

WESTERN BALKANS REGULAR ECONOMIC REPORT
No.21 | Spring 2022

Steering Through Crises



Western Balkans
Regular Economic Report No.21

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Spring 2022

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

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Abbreviations

AQR	Asset Quality Review	pp	percentage points
CAD	current account deficit	PPG	public and publicly guaranteed
CESEE	Central, Eastern and South-Eastern Europe	PPP	purchasing power parity
CPI	consumer price index	Q	quarter
ECA	Europe and Central Asia	S&P	Standard & Poor's
EMDEs	emerging markets and developing economies	7STEEs	seven small transition economies of Europe, which are Bulgaria, Croatia, Estonia, Latvia, Lithuania, the Slovak Republic, and Slovenia
EPS	Elektroprivreda Srbije (Serbia)	SILC	Survey of Income and Living Conditions
EU	European Union	SOEs	state-owned enterprises
EUR	euro	SWIFT	Society for Worldwide Interbank Financial Telecommunication
FBiH	Federation of Bosnia and Herzegovina	TPP	thermal power plant
FDI	foreign direct investment	VAT	value-added tax
GDP	gross domestic product	WB	World Bank
H1	first half (of the year)		
HBS	Household Budget Survey		
ICT	information and communications technology		
kWh	kilowatt hour		
LFS	Labor Force Survey		
LMIC	low- and middle-income countries		
MWh	megawatt hour		
NBS	National Bank of Serbia		
NPLs	nonperforming loans		
PM	particulate matter		

Country abbreviations

ALB	Albania
BIH	Bosnia and Herzegovina
KOS	Kosovo
MKD	North Macedonia
MNE	Montenegro
SRB	Serbia
WB6	Western Balkans 6

Steering Through Crises

1. Overview

Just as the economies of the Western Balkans were looking to growth recovery beyond the pandemic, a new set of challenges confronted the region. Output for the Western Balkans has now surpassed pre-pandemic levels, but the response to the COVID-19 pandemic has resulted in higher public debt and has left lasting scars. Potential growth remains constrained by the need for structural reforms to boost productivity, increase competition, invest in human capital, and strengthen governance. Even before the Russian invasion of Ukraine, higher energy prices and the challenges of the green transition were putting the Western Balkans under stress. The war is now sending shockwaves across the region, particularly through higher energy and food prices but also via a disruption in trade and investment flows, putting the region's recovery at risk. Careful policy support within a more constrained fiscal space will be needed to navigate the Western Balkans through the next set of challenges.

The economies of the Western Balkans saw a strong growth rebound in 2021 with a broad-based bounce back in economic activity. In 2021, GDP growth in the Western Balkans reached 7.4 percent after a contraction of 3.2 percent in 2020. The strength of the recovery exceeded initial projections (from the Fall 2021 *Regular Economic Report*), and real GDP is now expected to surpass pre-pandemic levels by 2022, with only Montenegro expected to reach pre-pandemic output in 2023. Growth was driven by an exceptionally strong rebound in consumption, contributing 5.3 percent to the region's growth rate, helped by fiscal stimuli, pent-up demand, and a relaxation in movement

and travel restrictions. Investment also saw a notable recovery, contributing 2.9 percentage points to regional economic growth in 2021, although performance was more mixed across the region due to a more sluggish performance in Bosnia and Herzegovina and Montenegro. Exports also roared back across the region as global demand for tradables strengthened, but net exports subtracted 0.7 percentage points from growth as in parallel import demand surged faster than exports, in line with strong domestic consumption and investment, as well as high import content of exports in some countries.

A return to growth saw significant job creation, helping to reverse some of adverse impact of the pandemic. Rapid growth in 2021 saw the creation of 227,300 new jobs in the Western Balkans. Strong domestic and external demand, coupled with a resumption in tourism and construction, helped drive the employment rate to a historical high of 45.8 percent of the working-age population, up 0.9 percentage points from 2020. Job creation was strongest for women and youths, who work disproportionately in the services sectors, which were most affected by the pandemic. However, unemployment in the Western Balkans also rose at the same time to 13.7 percent in 2021, as labor market support programs were gradually wound down and people re-entered the labor market after pandemic-induced inactivity. Nevertheless, labor force participation rates remain low across the region, particularly for women, and the youth unemployment rate at 33.2 percent at the end of 2021 remains high.

Employment demand helped reduce poverty across all six Western Balkan economies.

The poverty rate is estimated to have fallen by 2.9 percentage points in 2021, reversing the 1.4 percentage points increase in poverty of 2020. This is equivalent to 408,000 people being lifted out of poverty in 2021, meaning that net poverty has now fallen below pre-pandemic levels. The strongest reduction in poverty was in Albania and Kosovo. However, rising energy and food prices are expected to weigh heavily on low-income households in the Western Balkans, which spend a much higher share of their income on basic needs such as food and heating.

Strong revenue performance helped reduce fiscal deficits across the region.

For most economies in the Western Balkans in 2021, the buoyant recovery in economic activity together with higher inflation fueled a nominal growth in revenues that outpaced expenditures. The average deficit for the region dropped by 4 percentage points of GDP compared to 2020. Montenegro, Kosovo and Serbia saw sharp declines in the size of deficits. In North Macedonia and Albania, the pace of fiscal consolidation was more modest due to higher spending, while in Bosnia and Herzegovina the fiscal shortfall widened due to higher wages and social transfers that spilled over from 2020. Public expenditure contracted (except in Bosnia and Herzegovina) but remains above pre-pandemic levels (except in Montenegro). Pandemic-related fiscal support, especially on transfers and subsidies, has been gradually unwound, although governments are now facing increased pressure to finance energy- and food-related subsidies. A healthy combination of higher growth and lower deficits helped reduce public debt ratios across the Western Balkans, with the average public and publicly

guaranteed debt-to-GDP ratio declining from 60.8 percent of GDP in 2020 to 56.5 percent of GDP in 2021, with Montenegro making the largest adjustment.

Inflation is on the rise due to a combination of factors.

Stronger global growth since mid-2020 has placed upward pressure on commodity prices and shipping costs, feeding through into higher imported inflation across the Western Balkans. Similarly, strengthened domestic demand in 2021 placed further pressure on prices. Core inflation in the Western Balkans reached a record high of 2.9 percent in December 2021, as persistent supply shocks and wage increases fueled inflationary expectations. The conflict between Russia and Ukraine has added significant further impetus to already rising inflationary trends, driving energy and food prices sharply upwards. Consumer price inflation growth in January 2022 ranged from 3.7 percent in Albania to 8.2 percent in Serbia. In all countries, food and nonalcoholic beverages price inflation contributed the most to headline inflation, with increases ranging from 6.7 percent in Albania to 13.5 percent in Serbia. Increases in wages across the region may fuel price pressures further in 2022.

Financial stability remains sound due to support measures, but vigilance will be needed given exceptional uncertainty.

The financial systems of the Western Balkan economies have remained resilient through the pandemic, with adequate capital and liquidity buffers and the maintenance of asset quality. Policy support, including borrower relief measures, coupled with a growth recovery has helped reduce banking sector risks and even increase commercial bank profitability. The imposition of financial sanctions on Russia had a direct impact on the Western Balkans

with the takeover of subsidiaries of Russian banks operating in Serbia and Bosnia and Herzegovina. Wider macro-financial risks include indirect transmission channels from European banking groups active in the Western Balkans, which are exposed to Russia and Ukraine. The Western Balkans also need to get prepared to manage the physical and transition climate risks through gradually greening its financial sector.

There was especially strong growth in trade in 2021 as the region benefited from a recovery in global demand, but the conflict between Russia and Ukraine is expected to disrupt this trend. Exports surged by 39.2 percent and imports by 29.0 percent in 2021, as the economies of the Western Balkans profited from a strong and broad-based recovery in demand for the region's goods and services. As a result, current account deficits narrowed in many countries (Albania, Bosnia and Herzegovina, and Montenegro). The deficit was broadly unchanged in North Macedonia, and somewhat higher in Serbia and Kosovo as rapid expansion in consumption pushed imports up faster than exports.

There are several channels of impact from the war in Ukraine on the economies of the Western Balkans. Among these, it is certain that inflation will be even higher, because of additional increases in food and energy prices, and that lower exports, disruptions in supply chains, and lower tourism revenues would also likely lead to a slowdown in growth. Direct trade and investment linkages with Russia and Ukraine are more limited, except in Serbia and Montenegro. A broader shock to business confidence across Europe would also have

implications for investments into and demand from the Western Balkans, and for the flow of remittances.

The economies of the Western Balkans now face an unusually uncertain outlook.

Growth was already expected to slow as the region's economies closed the pandemic-induced output gap in 2021 and saw their growth rates returning to the weak pre-crisis rates of potential growth in 2022 and beyond. Similarly, inflation was already rising before the outbreak of hostilities. Russia's invasion of Ukraine, and the related economic implications of the conflict, will exacerbate these two trends, placing further downward pressure on growth and upward pressure on prices. In such an uncertain period, economic forecasting becomes especially challenging. However, the baseline projection for GDP growth in 2022 in the Western Balkans is now 3.1 percent, a downward revision by almost 1 percentage point (Table 1.1).

Risks are heavily tilted to the downside.

COVID-19 remains a concern, and the emergence of new and more infectious variants could trigger disruption, especially given the sizable vaccination gap that remains between populations in the Western Balkans and advanced economies. An expanded conflict or prolonged war between Russia and Ukraine could trigger further disruptions to global trade and to energy and food prices. Refinancing risks could arise if external financial market conditions continue to tighten. Debt sustainability may become a concern if limited fiscal space is eroded by policy responses to higher energy and food prices. Risks of political polarization also remain.

Table 1.1. Western Balkans Outlook, 2019–2024

	2019	2020	2021p	2022f	2023f	2024f
Real GDP Growth (percent)						
Albania	2.2	-3.5	8.5	3.2	3.5	3.5
Bosnia and Herzegovina	2.8	-3.1	7.1	2.7	3.1	3.5
Kosovo	4.8	-5.3	9.1	3.9	4.3	4.2
North Macedonia	3.9	-6.1	4.0	2.7	3.1	3.2
Montenegro	4.1	-15.3	12.4	3.6	4.7	3.7
Serbia	4.3	-0.9	7.4	3.2	2.7	2.8
<i>WB6</i>	3.7	-3.2	7.4	3.1	3.1	3.2
Real GDP Components Growth (percent)						
Consumption	3.1	-1.3	5.3	3.1	2.9	2.8
Investment	2.4	-1.5	2.9	1.0	1.1	1.3
Net exports	-1.6	-0.4	-0.7	-0.9	-0.9	-0.9
Exports	3.8	-5.9	11.8	3.1	3.1	3.2
Imports (-)	5.4	-5.4	12.5	4.0	4.0	4.0
Consumer Price Inflation (percent, period average)	1.5	0.9	3.3	6.3	3.8	2.8
External Sector (percent of GDP)						
Goods exports	28.5	27.6	32.0	31.5	31.9	32.8
Trade balance	-13.6	-13.6	-12.8	-13.4	-12.7	-11.8
Current account balance	-6.2	-5.7	-4.9	-6.3	-5.6	-5.0
Foreign direct investment	4.8	5.3	5.7	5.0	5.2	5.2
External debt	76.7	90.6	85.0	92.0	90.2	89.3
Public Sector (percent of GDP)						
Public revenues	35.5	34.9	36.2	35.4	35.5	35.5
Public expenditures	36.9	42.2	39.5	39.2	38.1	37.4
Fiscal balance	-1.3	-7.3	-3.3	-3.8	-2.6	-1.9
Public and publicly guaranteed debt	50.3	60.8	56.5	55.7	55.7	55.3

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

Note: p = preliminary; f = forecast.

In such an environment, policy needs to focus on building resilience and on undertaking structural reforms to support growth and steer through the crises. With limited fiscal space, countries will need to carefully weigh the costs and benefits of new spending commitments in response to higher energy and food prices and prioritize vulnerable households. Measures need to be targeted and timebound. Improving tax compliance and

increase progressivity should be a priority across the Western Balkans as much as building energy resilience through investing in renewables and energy efficiency. Policymakers will also need to resist the temptation to impose restrictions on trade, especially on food, which would cause market distortions. Structural measures to reduce business regulatory costs, increase market competition, support labor market participation, and strengthen the independence

of public institutions would all be supportive of growth in an uncertain environment. Higher growth would help alleviating debt sustainability concerns ahead of financial markets tightening.

2. Western Balkan economies have rebounded fast in 2021

The Western Balkan economies rebounded strongly from the crisis. The region experienced higher growth in 2021 compared to EU countries, despite a more moderate economic recession caused by the pandemic in 2020. Growth in the Western Balkans rebounded to 7.4 percent in 2021 after contracting 3.2 percent in 2020. The recovery was 1.5 percentage points stronger than initially projected in October 2021 (Figure 2.1). Overall, real GDP growth exceeded 4 percent in 2021 in all Western Balkan countries. The rebound was most pronounced in Montenegro totaling over 12 percent due to the revival in tourism revenues. The strong growth of 9 percent in Kosovo and Albania was also driven by a sharp rebound in travel receipts and government spending. Private consumption has been supporting economic activity in Serbia, Bosnia and Herzegovina, and North Macedonia, with total growth of 7.4, 7.1, and 4 percent, respectively.

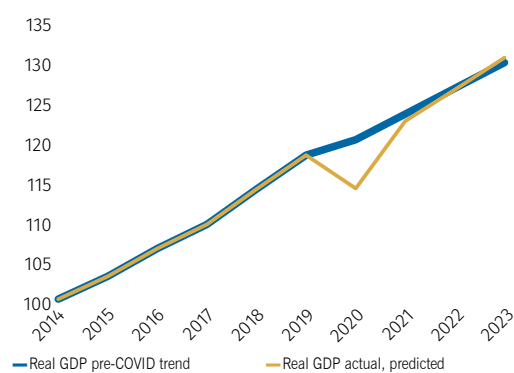
Figure 2.1. The economic recovery was strong throughout the Western Balkan countries in 2021



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

Real GDP in some of the countries in the region is predicted to catch up in 2022 with the level it would have reached without the pandemic. The region is experiencing a fast economic recovery as real GDP in 2021 is close to its long-term trend level (Figure 2.2). Real GDP in 2021 surpassed its pre-pandemic level in Albania, Bosnia and Herzegovina, Kosovo, and Serbia. Given the relatively modest 2020 recession and strong recent growth, Serbia stands out with a 6 percent higher real GDP in 2021 relative to 2019. At the same time, Montenegro's 15 percent decline in economic activity in 2020 and North Macedonia's more modest economic recovery in 2021 mean that neither country's real GDP levels has yet reached their pre-pandemic level. In part because of the significant adverse impact of the war in Ukraine on the summer tourism season, Montenegro is the only Western Balkan country whose real GDP is predicted to recover to its pre-pandemic level only in 2023.

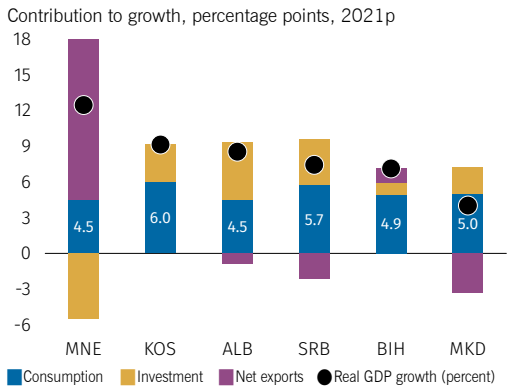
Figure 2.2. Real GDP level in the Western Balkan region is predicted to recover in 2022 to its pre-COVID trend



Source: National statistical offices; World Bank staff estimates.

