	17.0	9.8	n.a.	n.a.	n.a.
Unemployment rate (percent, period average)	19.2	17.7	15.3	13.5	13.0	12.5	11.5
Youth unemployment rate (percent, period average)	47.0	42.9	35.0	32.0	n.a.	n.a.	n.a.
Labor force participation rate (percent, period average)	51.9	51.6	53.3	54.0	n.a.	n.a.	n.a.
GDP per capita, PPP (current international $)	13,398	13,454	13,773	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.
Notes: Non-performing loans show year-to-date actuals.

Key Economic Indicators

	2014	2015	2016	2017	2018[e]	2019[f]	2020[f]
Real GDP growth (percent)							
Albania	1.8	2.2	3.4	3.8	4.0	3.6	3.5
Bosnia and Herzegovina	1.1	3.0	3.1	3.0	3.2	3.4	3.9
Kosovo	1.2	4.1	4.1	3.7	4.0	4.5	4.5
Macedonia, FYR	3.6	3.9	2.9	0.0	2.5	2.9	3.2
Montenegro	1.8	3.4	2.9	4.3	3.8	2.8	2.5
Serbia	-1.8	0.8	2.8	1.9	3.5	3.5	4.0
WB6	*0.3*	*2.2*	*3.1*	*2.4*	*3.5*	*3.5*	*3.8*
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	1.1	1.4	1.4
Kosovo	0.4	-0.5	0.3	1.5	0.7	1.5	1.6
Macedonia, FYR	-0.2	-0.3	-0.2	1.3	1.6	2.0	2.0
Montenegro	-0.7	1.5	-0.3	2.4	3.1	2.1	1.6
Serbia	2.1	1.4	1.1	3.2	1.6	2.6	3.0
WB6	*1.0*	*0.7*	*0.4*	*2.2*	*1.6*	*2.2*	*2.4*
Public expenditures (percent of GDP)							
Albania	32.3	31.5	29.4	29.7	30.0	29.9	29.5
Bosnia and Herzegovina	46.2	42.5	42.1	41.4	45.0	42.6	41.5
Kosovo	26.6	27.1	27.7	28.2	29.9	30.2	31.2
Macedonia, FYR	33.9	34.4	33.0	33.7	34.6	35.3	35.4
Montenegro	47.7	48.8	45.6	47.4	46.3	45.6	39.2
Serbia	48.1	45.6	44.5	43.0	42.7	42.7	42.5
WB6	*39.1*	*38.3*	*37.0*	*37.2*	*38.1*	*37.7*	*36.6*
Public revenues (percent of GDP)							
Albania	26.3	26.6	27.6	27.7	28.0	28.2	28.3
Bosnia and Herzegovina	44.2	43.2	43.1	43.7	44.5	42.9	42.7
Kosovo	24.0	25.1	26.3	27.0	27.5	27.4	27.7
Macedonia, FYR	29.7	31.0	30.3	30.9	32.0	32.7	32.8
Montenegro	44.6	41.5	42.5	42.0	44.1	43.9	43.0
Serbia	41.5	41.9	43.2	44.2	43.3	42.2	42.0
WB6	*35.0*	*34.9*	*35.5*	*35.9*	*36.6*	*36.2*	*36.1*

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

	2014	2015	2016	2017	2018[e]	2019[f]	2020[f]
Fiscal balance (percent of GDP)							
Albania	-6.0	-4.9	-1.8	-2.0	-2.0	-1.7	-1.2
Bosnia and Herzegovina	-2.1	0.7	1.0	2.4	-0.5	0.3	1.2
Kosovo	-2.6	-2.0	-1.4	-1.2	-2.4	-2.9	-3.5
Macedonia, FYR	-4.2	-3.4	-2.7	-2.8	-2.6	-2.6	-2.6
Montenegro	-3.1	-7.3	-3.1	-5.4	-2.2	-1.8	3.8
Serbia	-6.6	-3.7	-1.3	1.2	0.6	-0.5	-0.5
WB6	*-4.1*	*-3.4*	*-1.5*	*-1.3*	*-1.5*	*-1.5*	*-0.5*
Public debt (percent of GDP)							
Albania	66.1	69.1	68.7	67.8	65.5	62.7	61.7
Bosnia and Herzegovina	42.0	41.9	42.4	36.1	35.1	34.0	33.2
Kosovo	10.4	12.7	14.1	15.9	17.2	18.6	20.1
Macedonia, FYR	38.1	38.1	39.6	39.3	42.4	43.5	44.2
Montenegro	59.9	66.2	64.4	65.1	67.6	66.8	60.6
Serbia	64.2	68.8	67.8	57.7	53.8	51.3	49.0
WB6	*46.8*	*49.5*	*49.5*	*47.0*	*46.9*	*46.1*	*44.8*
Public and publicly guaranteed debt (percent of GDP)							
Albania	72.0	72.7	72.3	71.6	69.5	67.2	64.8
Bosnia and Herzegovina	43.1	43.2	43.3	38.0	36.7	35.6	34.8
Kosovo	10.6	12.8	14.4	16.6	18.0	19.3	20.8
Macedonia, FYR	45.7	46.6	48.4	47.6	50.6	55.7	58.3
Montenegro	67.1	73.7	71.4	72.5	74.6	73.5	67.0
Serbia	71.9	75.9	73.0	62.5	58.4	55.8	53.0
WB6	*51.7*	*54.2*	*53.8*	*51.5*	*51.3*	*51.2*	*49.8*
Goods exports (percent of GDP)							
Albania	9.3	6.8	6.0	6.7	6.3	6.4	6.5
Bosnia and Herzegovina	25.1	25.2	25.7	28.5	31.2	33.9	35.2
Kosovo	5.8	5.6	5.1	6.0	5.6	5.6	5.7
Macedonia, FYR	32.5	33.6	35.7	40.4	42.7	44.6	46.3
Montenegro	10.3	8.9	8.7	9.0	9.5	9.8	10.3
Serbia	31.9	33.9	37.0	38.3	39.7	41.3	42.5
WB6	*24.7*	*25.1*	*26.7*	*28.5*	*29.8*	*31.2*	*32.2*