Note: Based on real GDP pre-COVID linear trend growth 2013–19.

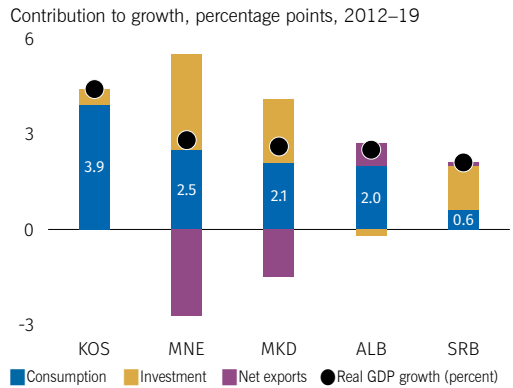
Figure 2.3. The recovery was driven by a strong rebound in consumption and tourism



Sources: National statistical offices; World Bank staff estimates.

The growth in Western Balkan countries was driven by an exceptionally strong rebound of private consumption paired with high fiscal stimuli. Private consumption contributed 5.3 pp to the region's economic growth. Its growth contribution exceeded 5 pp in Kosovo, North Macedonia, and Serbia (Figure 2.3). It was strongest in Kosovo where consumption growth was fueled by restored consumer confidence, fewer mobility restrictions, a double-digit credit expansion, higher remittances, and a significant fiscal stimulus. Similarly, private consumption surged in North Macedonia and Serbia after the relaxation of mobility restrictions while strong government consumption also contributed to growth. The contribution of consumption to economic growth is well above its historic pre-pandemic levels in all Western Balkan countries (Figure 2.4)—it is at least twice as high in Albania, North Macedonia, and Serbia. Strong private consumption fueled by household lending and paired with strong government consumption will be difficult to sustain in 2022.

Figure 2.4. Consumption's contribution to growth in 2021 was well above recent historic averages



Sources: National statistical offices; World Bank staff estimates.

Investment contributed 2.9 percentage points to economic growth in the region in 2021. The strong average contribution, however, masks significant differences across the six countries (Figure 2.3). The contribution of investment to growth exceeded 3 pp in Albania, Kosovo, and Serbia. In Kosovo, it was spurred by credit expansion to private sector investment and higher real estate foreign direct investment. In Serbia, real investment soared by almost 15 percent, primarily driven by the surge in government investment of up to 37.5 percent in real terms. In contrast, investment hardly grew in Bosnia and Herzegovina due to higher costs of materials, and continued supply-chain disruptions, while in Montenegro it dragged growth by 5.5 pp due to lower public investment. In all Western Balkan countries, the higher costs of energy and materials are expected to weigh on private investment in 2022. Public investment contributed strongly to economic activity in several Western Balkan countries in 2021 (Box 2.1), which may change in 2022 as public resources are redirected towards addressing the impact of energy crisis.

Net exports subtracted 0.7 pp from economic growth in the region due to the recent surge in import prices. Higher commodity prices and a favorable external environment in general supported export growth in all Western Balkan countries. Fueled by the strong consumption rebound and high energy, material cost, and food prices, the growth in imports overshadowed in some cases the recovery in gross exports (Figure 2.3). One of the exceptions is Montenegro, where net exports soared due to tourism revenues that rose more than six-fold relative to 2020. The contraction in net exports was especially strong in North Macedonia and Serbia, whose export structures are based on manufacturing, such as automobiles and automobile parts. The rise in imported material costs and continued supply chain disruptions weighed on net exports in both countries.

A strong rebound in services spearheaded the economic recovery. The recovery was broad-based across economic activities, except for agriculture. In Kosovo and Serbia, a decline in agricultural output due to weather-related shocks subtracted from growth. While construction declined in North Macedonia and Montenegro, higher industrial activity added to growth in most countries. Across the region, real GDP growth was driven by service sectors. Retail trade expanded strongly in all countries, mirroring the strong rebound in private consumption. The sharp rise in tourism and transport after the relaxation of mobility restrictions also fueled services growth in the Western Balkans, especially in Albania, Kosovo, and Montenegro. ICT services further contributed to growth in North Macedonia.

Box 2.1. How much did the fiscal expansion contribute to the economic recovery?

The COVID-19 pandemic prompted an unprecedented fiscal stimulus by governments across the world, including in the Western Balkans. The scale of support has varied across countries, depending on the depth of the crisis but also on the available fiscal space. In the Western Balkans region, public spending in 2020 increased by an average of 6 percentage points of GDP year on year, above 9 percent nominally.¹ The size of the fiscal packages ranges from 2.6 percent of 2020 GDP in Albania to above 8 percent of 2020 GDP in Serbia, reflecting different needs but also different starting fiscal positions.²

The impact of fiscal spending has been stronger, yet delayed, compared to previous episodes. Government spending multipliers measure the change in output in response to a change in spending. The analysis estimates total expenditure multipliers for three selected regions—the European Union, 7STEEs, and the Western Balkans³—using a local projection model (Jordà, 2005).⁴ The dataset spans 1980 to 2020. Given limited data, the results should be treated as indicative, and further robustness analysis would be needed to more precisely quantify the impact of overall spending and its components. In line with existing literature, across the three regions the size for the fiscal multiplier

1 WB6 RER Spring 2021.

2 IMF Fiscal Monitor: Database of Country Fiscal Measures in Response to the COVID-19 Pandemic. July 2021 Database.

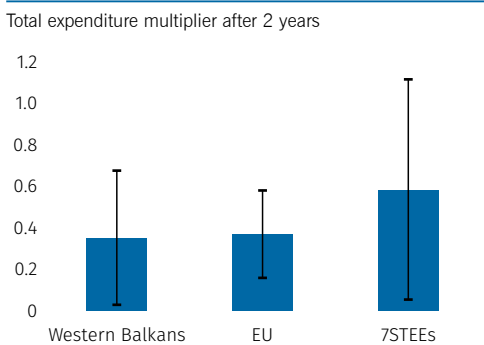
3 The selected regions are the European Union, the Western Balkans, and the 7STEEs, including Estonia, Latvia, Lithuania, Bulgaria, Croatia, Slovak Republic, Slovenia.

4 Jordà, O. 2005. Estimation and Inference of Impulse Responses by Local Projections. *American Economic Review*, 95 (1): 161 – 82.

Box 2.1 continued

associated with total expenditure is below 1 and ranges from 0.2 to 0.4 on impact to 0.4 to 0.6 at three-years' time horizon. Figure 2.5 shows the estimate of the fiscal multiplier for total expenditure after two years for the three regions. Figure 2.6 shows the difference in the fiscal multiplier at impact and after a year, estimated with and without accounting for the 2020 crisis and the associated fiscal expansion. The fiscal multiplier on impact has been more compressed than historically, while the impact one year after has been larger. This may be because the drop in aggregate demand in 2020 was not primarily driven by deleveraging but rather by lockdown restrictions due to health precautions. In this sense, the restrictions imposed to slow the spread of the virus might have delayed the effects of adopted fiscal measures.⁵

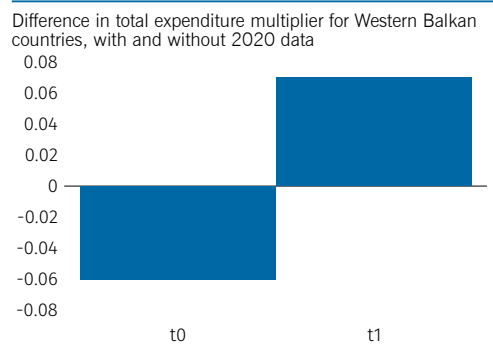
Figure 2.5. The fiscal multiplier for total expenditure remains below one



Notes: Bars measure standard multipliers, i.e., change in output in response to a change in spending after two years. Black lines denote 90% confidence intervals.

Source: Authors' calculations based on WEO data. Estimation sample in this case is 2000–2020.

Figure 2.6. The fiscal impact after one year has been larger than historically



Notes: Change in the multiplier for government spending, with and without 2020.

Source: Authors' calculations based on WEO data; estimation sample in this case is 2000–2020.

The combination of the automatic stabilizers and discretionary measures contributed to the strong response in 2020 in the Western Balkan countries. To assess whether governments responded proactively to the business cycle, the automatic features built into the tax and expenditure systems (such as a fall in tax revenues or a rise in unemployment benefits when the economy is in crisis), known as automatic stabilizers, should be distinguished from the discretionary actions, namely the fiscal impulse. As shown in Figure 2.7, there is a large variation across the six countries and across time. However, in 2020, all countries reacted strongly to the downturn, jointly through automatic and discretionary features of the fiscal framework. Figure 2.7 shows that historically, fiscal impulses (in red) tend to be positive when the economy was already booming, and negative when the economy was in a downturn, hence ending up accentuating cycles, but with some exceptions such as Albania after the global financial crisis. Automatic stabilizers (in green) should automatically react to the business cycle, with revenues decreasing and some spending increasing in times of crisis, the relatively small size of which, observed in some episodes like Serbia in 2020, points to the need to reinforce the automatic features of the tax and expenditures systems.

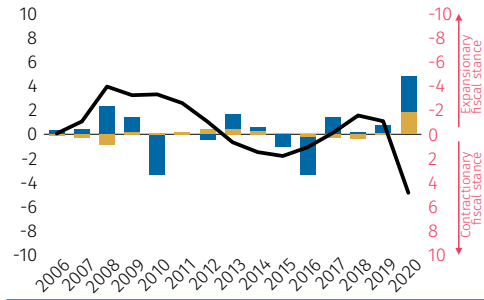
⁵ Auerbach, A J, Y Gorodnichenko, P McCrory and D Murphy (2021a), “Fiscal Multipliers in the COVID19 Recession”, CEPR Discussion Paper 16754.

Box 2.1 continued

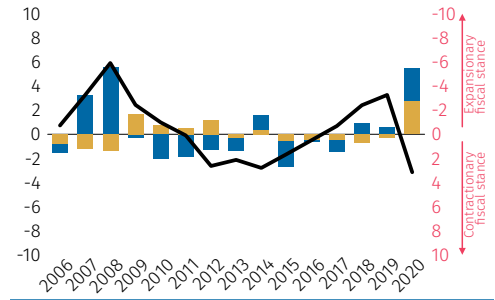
Figure 2.7. Fiscal impulse, automatic stabilization, and output gap

In percent of GDP, unless otherwise stated (rhs = inverted scale)

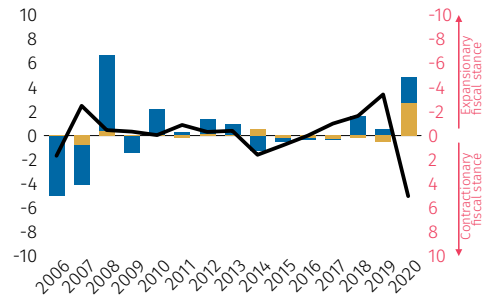
Albania



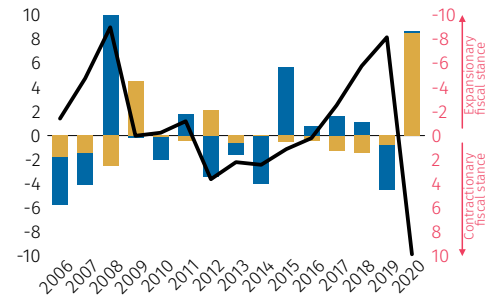
Bosnia and Herzegovina



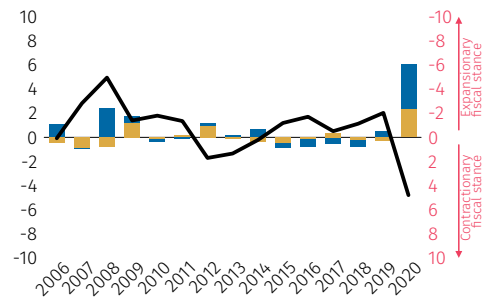
Kosovo



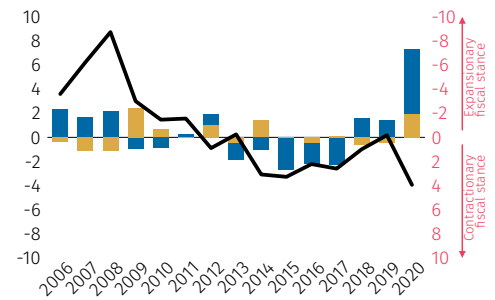
Montenegro



North Macedonia



Serbia



■ Fiscal impulse (Δ cyclically adjusted primary balance), rhs /1

■ Automatic stabilizers (residual: Δ primary balance - Δ cyclically adjusted primary balance), rhs /2

— Output gap (real output gap in percent of potential real GDP), lhs

Notes: Methodology based on Abdih, Y., Lopez-Murphey, P., Roitman, A., and R. Sahay (2010), "The Cyclicity of Fiscal Policy in the Middle East and Central Asia: Is the Current Crisis Different", IMF Working Paper.

Sources: IMF World Economic Outlook, October 2021, and World Bank staff calculations.

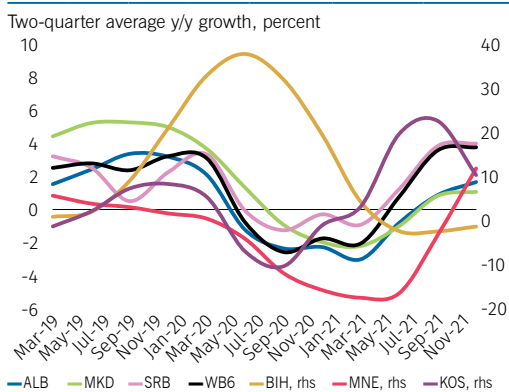
3. Labor market recovery faces headwinds

The growth recovery and mostly services sectors helped create 245,000 new jobs in the Western Balkans in 2021 compared to pre-crisis 2019.⁶ While countercyclical and discretionary measures undertaken in 2020 in response to the crisis helped mitigate major job losses, the growth recovery in 2021 has had a much stronger job creation impact (Figure 3.1). In Bosnia and Herzegovina, Serbia, and Kosovo, the number of employed in 2021 well surpassed the 2019 level. Employment in Albania, North Macedonia, and Montenegro, despite wage subsidies kept in place until early 2021 for harder-hit sectors, remained below the pre-crisis level. From mid-2021, public sector employment, industry, and services led the job market recovery (Figure 3.2). During the summer, the tourism sector boosted employment, followed by a rise in

trade, ICT, and transport. The construction sector also observed an increase in employment across countries, except in North Macedonia. Employment in agriculture continued to shrink, except in Bosnia and Herzegovina and Kosovo. Yet, from the last quarter of 2021, North Macedonia and Serbia observed a slowdown in employment growth, an early sign of the global energy crisis impact on their export industries. Services that are an engine of growth in many middle-income countries (Box 3.1) struggled throughout 2021 in North Macedonia.

In 2021, the Western Balkan employment rate increased to a historical high of 45.8 percent, an expansion of 0.9 percentage points from 2020. The largest increase in the employment rate was observed in Kosovo (4.2 percentage points), due to gains in formal

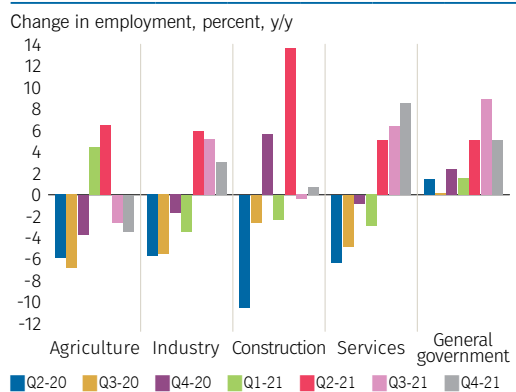
Figure 3.1. Employment recovered from mid-2021...



Sources: National statistical offices; World Bank staff estimates.

Note: 2019–20 data for Bosnia and Herzegovina lack comparability due to methodological changes.

Figure 3.2. ...led by public sector, industry, and services.



Sources: National statistical offices; World Bank staff estimates.

6 This analysis was affected by (1) now discontinued publishing of Labor Force Survey (LFS) data in Kosovo since Q 2021; (2) discontinued publishing of sectoral employment data in Albania; and (3) a sampling revision in Bosnia and Herzegovina and Montenegro that reduced comparability with previous LFS data. Using administrative register, employment, and unemployment data helped approximate what happened with labor market in 2021 in Kosovo, as well as in Albania.

Box 3.1. Services to the rescue: A labor market perspective

Owing to the manufacturing-led economic miracle of East Asia, the potential of the service sector to revamp labor markets and stimulate income convergence of low- and middle-income countries (LMICs) has been questioned by many and, as a result, has been left largely untapped.

The nature of services is also changing with the advent of technology and is heterogenous, using labor from the entire skills spectrum. In fact, services have taken center stage on the development path, and this trend also holds for the Western Balkans, mirroring that observed in most LMICs.

Services employment is around 60 percent of total employment across the Western Balkans, and the share is consistently increasing over time. On average, the share of the service sector in total employment for the region is more than twice the share of industry and more than four times the share of agricultural employment. However, the regional average masks large within-region differences, with the average share of services employment being at 42.5 percent in Albania and as high as 81.4 percent in Montenegro (Figure 3.3). Over time, the share of services employment increased steadily across all six Western Balkans countries, most notably in North Macedonia, by 4 percentage points since 2016.

Figure 3.3. The service sector is an important employer...

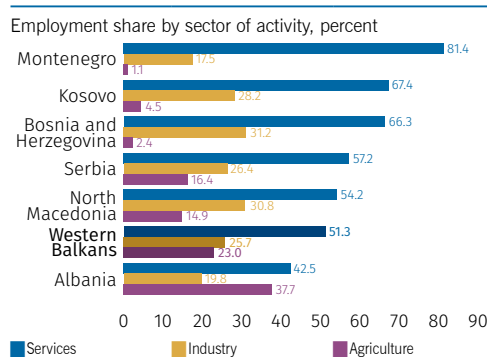
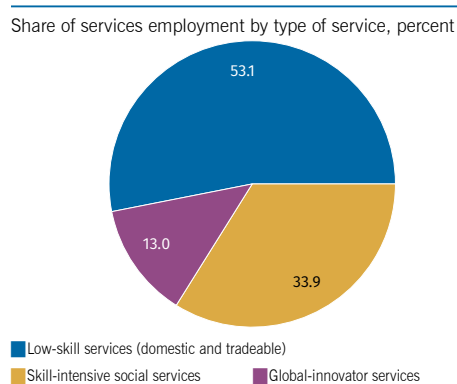


Figure 3.4. ...in the Western Balkans focused on low-skill sectors.



Sources: National statistical offices. Employment data by sector of activity/type of service is obtained from either labor force surveys or administrative sources (average for the period 2016–2020). Classification of services by type follows Nayyar, Hallward-Driemeier and Davies (2021).

In the Western Balkans, more than half of service sector employment is in low-skill services (Figure 3.4). Services differ in terms of labor skills required, accessibility to foreign markets, offshorability, innovation capacity, capital intensity, and intersectoral linkages. Low-skill services include a range of services⁷ and vary greatly in terms of employment share. An outlier in the share of low-skill services in total services employment is wholesale and retail trade, where more than 25 percent of low-skilled employment is concentrated in the Western Balkans. This pattern is consistent with the identified “first wave” of services sector growth across LMICs, consisting primarily of traditional services, like trade and transport, as countries move from low to middle-income status.⁸

7 Transportation and storage, wholesale and retail trade, accommodation and food, administrative and support services, real estate activities, arts, entertainment and recreation and other service activities.

8 Eichengreen and Gupta, 2011.

Box 3.1 continued

However, over 30 percent of total services employment in the Western Balkans is in skill-intensive social services⁹ which include jobs which are predominantly in the public sector. Only 13 percent of total services employment is in global innovator services,¹⁰ producing more than 20 percent of the real value added in the economies of the Western Balkans.

Global innovator services receive the highest gross wages, with skill-intensive social services being in the middle of the distribution. Although employees in ICT and finance and insurance activities constitute only 7.5 percent of total services employment, they are paid more than twice the wages of employees in wholesale and retail trade (Figure 3.5). However, finance and insurance activities also embody the greatest variation across services wages in the region, with the highest wages for these services being paid in Montenegro, and the lowest wages being paid in Kosovo, where this sector is yet to be developed. On the other end, the lowest gross wage in the Western Balkan economies is paid for transportation and storage services, with Montenegro being an exception.

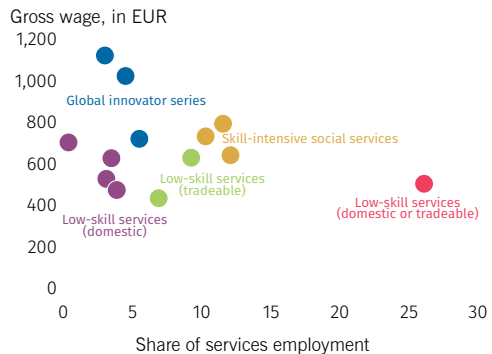
The services sector has become an important growth contributor in the Western Balkans, expanding job opportunities and improving living standards for workers in this region. While increased employment concentration in low-skill services was linked to minimum barriers to entry for workers, and to more opportunities for women, informal, and agricultural workers, these services have a limited potential to reduce productivity gaps with higher-income economies in the long run. As Western Balkan countries move up on the income distribution ladder, the share of global innovator services in total employment should rise, generating more value-added and better employee compensation for people in the region.

⁹ Public administration, defense, education, human health, and social work activities.

¹⁰ Information and communication, financial and insurance activities, professional, scientific and technical activities.

Figure 3.5. The largest number of employees is in low-skill services

Wages and employment by type of service



Sources: National statistical offices. Classification of services by types follows Nayyar, Hallward-Driemeier, and Davies (2021). Albania is excluded because of lack of detailed services data.

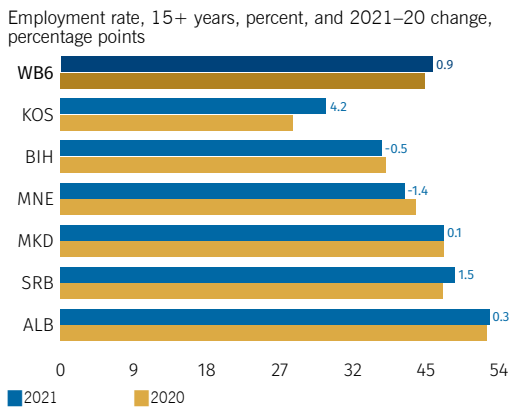
employment. According to the Kosovo Pensions Savings Trust, the number of active pension contributors increased by 10.7 percent year-on-year during the last quarter of 2021, which is about 40,000 formal jobs added compared to the same period of 2020. Still, while Albania tops the region with the highest employment rate of 52.9 percent, in Kosovo, despite recent gains, only 32.7 percent of the working-age population is employed (Figure 3.6). Bosnia

and Herzegovina and Montenegro are outliers, as the annual employment rate dropped in both countries in 2021.

In parallel with employment, the activity rate also rose due to women returning to the labor market. The inactivity rate dropped to 46.9 percent for the region (Figure 3.7), meaning that the region's labor force participation rate increased to 53.1 percent, up

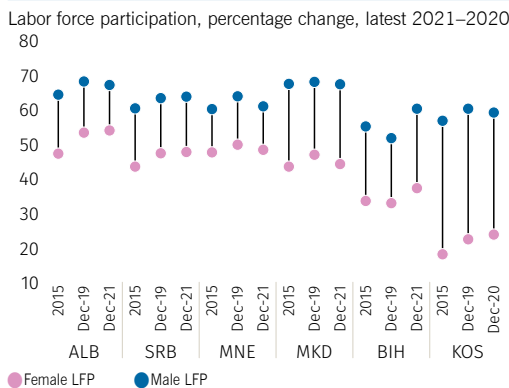
1.3 percentage points compared to 2020. While the participation rate of women is still lagging that of men, at the end of 2021, the female participation rate increased to 42.5 percent (compared to men of 63.1 percent), an increase of 1.3 percentage points from end-2020 (Figure 3.8). The largest improvement was in Montenegro (5.3 percentage points) as the tourism sector recovered. The female labor force participation rate is still the highest in Albania at 53.9 percent (a new record), while it is below 24 percent in Kosovo.

Figure 3.6. The employment rate reached a historical high in the Western Balkans...



Sources: National statistical offices; World Bank staff estimates.

Figure 3.8. More women returned to labor market than men

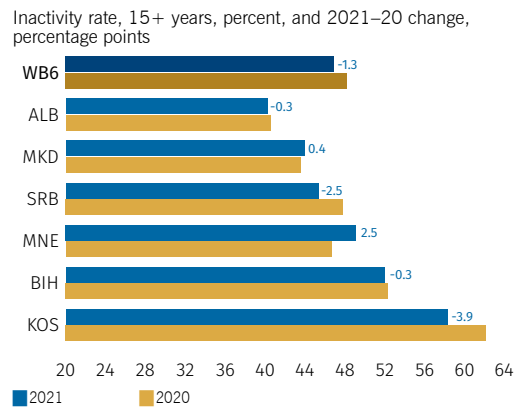


Sources: National statistical offices data; World Bank staff calculations.

The unemployment rate in the Western Balkans increased to 13.7 percent as more people started looking for jobs (Figure 3.9).

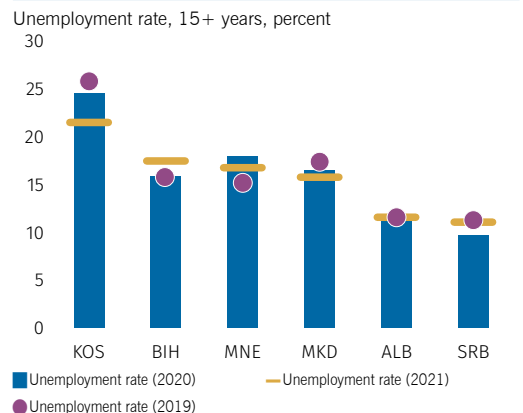
As government support programs gradually declined, some of the foreign-owned large manufacturers closed their operations in Serbia, resulting in significant layoffs. The unemployment rate in Serbia in 2021 H1 increased to 11.9 percent (compared to an average of 9.2 percent in the same period of 2020) and declined only marginally during the rest of the year. The unemployment rate in Bosnia and Herzegovina also increased in

Figure 3.7. ...while inactivity dropped in four countries.



Sources: National statistical offices; World Bank staff estimates.

Figure 3.9. The unemployment rate declined except in Bosnia and Herzegovina and Serbia



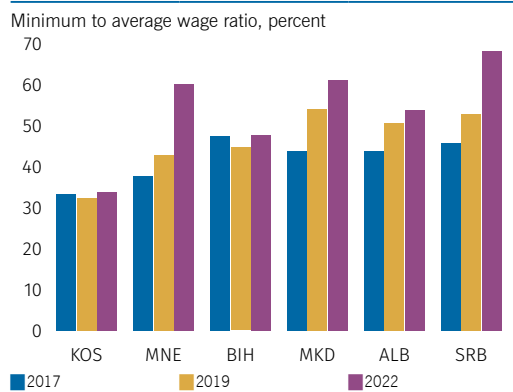
Sources: National statistical offices data; World Bank staff calculations.

2021, by 1.5 percentage points to 17.4 percent, compared to a year ago. In Montenegro, the late start of the tourism recovery reduced unemployment in the second half of the year. North Macedonia observed a continued decline in the unemployment rate but largely on account of a decline in the activity rate—its unemployment rate declined to 15.7 percent in 2021, the lowest since the measurement was introduced in 2007. Youth unemployment declined as well, to 34.9 percent in Q4 2021, down by almost 5 percentage points year on year, but has not reached the pre-crisis level yet. Albania continues to have the lowest youth unemployment rate—at 20.6 percent—while, despite improvements, the youth unemployment rate in Kosovo remains above 42 percent.

Higher minimum wages created wage pressures, which may postpone a decline in unemployment. In Montenegro, the gross minimum wage rose by 43 percent (a net increase of 80 percent) as the government reformed payroll taxation, abolishing the health insurance contributions. In North Macedonia, Serbia, and Albania, the government approved minimum wage increases by 18.5 percent, 9.4 percent, and 6.7 percent, respectively. This sharp rise in wages likely skewed wages toward lower incomes, as firms try to mitigate labor costs. In North Macedonia, the government decided to compensate firms for higher labor costs due to the minimum wage rise. The ratio of minimum to average wage in the three countries is already above 60 percent of the average wage, which compares to the EU range of 35 to 50 percent (Figure 3.10).

The increase in minimum wages comes at a time when firms are struggling with rising commodity and energy costs at unprecedented rates. The corporate sector still has not recovered from the impact of the pandemic and supply chain disruptions and is already hit with a surge in input prices, ranging from raw materials to transport fuel. Defensive restructuring is already happening in the car supply industry through furloughs, but the war in Ukraine, and the related sanctions on Russia, will likely hurt the industry even more. The car supply industry is a large employer in Serbia and North Macedonia, in particular. The pandemic and energy crises weakened corporate balance sheets and could lead to a deterioration of the hard-won gains in the labor market if such wage pressures persist.

Figure 3.10. Minimum wages increased in four countries



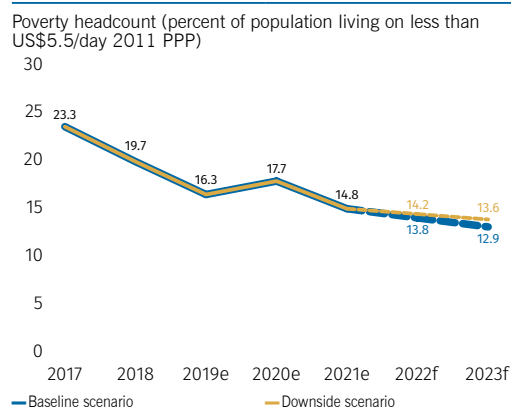
Source: National statistical offices data; World Bank staff calculations.