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

	2014	2015	2016	2017	2018[e]	2019[f]	2020[f]
Trade balance (percent of GDP)							
Albania	-19.1	-17.3	-16.8	-15.1	-14.8	-14.2	-13.7
Bosnia and Herzegovina	-22.7	-18.8	-17.1	-16.7	-16.7	-17.0	-17.2
Kosovo	-28.7	-28.5	-27.2	-26.4	-27.6	-27.4	-26.8
Macedonia, FYR	-17.2	-16.2	-15.0	-13.9	-13.3	-13.1	-12.5
Montenegro	-19.8	-18.5	-22.5	-23.8	-23.6	-22.8	-21.9
Serbia	-10.9	-9.8	-6.4	-8.2	-8.2	-7.7	-7.9
WB6	*-16.7*	*-15.1*	*-13.2*	*-13.6*	*-13.5*	*-13.1*	*-13.0*
Current account balance (percent of GDP)							
Albania	-10.8	-7.8	-6.8	-6.9	-6.8	-6.6	-6.1
Bosnia and Herzegovina	-7.4	-5.7	-5.1	-4.8	-5.3	-5.5	-5.6
Kosovo	-6.9	-8.6	-7.9	-6.6	-6.9	-8.5	-9.0
Macedonia, FYR	-0.5	-2.0	-2.7	-1.3	-1.2	-1.4	-1.5
Montenegro	-12.4	-11.0	-16.2	-16.3	-16.4	-15.7	-15.1
Serbia	-6.0	-3.7	-3.1	-5.7	-5.7	-5.5	-5.3
WB6	*-6.6*	*-5.1*	*-4.9*	*-5.7*	*-5.8*	*-5.8*	*-5.7*
External debt (percent of GDP)							
Albania	69.6	73.6	73.6	73.6	73.6	73.6	73.6
Bosnia and Herzegovina	77.1	72.2	71.0	70.3	69.3	68.8	68.8
Kosovo	31.2	33.3	32.7	33.4	34.4	34.6	35.2
Macedonia, FYR	69.6	68.5	72.0	72.7	77.4	78.2	78.9
Montenegro	163.3	162.2	160.9	161.7	163.4	159.9	159.2
Serbia	77.1	78.3	76.5	72.0	65.2	61.0	56.7
WB6	*81.3*	*81.4*	*80.9*	*80.1*	*80.5*	*78.8*	*77.9*
Unemployment rate (period average, percent)							
Albania	17.5	17.1	15.2	13.8	n.a.	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	30.4	n.a.	n.a.	n.a.
Macedonia, FYR	28.0	26.1	23.7	22.4	20.4	19.4	18.0
Montenegro	18.0	17.6	17.7	16.1	15.8	15.5	15.0
Serbia	19.2	17.7	15.3	13.5	13.0	12.5	11.5
WB6	*24.3*	*23.2*	*20.8*	*19.4*	*16.9*	*15.8*	*14.8*

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

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Room 28
by Rikardo Druskic

Rikardo Druskic is a 28-year-old artist from Bosnia and Herzegovina who has to date created about 600 works of art. His work has been exhibited not only in his home country, but also internationally, including in New York, Miami, and Los Angeles. In November 2017, he had his first solo international exhibit, "Digginside", in Berlin. Twenty of his artworks are currently on view in the Los Angeles Center for Digital Arts (LACD).

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.