4. Poverty reduction has resumed, but further progress is uncertain

Poverty fell in 2021 as the Western Balkan economies experienced a robust recovery, lifting an estimated 408,000 people out of poverty. The crisis caused by the COVID-19 pandemic in 2020 gave way to a strong economic recovery in 2021 as travel and trade resumed and the population started gaining access to the vaccine. Revived employment and earnings contributed to reducing poverty. After an estimated 1.4 percentage-point increase in regional poverty in 2020 (Figure 4.1), equivalent to about 200,000 new poor, in 2021 poverty is estimated to have fallen by 2.9 percentage points, equivalent to about 408,000 fewer poor.¹¹ Albania and Kosovo account for 82 percent of the regional poverty decline, and their poverty rates are estimated to now be below their 2019 levels. North Macedonia and Serbia experienced more modest declines, and Montenegro and North Macedonia still have estimated poverty rates above their 2019 levels (Table 4.1).

The economic rebound across countries had heterogeneous impacts on poverty in 2021, reflecting variations in sectoral growth, wages, and employment. The 2020 crisis translated into job losses and possibly earnings reductions, especially in some sectors with high shares of self-employed workers.¹² In 2021, the strong growth rebound (from 4 percent in North Macedonia to 12.4 percent in Montenegro) was driven in large part by the services sector,

Figure 4.1. The region's poverty rate declined in 2021, but there are significant risks for further reduction



Source: World Bank estimates and projections based on 2018 income data from the Survey of Income and Living Conditions (SILC) for North Macedonia, Albania, Montenegro, 2019 for Serbia; and 2017 Household Budget Survey (HBS) data for Kosovo.

Note: Income measures in the SILC and consumption measures in the HBS are not strictly comparable. Welfare is estimated in U.S. dollars using revised 2011 PPPs. The regional estimate excludes Bosnia and Herzegovina due to lack of comparable data. e = estimate; f = forecast.

particularly hospitality and trade. In Serbia, a notable agricultural output decline likely dampened the poverty reduction impact of an otherwise broad-based economic recovery. Job creation gained momentum at varying speed in 2021. It started picking up in the second quarter and accelerated in the third quarter in Albania, Montenegro, and Serbia.¹³ In Kosovo, although no nationally representative data are available after the first quarter, tax registered employment shows a significant increase. In North Macedonia, employment growth was modest, however. In some countries, a fiscal stimulus extended into 2021 continued to lift household income.

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

12 As of March 2022, there were no nationally representative data on earnings for 2020 in any of the Western Balkan countries; however, employment reductions were more pronounced in sectors with a higher share of self-employment, especially during 2020 Q2 and Q3.

13 Labor Force Survey data in Kosovo are only available up to 2021 Q1.

Table 4.1. Poverty reduction at the country level is projected to slow in 2022, reflecting rising food and energy prices and impacts of the war in Ukraine

Year	Poverty estimates and projections (percent)				
	ALB	KOS	MKD	MNE	SRB
2017	35.8	24.4	19.5	16.0	19.8
2018	32.4	23.3	17.9	16.9	14.3
2019	28.1	21.1	16.5	15.6	10.1
2020	31.3	23.2	18.3	19.9	10.2
2021	22.0	19.4	17.2	16.2	9.8
2022	19.4	17.6	16.4	15.6	9.6
2023	16.9	15.8	15.9	14.8	9.3

Source: Calculations based on ECAPOV (ECA Poverty database) harmonization using SILC-C data for Albania (ALB), North Macedonia (MKD), Montenegro (MNE), and Serbia (SRB), and HBS data for Kosovo (KOS).

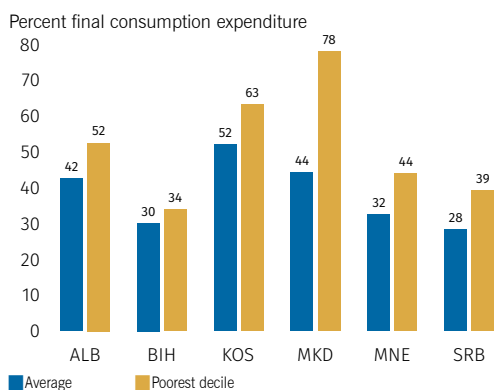
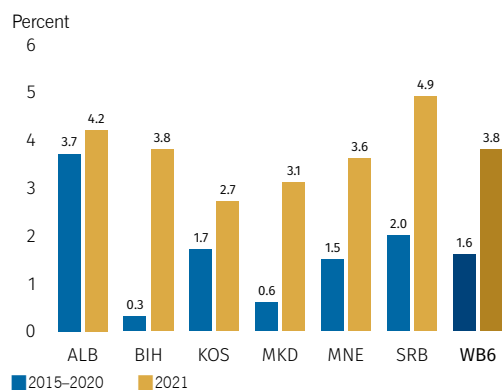
Note: Black = Actual. Orange=Nowcasted/projected. Income measures in the SILC and consumption measures in the HBS are not comparable. Poverty is defined as living on less than US\$5.5 per day per person in revised 2011 PPPs. Bosnia and Herzegovina is excluded due to lack of comparable data.

Rising global energy and food prices combined with the impacts of the unfolding war in Ukraine generate risks for poverty reduction in 2022. Under the baseline scenario of positive growth across the region, the poverty rate for the Western Balkans is projected to fall by about 1 percentage point to 13.8 percent in 2022. However, there are downside risks. First, food and energy prices increased faster than the Consumer Price Index throughout the region in the latter half of 2021 and are expected to rise even further in 2022, which reduces the purchasing power of households, especially the poor and vulnerable. Moreover, aside from higher energy, food, and input prices, sanctions on Russia could affect economic activity in countries and sectors with strong ties to Russia (such as tourism and hospitality, or real estate and construction), in turn lowering household income growth in these sectors. Countries with migrants in Russia will experience declines in remittance income. Finally, potential knock-on effects on cost of living and economic activity in the European Union (EU) may also lower

the EU demand for Western Balkan exports. This possibility of slower growth in the EU and rising transport costs may affect the ability of the diaspora to maintain remittance flows and travel to the Western Balkans. A downside scenario assumes that income growth will trail inflation even more than in the baseline scenario, especially for lower segments of the population. It projects a smaller fall in poverty of 0.6 percentage points.¹⁴

Persistent inflation is of significant concern for the welfare of households in the region (Box 4.1). Rising energy and food prices disproportionately hurt the poor, as they often spend a larger share of their budget on food (Figure 4.2, Panel A) and have fewer ways to cope with rising food and energy prices. In 2021, average food inflation already showed a marked increase relative to 2015–20 (Figure 4.2, Panel B). By December 2021, food prices in the Western Balkan countries had increased 6.8 to 12.7 percent year on year. While the overall inflation rate for 2022 is still

¹⁴ The downward scenario is projected for Albania and Kosovo, which account for over 80 percent of the poverty reduction in 2021. For Albania, it assumes a pass-through rate of 0.5 for GDP per capita growth to poverty reduction in 2022 (as household inflation outpaced official inflation). For Kosovo, a pass-through of 0.87 is assumed for 2022.

Figure 4.2. Food price inflation could significantly affect the purchasing power of poor households**Panel A.** Household consumption of food and non-alcoholic beverages**Panel B.** Average food inflation

Sources: World Bank staff calculations using HBS data (Panel A) and official CPI statistics from national statistical offices (Panel B).

Note: Years in Panel A: Albania and Serbia, 2019; Kosovo and North Macedonia, 2017; Bosnia and Herzegovina and Montenegro, 2015.

unknown, governments across the region have substantially adjusted minimum wages, which could partially cushion the shock, although this might also stifle formal job growth in the short term, at least, while possibly creating further price pressures over the medium term. However, inflation will bite into the incomes of workers in the informal sector and those depending on non-labor income (pensions, transfers if they are not inflation-indexed, or remittances), which could slow poverty reduction. The implications of energy price increases and government response measures are further discussed in the Spotlight section.

Poverty in Albania is estimated to have fallen significantly to 22 percent of the population in 2021, but inflation could disrupt this trend. Between 2016 and 2019, income-based poverty declined by 11.8 percentage points, from 40 percent of the population to 28 percent, as GDP per capita grew at 3.6 percent per year on average. In 2020, poverty is estimated to have increased by 3.2 percentage points due to the November 2019 earthquake and the COVID-19 pandemic. In 2021, the economy

bounced back strongly, and per capita GDP grew by 9 percent. Though employment has not fully recovered, there is evidence of significant income growth: 3.7 percent real growth for formal sector wages, 13 percent real minimum wage growth, and 14.7 percent growth in remittances, for example. Poverty is estimated to have fallen dramatically to 22 percent. Under a baseline scenario of historical inflation patterns, it is projected to fall again in 2022 by 2.6 percentage points, going below 20 percent of the population. However, rising inflation could severely reduce real income growth among poor and vulnerable households and dampen poverty reduction.

After the rebound in economic growth in 2021, household welfare could be affected in Bosnia and Herzegovina due to slower economic growth and higher inflation. Economic growth has not translated into more and better jobs in the past. As such, the poverty rate does not seem to have improved. The latest available data using the national poverty line of KM 205 per capita per month are for 2015, when the poverty rate was estimated

at 16 percent, very close to the 15 percent estimated for 2011. In 2020, the pandemic caused substantial damage to the labor market. The slowdown in the economy and the consequent loss of jobs and earnings have likely eroded household welfare. The policy measures the government introduced to protect firms and households prevented a worse impact on the labor market. Despite a renewed acceleration in COVID-19 cases toward the end of 2021 and beginning of 2022, improvements in the activity and employment rate continued until the end of 2021. Lower growth in the

EU could affect the non-labor income of households in Bosnia and Herzegovina by limiting remittances from those who have emigrated, on which the country is particularly dependent (about 8 percent of GDP in 2020). Higher prices, particularly for fuel and food, are likely to have a disproportionately negative effect on the less well-off, since the poor tend to spend a greater proportion of their expenditure on these items and have limited mechanisms to cope with higher inflation and preserve their purchasing power.

Box 4.1. The poor disproportionately feel the effects of inflation

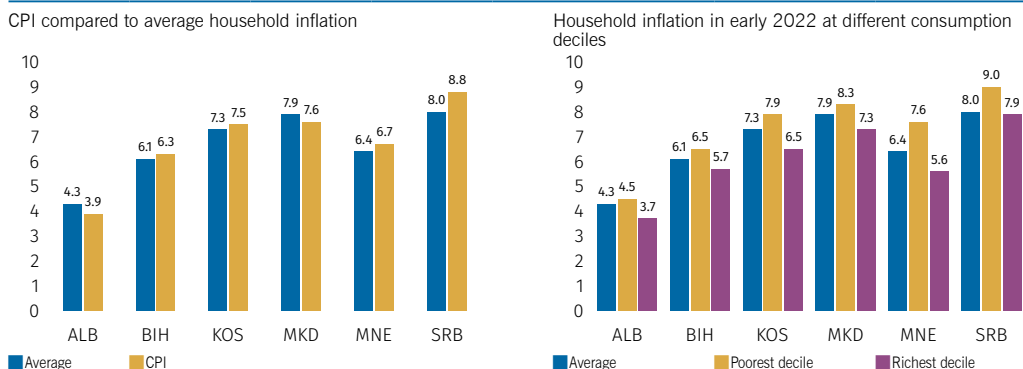
The Consumer Price Index (CPI) does not necessarily reflect the inflation felt by poorer households since their expenditure composition differs from that of the average household.

Since the CPI tracks the cost of a representative basket of goods, the index should approximate the inflation felt by an average household, provided that the weights used in the CPI basket closely reflect the composition of the average household's expenditure in the year. To examine how closely the CPI reflects inflation for the average household, we multiply the expenditure share of each category for the average household with the inflation reported for the respective category and add all weighted categories. As Figure 4.3 (left) shows, average household inflation is below but near the CPI in Bosnia and Herzegovina, Kosovo, Montenegro, and Serbia, but above the CPI in Albania and North Macedonia. Repeating this exercise for households in the poorest and richest deciles provides the inflation faced by these specific subgroups.

The poorest decile households systematically experience higher inflation than the average and richest decile households (Figure 4.3, right). Moreover, in the case of Albania and North Macedonia, the CPI more closely reflects the consumption composition of the richest households than the average household. The higher inflation faced by the poor partly reflects their higher food share and food price inflation. For the average household in the Western Balkans, food is the largest expenditure category, varying between 28 percent of total expenditure in Serbia to 52 percent in Kosovo. This share is even higher among poorer households, which devote between 34 percent (Bosnia and Herzegovina) and 78 percent (North Macedonia) of their total consumption expenditures to food. According to the official CPI, across the region, in 2021 food prices increased faster than the total basket of goods tracked by the CPI in all countries except North Macedonia.

Those on a lower income may perceive more pronounced increases in prices and the cost of living than what is captured by actual inflation. Consumers' views tend to be more heavily shaped by the price changes of the items they see and purchase more frequently. Rising prices of everyday purchase items like food and fuel, which are significant expenses for the poor, are likely to have a strong influence on the perception of inflation. Low-income individuals, who are more often in informal work, also tend to feel a stronger pressure of the rising cost of living because their income growth is less likely to keep pace with rising prices.

Box 4.1 continued

Figure 4.3. Poor households experienced higher inflation than average households in recent months

Sources: World Bank staff calculations using HBS data and official CPI statistics from each country's national statistical office.

Note: Years for data on expenditure composition: Albania and Serbia, 2019; Kosovo and North Macedonia, 2017; Bosnia and Herzegovina and Montenegro, 2015. Inflation is year on year for the latest month with available CPI: February 2022 for all countries except for BIH, for which data are from January 2022.

Poverty in Kosovo is estimated to have dropped to below its 2019 level in 2021, but for 2022 the downward trend is at risk.

During 2017–19, per capita growth averaged 4.1 percent annually and the (consumption-based) poverty rate fell from 24.4 percent in 2017 to an estimated 21 percent in 2019. In 2020, the crisis reversed this positive trend and GDP per capita dropped by 4.6 percent, while poverty is estimated to have increased by 2 percentage points. In 2021, the economy bounced back strongly and GDP per capita is estimated to have increased by close to 9 percent, as diaspora travel resumed, construction boomed, and manufacturing exports increased, while the impacts of early pension withdrawals and other fiscal stimulus measures fueled consumption. The strong recovery is estimated to have reduced poverty by 3.8 percentage points to under 20 percent of the population. In 2022, projected growth of GDP per capita is 3.7 percent, and poverty is expected to decline further to 17.6 percent. However, growing inflation of food and energy prices can hit Kosovo especially hard as the country is a net

importer of both, and if diaspora travel and remittances fall and wages fall behind inflation, real incomes could be significantly reduced, and poverty might not fall as projected.

Following the robust recovery of 2021, poverty reduction in Montenegro is projected to slow significantly in 2022 due to rising prices and risks of spillover impacts from the war in Ukraine. The COVID-19 pandemic and the collapse of tourism and related services caused a severe contraction of economic activity, estimated at 15.3 percent in 2020, and reversed six years of poverty reduction. Targeted wage subsidies and one-off cash assistance for vulnerable citizens helped the country avoid even larger layoffs and increases in poverty, but vulnerable workers in the informal sector might not have received much support. The strong recovery of Montenegro's economy in 2021, estimated at 12.4 percent and driven primarily by a rebound in tourism, led to an increase in employment and a decline in unemployment. Poverty is estimated to have increased by more than 4 percentage points to

about 19.9 percent in 2020 and then fallen to 16.2 percent in 2021. However, the outbreak of war in Ukraine and sanctions on Russia that followed have worsened the growth outlook for Montenegro in 2022, mainly due to an adverse impact on tourism, and is therefore expected to slow household income growth, particularly for those working in the tourism and hospitality sector. This, coupled with rising energy and food prices, limit the pace of poverty reduction in 2022.

As economic growth rebounded and poverty resumed its decline, the energy crisis and the war in Ukraine brought new challenges in North Macedonia. The country has made considerable progress in reducing poverty since the 2008 global financial crisis. The poverty rate (based on the upper middle-income poverty line of US\$5.5 per day in 2011 PPP) fell from about 36 percent in 2009 to 18 percent in 2018, mainly driven by increased employment opportunities and higher labor earnings. The adverse effects of the COVID-19 crisis have reversed earlier employment gains in the country. A simulation analysis estimated that poverty increased by more than 1.5 percentage points in 2020. The government provided support measures, including subsidies and social security contributions to private sector firms and cash benefits and vouchers for vulnerable people, which to a certain extent alleviated the negative poverty impacts of the COVID-19 crisis. Poverty is estimated to have resumed its decline in 2021. The labor market experienced a slow improvement that year. The unemployment rate decreased to 15.2 percent at the end of 2021, in part due to a small increase in the employment rate, but also due to a lower activity rate. As the recovery progressed, the

energy crisis and the war in Ukraine brought new challenges. Growth is projected to slow in 2022, affected by the conflict and the economic sanctions. Lower demand from the EU and higher prices of energy, metals, food, and agricultural inputs are expected to have an impact on the economy. Inflation would likely exceed 5 percent despite government measures. Inflationary pressures (in particular, prices of energy and food) may increase the cost of living and hurt the less well-off relatively more.

While Serbia weathered the COVID-19 pandemic without a large increase in poverty, it will be challenging to resume poverty reduction in 2022 due to new risks. The government's massive fiscal package of about 13 percent of GDP in 2020, including wage subsidies for all sectors and a universal cash transfer, helped to cushion the immediate impact of the pandemic on the population and the economy. In 2021, Serbia's economy grew by 7.4 percent, and the employment rate in the second half recovered to surpass pre-pandemic levels, contributing to poverty reduction. These positive developments were partly countered by an output decline in agriculture, rising inflation toward yearend, and the phasing out of government support programs. Poverty is estimated to have declined only slowly in 2021, and new challenges in 2022 are expected to halt progress. The unfolding Ukraine-Russia conflict will have an adverse impact on Serbia's exports, FDI, remittances, and tourism revenues, all of which will lower the prospects for household labor and non-labor income growth. The immediate impact through rising inflation will limit household purchasing power, and rising energy prices, in particular, often disproportionately hit the poor.

5. Continued need for fiscal support against limited space

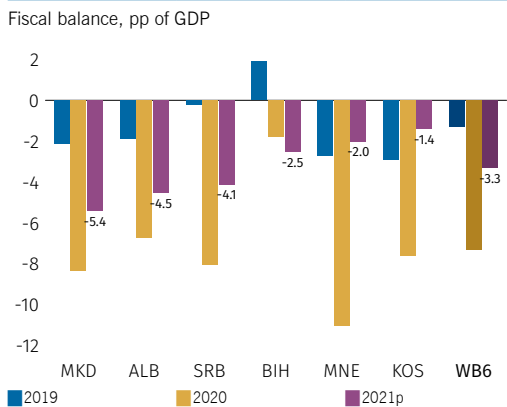
Fiscal deficits narrowed across the Western Balkans, except in Bosnia and Herzegovina, as economies rebounded in 2021. For most Western Balkan countries, a buoyant recovery in economic activity fueled nominal growth in revenues that outpaced expenditure growth in 2021. The average deficit for the region dropped by 4 percentage points (pp) of GDP compared to 2020 (Figure 5.1).¹⁵ Bosnia and Herzegovina increased the deficit to 2.5 percent of GDP, while Montenegro, followed by Kosovo and Serbia, experienced sharp declines in fiscal deficits. North Macedonia has seen a moderate reduction in its fiscal deficit as spending remained elevated and the rebound remained slower than in other Western Balkan countries. In Albania expenditures declined, while revenues rebounded, reducing the fiscal deficit by 2.2 percentage points of GDP.

In addition to the strong rebound in economic activity, inflation increased

revenue collection. Revenues increased by an average of 1.3 pp of GDP for the region, surpassing pre-pandemic levels, while statutory tax rates remained broadly constant. This is in part due to the withdrawal of tax relief measures used to counter the impact of the pandemic in 2020 and the resulting increase in effective taxation. In addition, higher revenues resulted from spillovers of fiscal measures on formalization efforts. That said, the exceptional nominal increase in revenue is also attributed to higher inflation that accompanied the rebound in economic activity, particularly for taxation of imports. In Kosovo, Serbia, and Albania nominal revenue growth surpassed 20 percent y/y, and including North Macedonia, provided the highest contribution in the reduction of fiscal deficits in 2021 (Figure 5.2).

Public expenditure contracted but remains above pre-pandemic levels. Compared to 2020, expenditures declined in GDP terms in

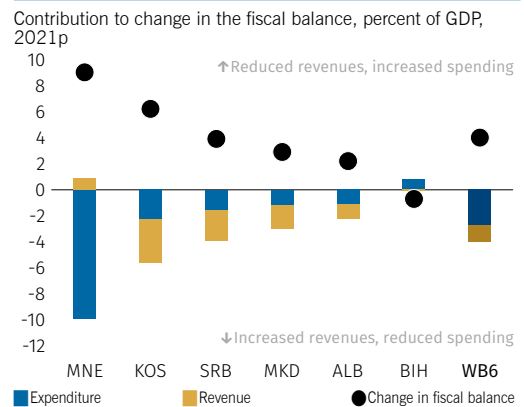
Figure 5.1. Fiscal balances improved across the Western Balkan countries...



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

15 Unweighted average of fiscal deficit levels in Western Balkan countries.

Figure 5.2. ...supported by revenue growth and lower expenditures.



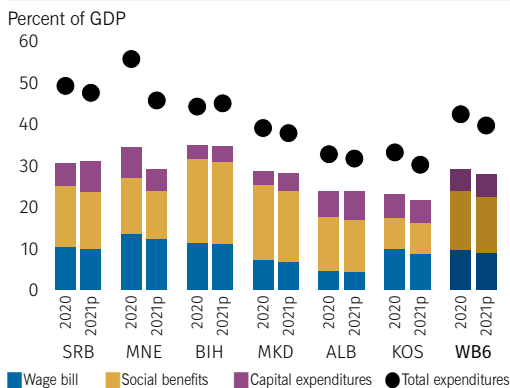
Sources: National statistical offices; Ministries of Finance; World Bank staff estimates.

all countries except Bosnia and Herzegovina (Figure 5.3). However, despite a gradual withdrawal of pandemic-related fiscal support measures, spending remains above the pre-pandemic level by an average of 2.6 percent of GDP owing to the persistence, albeit at a lower level, of counter-pandemic measures and energy subsidies. In contrast, for Montenegro, which experienced the strongest recovery, real expenditure decreased compared to pre-crisis levels on account of higher savings on goods and services and capital under-execution due to delays in implementation and budget approval. In Bosnia and Herzegovina, the paralysis in policy making contributed to a slowdown in capital expenditures, but current spending surged. Meanwhile, expenditures declined by 1.1 pp of GDP in Albania, despite higher infrastructure spending related to post-earthquake reconstruction and energy subsidies.

The wage bill and social benefits spending declined across Western Balkan countries, although pressures for higher energy subsidies intensified. While governments

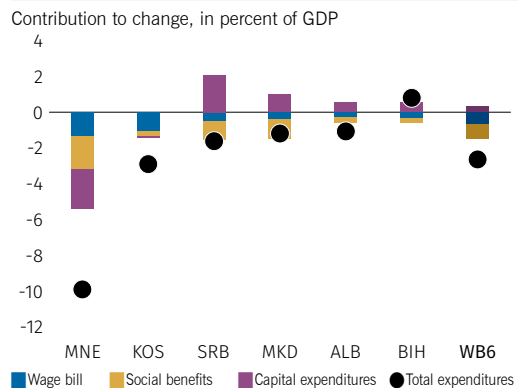
in the region continued to provide fiscal support measures to varying degrees, at the regional level, spending on social benefits fell by an average of 0.8 pp of GDP compared to 2020. The sharpest decline was recorded in Montenegro, while in Bosnia and Herzegovina, Kosovo and Albania social spending dropped by only 0.2-0.3 pp of GDP. The surge in energy prices intensified pressures for higher electricity subsidies in many Western Balkan countries, particularly in Albania, North Macedonia, and Kosovo, slowing the consolidation in current spending (please see the spotlight section for a further discussion of government measures in response to the energy crisis). The wage bill declined by 0.7 pp of GDP on average but remains higher than its pre-pandemic level. In Albania and Bosnia and Herzegovina spending on wages decreased by 0.3 pp of GDP. In North Macedonia and Serbia, a decline was 0.4 to 0.5 pp of GDP, respectively. In Albania, capital expenditures increased by 0.6 pp of GDP, driven by higher infrastructure and reconstruction spending, while Montenegro saw a significant decline due to the delays in highway construction (Figure 5.4).

Figure 5.3. Spending on social benefits and wages declined



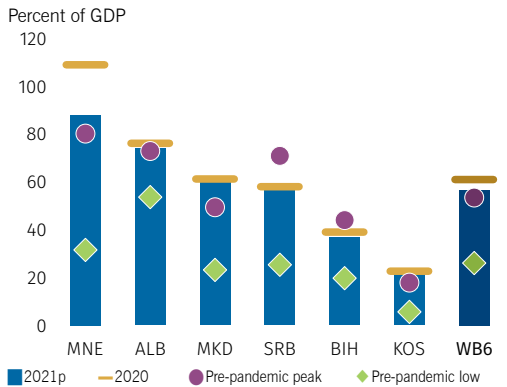
Sources: National statistical offices; Ministries of Finance; World Bank estimates.

Figure 5.4. Capital expenditures increased significantly in Serbia and Albania



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

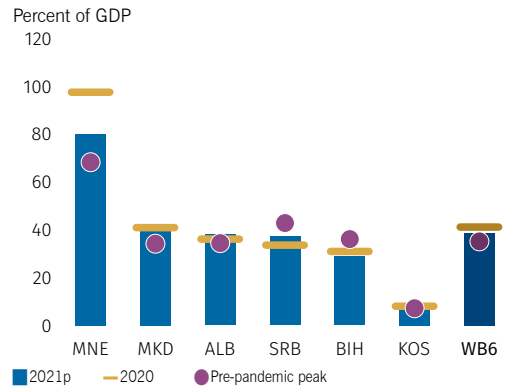
Figure 5.5. Public and publicly guaranteed debt declined in most countries, although it remains elevated...



Sources: National statistics offices; World Bank staff estimates.

Public and publicly guaranteed (PPG) debt declined in terms of GDP but remains high. As nominal GDP rebounded faster than expected in almost all economies in the region, the average PPG debt to GDP declined from 60.8 percent of GDP in 2020 to 56.5 percent in 2021 (Figure 5.5). The decline was most prominent in Montenegro, where it amounted to 21 pp, as most of the 2021 financing needs were covered from the deposits accumulated through the Eurobond issuance in December 2020, with no need for new borrowing. PPG debt as a percent of GDP also declined in Bosnia and Herzegovina, North Macedonia, and Serbia, although marginally. Also, Albania's PPG debt decreased by 1.9 pp despite raising €650 million Eurobond issued in November 2021, for addressing the 2022 financing needs. Kosovo's PPG debt has remained constant as a result of the decline in the fiscal deficit. However, PPG debt in terms of GDP in all countries remains above the 2019 levels, particularly in North Macedonia, with PPG debt as a percent of GDP more than 10 pp higher in 2021 than in 2019.

Figure 5.6. ...and so did external debt.



Sources: National statistics offices; World Bank staff estimates.

External PPG debt declined from its historical high of 41 percent of GDP in 2020 to 38.5 percent of GDP in 2021 (Figure 5.6). Montenegro has driven this decline as it repaid external debt (including the 2016 Eurobond of €227 million) in the total amount of 7.3 percent of GDP in 2021, bringing down its external PPG to a still elevated 80 percent of GDP. A decline in North Macedonia's and Bosnia and Herzegovina's external PPG debt as a percent of GDP was mainly driven by an increase in the nominal GDP. Albania's and Serbia's external PPG, however, increased as both countries issued Eurobonds in 2021, and in the case of Serbia, green bonds. In November 2021, Albania placed a €650 million Eurobond with a maturity of 10 years and a record-low interest rate of 3.625 percent. The issuance proceeds will be largely used to finance deficit and debt repayments in 2022. Serbia's external PPG debt increased due to two Eurobond issuances—first a 10-year Eurobond worth €1 billion in February 2021, and then a 15-year and seven-year Eurobond worth €750 million and €1 billion, respectively, in September 2021. The latter two also mark significant achievements—the €750 million Eurobond

comes with the longest maturity for Serbia so far, while the €1 billion Eurobond is the first European green Eurobond issued outside the EU, with a record-low interest rate of 1 percent and a seven-year maturity.

Favorable financing conditions are likely to revert due to geopolitical tensions in Europe and the announced monetary tightening.

Most Western Balkan countries have become increasingly reliant on external financing, and the monetary tightening in the United States and global geopolitical tensions are weighing on investors and have already resulted in significant outflows from emerging markets. The Western Balkan countries are vulnerable to these developments, particularly those countries with high debt burdens and limited fiscal space. The S&P credit rating agency has affirmed countries' credit ratings and stable outlooks, except for Serbia, where S&P

improved the outlook from stable to positive in December 2021; Fitch left North Macedonia with a negative outlook (Table 5.1). Yet, all countries have a non-investment speculative grade, with North Macedonia's and Serbia's rated as speculative and other countries in the region rated as highly speculative grades.

Rebuilding fiscal space and maintaining fiscal prudence can help mitigate the emerging risks. The surging energy and food prices, further exacerbated by the war in Ukraine, have forced governments to provide support to households and businesses and to distressed state-owned companies in the energy sector (Table 5.2). Yet, the space has been greatly exhausted by the COVID-19 support that is being phased out. Some of the countries already adopted support packages in excess of 4 percent of GDP, which would require budget rebalancing three months into the fiscal year.

Table 5.1. Country credit ratings stayed mostly stable

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

Note: — = not available.

Table 5.2. Estimated government support for the energy and food crisis, percent of GDP

	ALB	BIH	KOS	MKD	MNE	SRB
State aid to energy company	1.1	0.0	1.3	1.4	0.0	0.8
Tax exemptions	0.0	0.0	0.0	1.5	0.0	0.9
Social benefits	0.3	0.1	0.4	0.2	0.1	0.8
Subsidies	0.0	0.5	0.3	1.9	0.1	0.0
Total	1.4	0.6	2.1	4.9	0.2 ¹⁶	2.5

Sources: National authorities; World Bank staff calculations.

Note: The estimated support does not include the proposed but not yet approved measures by national parliaments. The packages of support include measures adopted by March 25, 2022.

16 Montenegro plans additional spending of 0.6 percent of GDP for emergency procurement of key commodities, as it does not have strategic commodity reserves.

The fiscal plans for 2022 initially targeted a modest increase in the fiscal deficit for the region of 0.5 pp in 2022, but the realism of such plans largely hinges on the persistence of the energy and inflationary impact from the war in Ukraine, including through pressures for higher fiscal support measures.

To ensure their fiscal space does not erode, governments of the Western Balkan countries should consider widening the tax base and improving tax compliance. Most of the countries reduced the VAT and/or excises on energy and food to reduce price pressures, given the ongoing crisis. While those will need to be reverted, targeted social assistance would be recommended, as it targets the most vulnerable. Tax exemptions given to certain sectors and foreign direct investment firms need to be reconsidered in a given context whereby firms are nearshoring to Europe. Further, the Western Balkan countries should significantly strengthen their public financial management, reduce payment arrears that increased in several countries (North Macedonia, Albania), and manage contingent liabilities coming from state-owned enterprises and public-private partnerships (Albania, North Macedonia, Serbia). Most countries plan to increase public investments, but to achieve optimal growth-enhancing effects of such spending, the public investment management systems should be strengthened. This is particularly needed in terms of greening public investments that can crowd in significant private sector investments and ensure more sustainable and inclusive growth.

6. Higher inflation presents policy challenges

The rebound in global activity since mid-2020, continuing supply disruptions, and rising food and energy prices, pushed headline inflation to decade highs across many countries even before the war in Ukraine. After decades of low price growth, inflation has returned, becoming a major challenge for central banks across the world (Figure 6.1). Global inflation, measured as the median headline consumer price inflation, rose to 4.6 percent in October 2021, from a pandemic-related trough of 1.2 percent in May 2020. Global food prices rose by 29.3 percent (year on year) during 2021,¹⁷ disproportionately affecting emerging market economies. Moreover, food prices exceeded 5 percent in 86 out of 109 (79 percent) emerging markets and developing economies (EMDEs).¹⁸ Food price inflation hits lower-income countries particularly hard, as food accounts for a much larger share of the average household consumption basket. Besides food, energy and other commodity price increases were strong during 2021. The 2021 annual average price of crude oil was 12.5 percent higher than in 2019 and—reflecting the pandemic downturn and rebound—67 percent higher than in 2020.¹⁹ The oil and energy price increase drove up production and transport costs across many industries, leading to a general increase in price levels. Core consumer price inflation—typically excluding food and energy—also increased globally.

With the start of the war in Ukraine in February 2022, inflationary pressures were amplified. With Russia and Ukraine as major wheat exporters accounting jointly for one-quarter of the global supply, another wave of food price increases has materialized. In addition, Russia is the world's largest exporter of fertilizers, while Ukraine is the largest exporter of seed oil (38 percent of the world market) and the fourth-largest exporter of corn (11 percent of the world market). In response to the crisis, several countries in the region introduced grain export bans, adding upward pressure to already high prices. Meanwhile, the EU has imposed a ban on transactions with Russian state-owned enterprises, except in the oil and gas sector, and select raw materials (such as aluminum, palladium, and copper), negatively affecting the global supply for a wide range of industries.

The war in Ukraine has especially impacted energy prices (Figure 6.2). The Brent oil index increased by 28 percent between February and March 2022. Russia is a major exporter of natural gas, and it also accounts for a large share of global exports of coal, and crude oil. Europe relies particularly heavily on Russian imports to meet energy demand—the EU imported 45 percent of natural gas and 27 percent of oil from Russia in 2021. While the oil and gas supply from Russia may continue under sanction carve-outs, there are risks that major gas transit routes through Ukraine may be disrupted, stricter financial sanctions on Russian banks may further disrupt

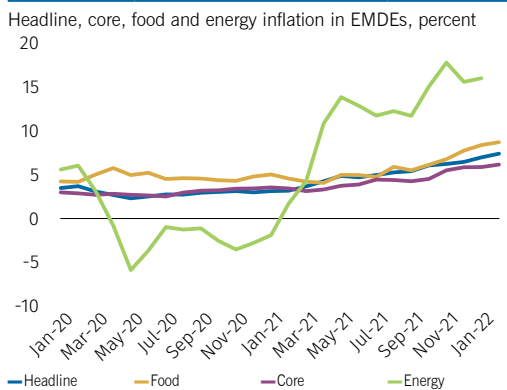
¹⁷ World Bank Global Economic Prospects, 2022.

¹⁸ Reinhart, von Luckner, 2022, <https://blogs.worldbank.org/voices/return-global-inflation>.

¹⁹ <https://thedocs.worldbank.org/en/doc/5d903e848db1d1b83e0ec8f744e55570-0350012021/related/CMO-Pink-Sheet-March-2022.pdf>

energy-related financial flows, or Russia may strategically halt the gas supply. Inventories of crude oil or natural gas to offset any disruption would provide temporary relief, but there are limited near-term prospects for additional pipeline gas imports and liquified natural gas terminal capacity. On March 8, the United States introduced import bans on Russian oil and gas, and the European Commission has proposed making Europe less dependent on Russian fossil fuels. The uncertainty in the energy market has already resulted in volatile and rising prices.

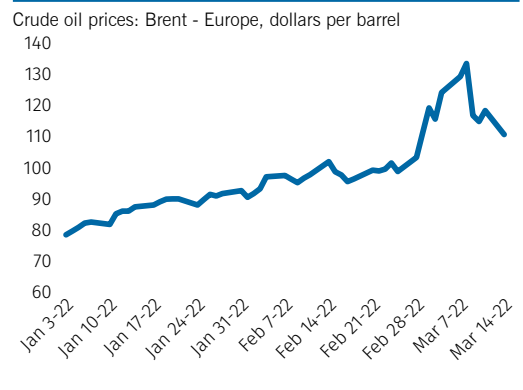
Figure 6.1. Inflation picked up in 2021 in most EMDEs



Sources: World Bank Global Economic Prospects 2022
 Note: Figure shows median year-on-year food, headline, and core consumer price index (CPI) inflation for 50 EMDEs.

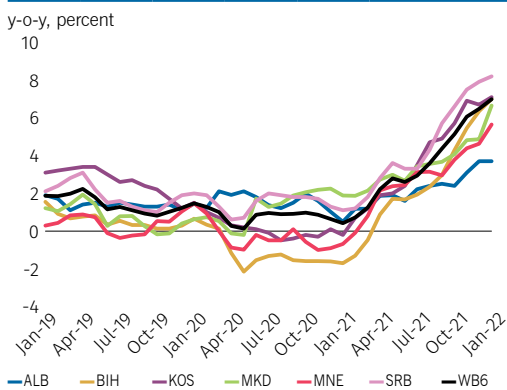
Inflation in the Western Balkan countries started picking up speed in the second half of 2021, predominantly through supply-side pressures (Figure 6.3). At the same time, strong consumer demand and higher passthrough effects also played a role. The headline consumer price index (CPI) growth in January 2022 ranged from 8.2 percent in Serbia to 3.7 percent in Albania. In all countries, food price inflation contributed the most to headline inflation: food and nonalcoholic beverages prices increased between 6.7 percent in Albania and 13.5 percent in Serbia (Figure

Figure 6.2. Energy prices soared at the start of the war in Ukraine



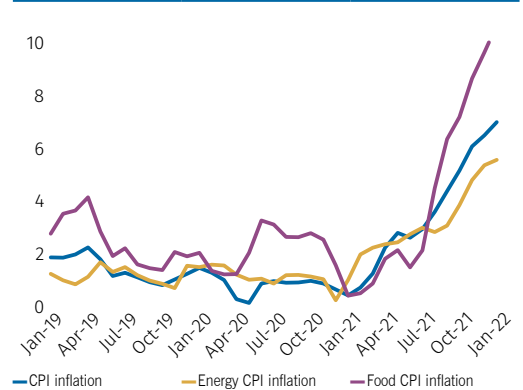
Source: Federal Reserve Economic Data.

Figure 6.3. Headline inflation in the WB6 started picking up in the second half of 2021



Source: National statistical agencies.

Figure 6.4. Energy and food inflation drove this increase



Source: National statistical agencies.

6.4). Higher energy prices also translated into higher transport prices across the region.

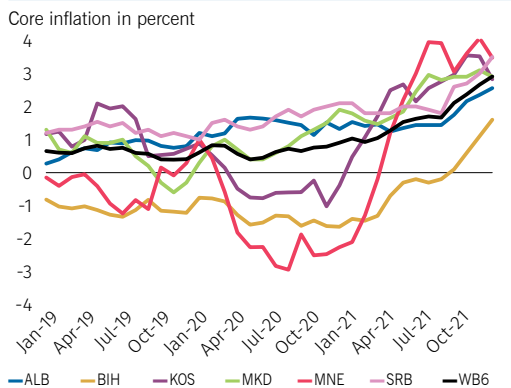
Besides food and energy prices, core inflation has increased in all countries of the region. Core inflation reached a record high of 2.9 percent in December 2021, as persistent supply shocks and wage increases are fueling inflation expectations. Since January 2022, inflationary pressures further intensified, especially after the start of the war in Ukraine. Some WB6 countries are dependent on Russia’s and Ukraine’s export of key food items including grains, vegetable oils and fertilizers, while all WB6 countries are exposed to the indirect impact of the global trade disruption in key commodities, including energy. Rising gas prices are likely to affect the prices of all other energy sources, including electricity, which has already been under price pressure due to insufficient production from renewable sources during 2021.

Avoiding further pressures on firms through rising labor and input costs will be important to tame inflationary expectations. Countries in the region increased the statutory minimum

wage, in some cases double-digit increase—partly in response to food and energy price increases. The increase in minimum wages will exert further pressure on the recent overall wage and inflation increase accompanying the recovery during 2021.

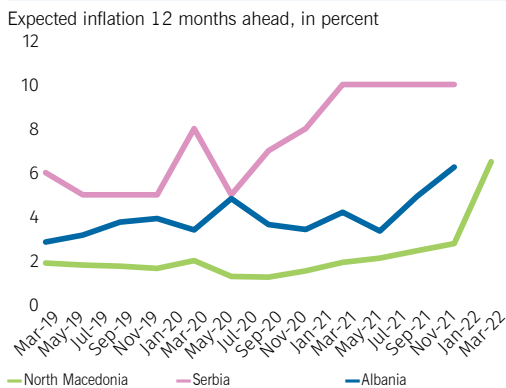
To protect households against the sharp increase in food and energy prices, governments in the WB6 countries have taken action. The increase in inflation will have an immediate impact on household welfare and poverty—particularly through rising energy prices, which disproportionately hit the poor. Short-term measures include selective price controls on some of the core food items, electricity and fuel for motor vehicles (Albania, Bosnia and Herzegovina, Kosovo, North Macedonia, Serbia), imposing export bans (North Macedonia, Serbia) and reducing the VAT (Montenegro, North Macedonia). Despite these measures, inflation is forecasted to average 6.3 percent in the region during 2022 and to remain above historical averages in 2023.

Figure 6.5. Core inflation has increased in most countries in the region



Sources: Central banks.

Figure 6.6. Inflationary expectations have started to materialize



Sources: Central banks’ surveys from December 2021.

Note: For Albania and Serbia the respondents are households; for North Macedonia, chambers and professional forecasters.

Monetary policy in the region started tightening in March 2022. In North Macedonia, the Central Bank increased the policy rate to 1.5 percent in April, while liquidity in the banking system stood high. In Serbia, the central bank sterilized excess liquidity from the banking sector through repo operations, but it increased the policy rate to 1.5 percent. In Albania, the Central Bank has started raising the policy rate earlier. The base interest rate was raised to 1 percent in March 2022. High inflation and rising inflationary expectations, normalization of monetary policy rates in advanced countries, and rising risk premia given the Ukraine crisis, have all pushed the central banks of Western Balkan countries toward future tightening of monetary policy. This will need to be weighed against the need to support the fragile recovery, given headwinds from the Ukraine crisis.

In the countries with a flexible exchange rate regime, the national currencies of the WB6 countries were stable during 2021. Increased trading volumes in energy and food caused a short-lived depreciation in late February 2022 of the Serbian dinar and the Albanian lek against the euro and the dollar. In both countries, the official reserves are significant, covering 6 and 8.2 months of imports, respectively.

7. Financial stability continued to be preserved amid looming economic risks

The financial system remained resilient during the post-COVID recovery; nevertheless, risks are tilted to the downside. Overall, in 2021, the Western Balkans' financial sector maintained adequate capital and liquidity buffers and avoided deterioration of its asset quality, while at the same time commercial banks managed to increase profitability. This was due to the COVID-19 financial support measures that included borrower relief measures (that is, loan moratoriums and loan restructuring), and the economic growth recovery in 2021 across the Western Balkans that helped minimize negative impacts on the financial sectors.

Although a major deterioration of asset quality has been avoided so far, economies remain fragile, and significant disparities persist in performance at the country, sector, and bank levels. The industries most negatively impacted by the short-term liquidity shocks of the COVID-19 pandemic—the food, accommodation, and entertainment industries—may face pressures in 2022 as the support measures begin to wind down and the economic recovery pace slows, which may increase their vulnerability to any further shocks.²⁰ According to the results of the Central, Eastern and South-Eastern Europe (CESEE) Bank Lending Survey,²¹ banks in the region do not expect the improvement in nonperforming loans (NPLs) to continue over the next six months, signaling a still elevated level of uncertainty. Going forward, financial sector regulators need to continue to closely monitor asset quality challenges and bank-

level vulnerabilities and strengthen supervision and enforcement of prudential requirements to cope with the highly uncertain economic outlook.

In addition to the post-COVID risks, which have been monitored closely by regulators and policy makers, new economic risks are building up for the region. The new risks include a protracted pandemic shock, the war in Ukraine, prolonged supply chain disruptions, inflationary pressures, tightening global liquidity, weak domestic political stability, and the energy crisis. They have the potential to impact the financial sector directly and indirectly through asset prices and macro-financial linkages, as well as potential spillovers to the financial sector from deteriorating government, private sector, and household balance sheets. Among the most recent impact is the war in Ukraine and the effect of the financial sanctions on Russia, which have had a direct impact on the Western Balkans. Specifically, Sberbank Europe AG, a fully owned subsidiary of Sberbank Russia, faced a liquidity crisis, which impacted three Sberbank subsidiaries – one in Serbia and two in Bosnia and Herzegovina. All three subsidiaries were rapidly taken over by other local banking groups, thereby containing further negative financial sector impacts.

Other risks faced by the region's financial sector are transmission mechanisms operating through the regional/European banking groups active in the Western

20 NPL monitor for the CESEE region, Vienna Initiative, 2021 H2.

21 The CESEE Bank Lending Survey - Autumn 2021.

Balkans, which are significantly exposed to Russia and Ukraine through loans and equity. Such exposure could trigger a deleveraging of these groups or at least avoid a further expansion of their current businesses in the Western Balkan region, while also slowing the region's integration into the EU financial system. The CESEE bank lending survey indicates that currently banking group strategies are tilted toward selective expansion in the region, and their medium-term assessment of market potential and positioning showed no significant deterioration in 2021. However, as of March 2022, the continuing war in Ukraine and the potential for further sanctions add to the uncertainty and may change the outlook. Mitigating factors include that most of the subsidiaries in the region are mainly funded by local deposits with less reliance on parent companies, which partly reduces an abrupt deleveraging risk. In addition, these subsidiaries are commonly the most competitive banks operating in the region without major financial stability vulnerabilities such as undercapitalization, exposure to high foreign exchange or liquidity risks, or asset quality challenges. Rising inflationary pressures driven by food, commodity, and energy prices;

the tightening of global financial conditions; and the impact of sanctions will be in the focus of central banks in the near future. The impact of these developments on asset prices and their macro-financial linkages will need to be closely monitored.

Credit growth has been positive in all Western Balkan countries, with household loans growing faster than corporate loans (Figure 7.1). After bottoming out in March 2021, average loan growth in the region has been increasing continuously. As of December 2021, the strongest credit growth has been registered in Kosovo (15.5 percent, y/y), followed by Serbia (8.8 percent, y/y). Demand for loans is strong in Kosovo across all segments while in Serbia loan growth is driven by households and corporate sector equally. In contrast, credit growth has been weak in Montenegro (3.2 percent, y/y) and Bosnia and Herzegovina (3.9 percent, y/y), driven by milder market outlooks, expiration or tightening of support programs, tighter loan supply conditions, and a generally volatile political environment fueling uncertainty. In all countries credit growth has been accelerating in the second half of 2021, except in Montenegro, where credit growth is

Figure 7.1. Credit growth has been positive in all countries and is accelerating

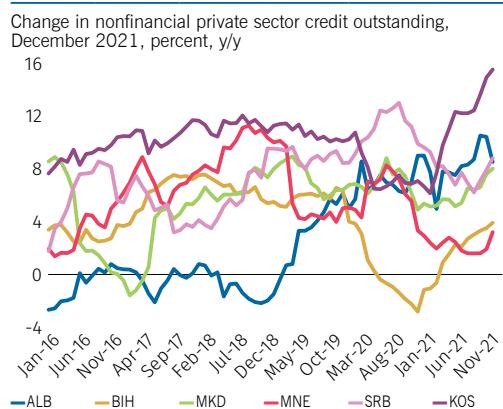
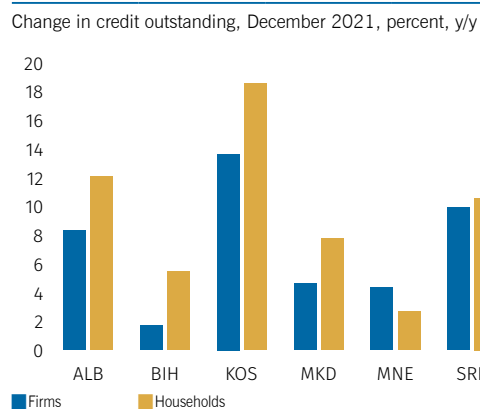


Figure 7.2. Lending to households continued to drive credit growth



below the June 2021 level. On average in the region, household loans grew by 9.5 percent, surpassing corporate loan growth at 7.1 percent, a trend that has continued since July 2020 (Figure 7.2).

While there are variations at the country level, local and subsidiary banks in the region reported a robust increase in demand for credit across the board, and somewhat easing supply conditions since 2021 Q1.

Loan demand was supported by working capital needs, positive housing market prospects, and consumer confidence, while contributions from investments had turned positive again. Supply conditions eased substantially for household segments, while they remained tight for companies, particularly for small and medium-sized enterprises. In addition, easing supply trends manifested primarily for short-term credit extensions. Banking groups' global access to funding continued to ease over the last six months and supported ease of supply conditions.²²

As of December 2021, the average NPL ratio in the region slightly decreased compared to its June 2021 value at 4.7 percent (Figure 7.3).

The regional average of 4.5 percent is slightly below the 5 percent threshold the European Banking Authority defines as a high NPL ratio; nevertheless, NPL ratios are still higher than the region's average in Montenegro (6.8 percent), Bosnia and Herzegovina (5.8 percent), and Albania (5.7 percent). NPLs are increasing only in Montenegro compared to its December 2020 level. Kosovo's NPLs remained the lowest in the

region throughout the COVID crisis, driven by a stronger decline in the retail segment.

The borrower relief measures expired by the end of 2021, except for the reintroduced targeted loan moratorium in Montenegro and extended measures in Bosnia and Herzegovina until March 2022.

These relief measures include moratoriums, relaxation of loan classification standards for NPLs, and favorable loan restructuring schemes. As the benefits of these measures begin to fade, asset quality challenges may surface with a lag in 2022. The CESEE Bank Lending Survey indicates a reversal of the improvement in asset quality in the first half of 2022.²³ These expectations are supported by some signs of vulnerabilities such as elevated stage 2 loans, vulnerable sectors (food, accommodations, and entertainment), and a continued rise in property values in some regions, building fears of value readjustments to come. The NPL Monitor (2021 H2), published by the Vienna Initiative, highlighted the surge of stage 2 loans due to COVID-19 in 2020. The study presents a bank-level analysis conducted with a sample of the five largest banks by total assets in each of the Vienna Initiative partner countries²⁴ and shows that stage 2 loan volumes increased in 18 of 25 banks, both from December 2018 to December 2019 and from December 2019 to December 2020.²⁵

Capital buffers in the Western Balkan countries remained broadly stable, while bank liquidity is at its highest level since December 2019. As of December 2021, bank capital adequacy averaged 18.2 percent,

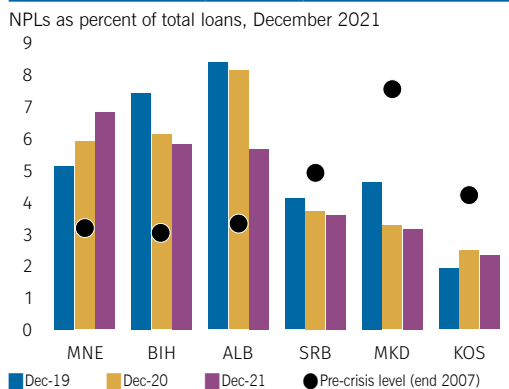
²² The CESEE Bank Lending Survey - Autumn 2021.

²³ The CESEE Bank Lending Survey - Autumn 2021.

²⁴ Vienna Initiative partner countries are Albania, Croatia, Hungary, Montenegro, and Serbia.

²⁵ NPL monitor for the CESEE region, Vienna Initiative, 2021 H2.

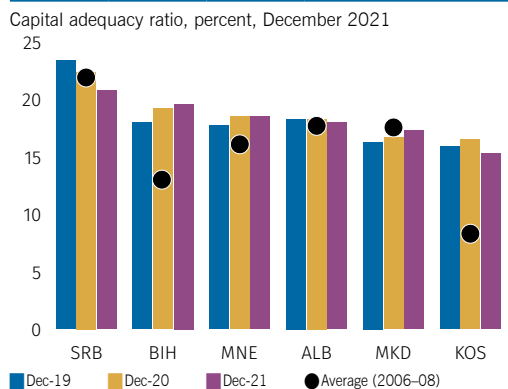
Figure 7.3. NPLs are consistently decreasing in Albania and Bosnia and Herzegovina while increasing in Montenegro



far above the regulatory minimum, and lower compared to December 2020, at 18.6 percent (Figure 7.4). The ratio of liquid to total assets averaged 29.9 percent, slightly higher than in December 2020 (29.1 percent). The loan-to-deposit ratios were well below 100 across the board (75.9 percent on average in December 2021) and declining, indicating a faster deposit growth compared to loan growth.

Regional average bank profitability continued its recovery, approaching its December 2019 value as of December 2021. Profitability as measured by return on assets has increased to 1.4 percent in December 2021 from 1.1 percent in December 2020, mainly due to expiring borrower relief measures, increasing loan growth, removal of additional provisioning, and declining impairment costs. As of December 2021, Kosovo has the highest profitability (2.3 percent) while Montenegro has the lowest (0.8 percent). The CESEE Bank Lending Survey also confirms this outcome, showing that all the international banks operating in Kosovo reported higher return on assets compared to their group profitability, while in Serbia this ratio is 40 percent. It

Figure 7.4. Banks capital buffers preserved



will be important to monitor profitability, considering the risks for the outlook. If asset quality deteriorates in 2022, this would put additional pressures on profitability, with increasing impairment costs, and would reverse the recovery.

Going forward, authorities need to keep their focus on monitoring credit risks and the evolution of distressed loans, as well as the potential spillovers from the risks related to the sanctions on Russia and the war in Ukraine. It is equally important for the authorities to refocus on a medium- to long-term reform agenda to align financial systems in the region with international standards (that is, Basel Core Principles, European Union Banking Directives) that might have been interrupted due to the pressing priority of the COVID-19 response. Within this framework, reforms related to greening the financial sector are emerging as a top priority especially for the Western Balkan countries that are aiming to achieve alignment with the EU. A growing number of central banks and regulators have issued warnings on the impact of climate and environmental risks on the stability of their

financial systems, resulting from both physical and transition risks. At the same time, there is a global recognition of the emerging role of the financial sector in mobilizing capital for green objectives. Greening the financial sector will be essential for the regulators and central

banks in the region to ensure that the financial sector has the capacity to cope with the climate change risks and that they are equipped with the instruments for green investment financing (Box 7.1).

Box 7.1. Greening the financial sector in the Western Balkans

The financial sector and firms are exposed to both physical and transition risks due to the impact of climate change. Physical risks stem from both the gradual and abrupt impacts of climate change and natural disasters – such as droughts, floods, and hurricanes—on the value of real assets and their underlying financial instruments. Transition risks originate from efforts to mitigate climate change and improve local environmental conditions by decarbonizing the economy, which may create economic adjustment costs in a broad range of sectors. These costs can create financial risks for firms and investors that did not anticipate the transition and ultimately jeopardize the functioning and stability of the financial system. At the same time, the financial sector’s role in developing new and long-term financing instruments and mobilizing private capital for green investment is equally important when considering the unprecedented financing needs. The investment and financing needs exceed the capacity of any public resources or national budgets and would require massive private financing for sustainable investments.

The Western Balkan (WB) countries are exposed to a number of physical and transition risks, while the financial sector is underprepared to manage these risks. Collectively, across the six countries (WB6), the high to medium climate risks are floods, landslides, wildfire, earthquakes, landslides, extreme heat, and water scarcity. Furthermore, the WB6 countries are one of the European hotspots of environmental pollution and have very poor air quality, with elevated levels of particulate matter (PM), especially fine particles. According to a study published by Europe Beyond Coal using data from the European Coal Plant Database (2019), the 16 coal-fired power plants in the WB6 produced on average 20 times the amount of sulfur dioxide and 16 times the amount of PM emissions as the average EU coal plant.²⁶ Consequently, the WB6 have some of the most polluted cities in Europe. A recent report by the European Commission has apportioned air pollution in the 13 largest WB6 cities. In addition to air pollution, these countries are at the low end of resource productivity, with values of 0.35 euro per kilogram, much lower than the EU average of 2.07 euros per kilogram, according to Eurostat. The recycling of waste is low—below 3 percent, compared to the 44 percent EU average. While exposed to above-mentioned physical and transition risks, all six countries are also signatories to the Paris Agreement and thus are obligated to take action to keep temperature increases below 2.0 degrees Celsius, and even aim to achieve global warming of no more than 1.5 degrees.

Financial markets in the Western Balkans are not deep and diversified enough to provide a sufficient variety of financial instruments and mobilize private capital for financing green investments. The investment and financing needed to economically transition to a green economy exceed the capacity of public resources or national budgets and would require substantive private financing for sustainable investments. However, the depth of the financial sector in WB6 economies

²⁶ The goal of Europe Beyond Coal, which was established in 2017, is to ensure that coal is phased out throughout Europe by 2030.

Box 7.1 continued

as measured by private sector credit to GDP stands at an average of 45 percent—significantly lower than the ECA average of 87 percent – with particularly low levels in Albania, Kosovo, and Serbia. Commercial banks, which dominate financial sectors, recently increased their funding of energy efficiency and renewable energy projects. However, green loan portfolios are not well measured and are still small. Only Serbia has issued a green bond in the region—in September 2021, for EUR 1 billion.

To manage financial risks stemming from climate change and to reorient capital flows toward sustainable and green investments, WB6 countries need to embark on a number of regulatory reforms and capacity building. Regulators and central banks should make sure that financial sector (banking, insurance, and capital markets) regulatory and supervisory frameworks and risk management capacities are developed to properly identify, measure, monitor, and manage climate-related risks. Taxonomies should be developed to establish a classification system for sustainable activities and to create standards and labels for green financial products. Disclosure and accounting regulations should be adopted and strengthened to reflect sustainability and climate risks. Financial institution’s governance and strategy frameworks should incorporate climate change considerations, with increasing board and senior management responsibilities and awareness. New financial instruments should be developed to stimulate long-term investments in green and sustainable projects, such as green bonds, securitizations, banking products (that is, guarantees), strategic investment funds, and green mortgages.

Financial sector standard-setting bodies²⁷ and the European Green Deal (EGD) framework provide necessary guidance to WB6 countries on how to strengthen the regulatory and enabling environment for greening the financial sector. The European Green Deal, launched in December 2019, provides a relevant framework for WB6 countries, as their ultimate goal is to join the EU. Transforming the financial sector and building capacity for managing climate-related risks and mobilizing capital for green development are integral elements of the Green Deal and EU sustainable finance framework. The EU introduced the Renewed Sustainable Finance Strategy to reform the financial sector and make it a key part of the solution toward a greener and more sustainable economy. The EU also introduced sustainable reporting standards, a green taxonomy, green bond standards, and stress test methodologies through the ECB as important enablers of greening the financial sector. Large-scale international collaboration and guidance are also available through the Network for Greening the Financial System, Task Force on Climate-related Financial Disclosures and financial sector standard setters.

The WB6 countries have begun preparatory efforts for greening their financial sectors. Serbia issued the first sovereign green bond in 2021 and adopted a green bond framework. Beyond this, financial instruments targeting energy efficiency and renewable energy investments are getting widespread in the region. The World Bank initiated green finance diagnostics to help WB6 countries identify challenges and opportunities and prepare their strategy along with actionable roadmaps for greening their financial sectors. Pilot diagnostics are currently taking place in Serbia and Albania. In addition, the World Bank’s Financial Sector Advisory Center (FinSAC) has introduced a program to support regulators and central banks in the region to strengthen risk management capacities for climate-related risks.

²⁷ Bank for International Settlements (BIS), Basel Committee on Banking Supervision (BCBS), Financial Stability Board (FSB), International Association of Insurance Supervisors (IAIS), International Organization of Pension Supervisors (IOPS), International Organization of Securities Commissions (IOSCO).

8. The new crisis has cut short the better-than-expected post-pandemic trade recovery in the Western Balkans

The global economic effects of the war in Ukraine, and associated sanctions on Russia, have significantly disrupted a strong but short-lived post-pandemic recovery in the Western Balkans. The strength of the post-COVID rebound across the Western Balkans exceeded expectations. Yet, this speedy recovery was short-lived due to the external shock of the Ukraine war propagating through the external sector. The global economic fallout from the war in Ukraine disrupted commodity and energy trade and further increased commodity prices. It also aggravated already significant inflation pressures caused by the COVID-19 pandemic, disrupted financial and tourism flows, and in general exacerbated consumer and investor uncertainties (Table 8.1.). The effects of these disruptions could be amplified by countries' protectionist measures, such as the export bans on wheat announced by Hungary and Serbia, key regional suppliers.

In 2021, the current account deficit (CAD) narrowed in most countries in the region. As expected, the largest decline in external imbalances occurred in Montenegro, which recovered from the COVID-19-induced tourism crisis in 2020. The CAD narrowed by 17 percentage points to 9.2 percent of GDP (Figure 8.1). Similarly, the external deficit narrowed in Albania and Bosnia and Herzegovina by 0.9 and 1.6 percentage points of GDP, respectively, although at significantly different levels—in Albania, the CAD totaled 7.7 percent in 2021, and in Bosnia and Herzegovina, 2.3 percent of GDP. North

Macedonia maintained a broadly unchanged CAD of 3.5 percent of GDP, despite a rebound in real private consumption growth to 5.9 percent and an increase in both public and private investment. Serbia and Kosovo are the only two countries in the region that widened their external deficits, despite an outstanding merchandise export performance. In Kosovo, the worsening of the external imbalance was more substantial than in Serbia and is testament to the large import content of exports. The imbalance in Kosovo was supported, among others, by the sharp increase in private consumption fueled by strong credit growth amounting above 10 percent, in nominal terms. In response, the CAD expanded from 7 percent in 2020 to 9.1 percent of GDP in 2021. In Serbia, the external imbalance widened marginally, by 0.3 percentage points compared to the year before, to 4.4 percent of GDP.

The value of merchandise trade²⁸ in the Western Balkans soared about 30 percent in 2021, after the pandemic-induced contraction in 2020. The strong rebound reflected an increase of 39 percent year on year in exports, and a strong jump in imports of 29 percent year on year. In all countries but North Macedonia, exports outpaced imports, yet across the board, merchandise trade deficits deteriorated to pre-crisis levels, and even exceeded them, in GDP terms, due to a larger import base. The exceptions are Bosnia and Herzegovina, Montenegro and Serbia, with merchandise trade deficits of 1 to 3 percentage

²⁸ Exports and imports of goods from the trade statistics.

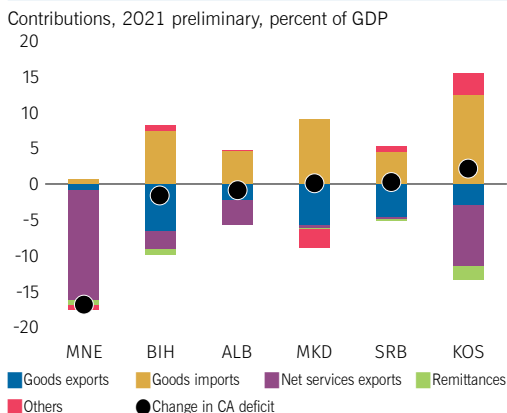
points lower compared to 2019, or close to 20 percent in Bosnia and Herzegovina and 40 percent of GDP in Montenegro. Serbia exhibited the lowest merchandise trade deficits in the Western Balkans in 2021 (11 percent of GDP).

Exports to Germany, Italy, Croatia, Slovenia, and Greece, but also within-region trading, accounted for most of the rapid deepening of exports in 2021. Albania’s rapid growth in exports to Spain, Kosovo, and Greece was mainly in minerals, fuel, and electricity, whereas textile and footwear as well as construction materials and metals were exported to Italy. In Bosnia and Herzegovina, meanwhile, exports of mineral fuels rose 71 percent and furniture 22 percent, with the rise in aluminum product exports reaching 159 percent, and wood products totaling 36 percent compared to the year before. Kosovo’s merchandise exports doubled to Italy and North Macedonia and rose 40 percent to Switzerland and Germany in 2021. This spike was the result of exports of plastic products and base metals, which grew 40 percent and account for close to half of total merchandise exports. Finally, Serbia’s exports

of base metals and rubber and plastic products rose 59 and 24 percent, respectively, while the export of electrical equipment increased nearly 25 percent. The hike in the export of these products offset the slowdown in trade of car supply chain firms due to supply disruptions and lower demand from EU car manufacturers. Such developments were also observed in North Macedonia’s suppliers of car manufacturers. Serbian exports to Germany, Italy and Bosnia and Herzegovina grew between 25 and 29 percent, while exports to Hungary recorded a growth rate of 35 percent. Serbia’s exports are spatially more diversified compared to the rest of the Western Balkans, with these four markets accounting for one-third of all exports.

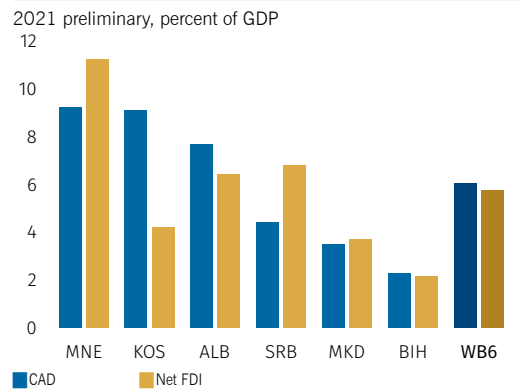
Net services and remittances largely returned to pre-pandemic levels, helping narrow the external deficits. Net services were an important source of net inflows that in part offset the structurally high merchandise trade deficits in the region, which range from 11 percent of GDP in Serbia to 47 percent of GDP in Kosovo. In Albania, Kosovo and North Macedonia, net services, in GDP terms, exceeded pre-pandemic levels by as much as 1 percent of

Figure 8.1. Current account deficits (CAD) narrowed in most countries in the region...



Sources: Central banks; World Bank staff estimates.

Figure 8.2. ...and were mostly met by recovering FDI.



Sources: Central banks; World Bank staff estimates.

GDP. In Kosovo and North Macedonia, visits by workers living abroad account for the majority of travel inflows, whereas Albania has a more prominent tourism sector. Together with net services, remittances also exceeded pre-pandemic levels, relative to GDP, except in Albania, Bosnia and Herzegovina, and Serbia. Overall, across the region, net inflows of services and remittances in 2021 offset two-thirds of the merchandise trade deficit. North Macedonia, with traditionally much lower levels of net service and remittances inflows, is the exception, with this coverage totaling only 35 percent in 2021.

The external imbalances were largely funded by non-debt-creating flows. Net foreign direct investment (FDI) in the form of equity and reinvested earnings drove the financing of the external shortfalls in the region (Figure 8.2). In Albania, Bosnia and Herzegovina, and Montenegro, this was especially pronounced, with equity and reinvested earnings totaling 7 percent of GDP, 5.8 percent of GDP,²⁹ and 8.1 percent of GDP, respectively, as investment in retail trade, financial services, the metal industry (Bosnia and Herzegovina) and tourism (Montenegro) represented a multiple of net FDI in 2019. In Albania, net equity and reinvested earnings from FDI financing closed 80 percent of the external imbalance, and offset large portfolio outflows in 2021. The latter was driven by a sizable increase in foreign exchange deposits, which banks invested abroad in bonds. In North Macedonia, meanwhile, non-debt creating FDI inflows remained below pre-pandemic levels, but were accompanied in 2021 by a sizable inflow of intercompany loans. In Serbia, net FDI equity and reinvested earnings did not pick up in 2021 and remained at levels

recorded in 2020, roughly at 3.5 percent of GDP. Instead, intercompany loans accelerated and more than doubled during the past two years compared to the pre-pandemic period.

Strong financial net inflows resulted in a sizable buildup of foreign exchange reserves.

By end-2021, foreign exchange reserves were strengthened across the region, except in Montenegro, where they remained constant due to net debt repayments by the government, banks, and the private corporate sector. Overall, foreign exchange reserves exceed the metric of internationally prudent adequacy levels for all countries. Nominal exchange rates remained stable in Serbia and North Macedonia throughout 2021 and appreciated slightly in Albania. This trend continued in early 2022 before the outbreak of war in Ukraine.

The energy shock and accompanying terms of trade deterioration are likely to widen the current account deficit across the Western Balkans in 2022.

Russia is a major supplier of natural gas and oil, and Ukraine is one of the main transit routes. If oil prices remain above US\$95 per barrel, together with other global commodity price increases, this will raise the oil import bill, among others, and widen the already structurally large merchandise trade deficits across the region. The impact of a slowdown in the EU could also affect car manufacturing exports in the Western Balkans, and dampen remittances and services exports from the EU, on top of the reduction in tourists from Russia in Ukraine, which are important source markets for two Western Balkan countries. Nevertheless, sizable foreign exchange reserves in the region built up in recent years provide a viable shock absorber. In other countries,

²⁹ For the first three quarters of 2021.

with either unilateral euroization or currency boards, the adjustment will take place through the real sector.

Risks from direct trade linkages with Russia, Ukraine, and Belarus show a mixed picture in the Western Balkans (Table 8.1). Unlike the Middle East and North Africa, imports of agricultural commodities, especially wheat, do not represent a major risk for the Western Balkans, except in Albania, which imports 50 percent of its wheat from Russia and Ukraine. That said, an agreement between Albania and Serbia may have in part alleviated potential supply shortages. Considering the limits in expanding production worldwide, the dislocation in the trade of wheat accounts for 60 to 70 percent spike in its price from early 2022 until March. Furthermore, Russia is the main supplier of natural gas to the region.

While a disruption of natural gas supply looks remote at this stage, barring future sanctions in the form of import restrictions by the West or export controls by Russia, natural gas prices may soar going forward on top of the 400 percent increase in 2021, affecting households and industry in the region. Spillover effects will be most acute for electricity production, heating, and the steel, iron, and aluminum industries, to mention a few. Finally, Albania imports one-tenth of its total oil imports from Russia, and Serbia imports one-third, with risks of supply disruptions. It is also unclear how western sanctions will impact operationally the national oil company in Serbia, with Gazprom as the majority owner. The oil company's annual revenues are about EUR 2 billion, of which nearly EUR 500 million are export earnings, which could be affected by the sanctions.

Table 8.1. Heatmap of select transmission channels to Western Balkan countries

	Natural gas import dependency ^a	Natural gas imports from Russia ^b	Exports ^c	Imports ^d	Russian inbound FDI stock ^e	Wheat imports from Russia	Wheat imports from Ukraine	Banking ^f	Tourism ^g	Remittances from Russia	Nitrogenous fertilizer	Potassium fertilizer
Albania												
Bosnia and Herzegovina												
North Macedonia												
Montenegro												
Serbia												
Kosovo												
	75+	75+	20+	20+	15+	75+	10+	3+	3+	10+	60+	60+
	50–75	50–75	10–20	10–20	5–15	50–75	5–10	2–3	2–3	5–10	40–60	41–60
	25–50	25–50	5–10	5–10	2–5	25–50	2–5	1–2	1–2	2–5	20–40	21–40
	0–25	0–25	0–5	0–5	0–2	0–25	0–2	0–1	0–1	0–2	0–20	0–21
	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Note: (a) Energy import dependency is the share of energy needs met by imports, calculated from energy balances as net imports divided by the gross available energy (Eurostat); (b) Share of natural gas imports from Russia in total natural gas imports (c,d) Exports to and imports from Russia as percent of trading partners' GDP (COMTRADE); (d) FDI stock from Russia as percent of recipient country's total (CDIS); (f) Bank claims to Russia are percent of consolidated positions, including risk transfers and commitments, of creditor country's GDP (BIS); (g) Share of international tourism receipts adjusted for the share of Russian and Ukrainian tourist arrivals in total foreign tourists arrivals, as share of GDP.

With sanctions impeding air transport from Russia, direct trade in services could have a sizable impact on several countries in the region. In Montenegro, service exports to Russia, Ukraine, and Belarus totaled EUR350 million, or 7 percent of GDP in 2019. Specifically, Russian tourists accounted for a quarter of total overnight stays during 2017 to 2020. In 2021, in the absence of direct flights, Russian tourists still accounted for 12 percent of total overnight stays. In addition, Ukrainian tourists constituted almost 10 percent of total overnight stays in 2021. In Serbia, meanwhile, revenues from Russian and Ukrainian tourists amounted to about EUR140 million annually, or 10 percent of total tourism revenues. The lack of tourist inflows from these two source markets could further aggravate Serbia's merchandise export exposure to the Russian market, which totals roughly 5 percent of total exports. At the same time, it could also benefit from trade diversion as it has not joined the EU-imposed sanctions. Ukraine is the second largest source country of tourists visiting Albania through charter flights and accounts for 30 percent of tourism exports.

The direct financial channel exposure to the war in Ukraine is limited, while indirect spillover effects from exposures by parent companies are unclear. Authorities in Bosnia and Herzegovina and Serbia acted promptly and sold subsidiaries of Sberbank shortly after the outbreak of war in Ukraine. Other banks with Russian or Ukrainian capital in the region are small in market size. Indirect effects stemming from exposures from European parent companies to Russia are uncertain and are being monitored carefully.

The indirect impact on trade involves a terms-of-trade shock and reduced exports to Russia by EU trading partners. Machinery and vehicles account for about a quarter of Russian imports, and countries that supply components used in the production of these goods will suffer a further contraction in exports. In addition, supply-chain disruptions associated with exports from Russia and Ukraine are likely to cause production frictions in European manufacturing exacerbating adverse demand effects for suppliers in the Western Balkans. In North Macedonia and Bosnia and Herzegovina, the adverse impact on the textile supply chain and car manufacturing, respectively, will affect exports. At the same time, however, iron, steel and aluminum producers across the region might benefit from trade diversion.

9. The post-pandemic rebound is cut short

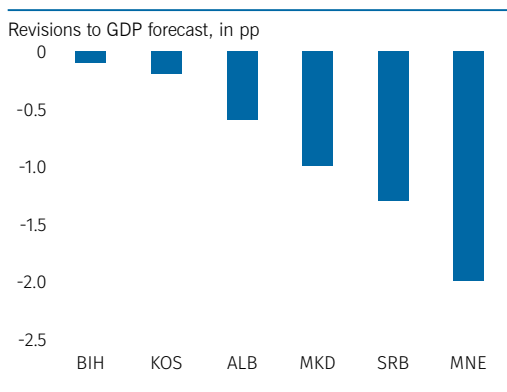
The outlook for Western Balkan countries has changed significantly since the start of the war in Ukraine. After a better-than-expected recovery in 2021, a relatively robust growth path was expected to persist in 2022 and beyond. GDP growth for the Western Balkans was expected to be 4.1 percent in 2022 and 3.8 percent in 2023. However, the outbreak of war in Ukraine has cut short the post-pandemic rebound, and growth for 2022 has now been revised downward by almost one percentage point to 3.1 percent in 2022.

There are several channels of impact from the war in Ukraine on the economies of the Western Balkans. Among these, it is certain that inflation will be even higher, because of additional increases in food and energy prices, and that lower exports, disruptions in supply chains, and lower tourism revenues would also likely lead to a slowdown in growth. A broader shock to business confidence across Europe would also have implications for investments

into and demand from the Western Balkans. As a result, projected GDP growth for 2022 has been cut by almost one percentage point, in line with revisions to growth for major economies (Figure 9.1).

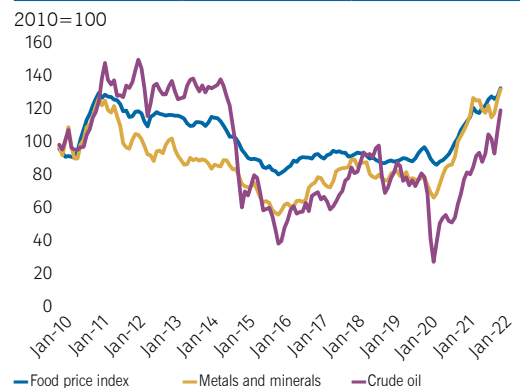
Increased international prices of food, oil, and metals started hurting the global recovery and growth in the Western Balkans, even before the war started. Food prices (as measured by the United Nations Food and Agriculture Organization Food Price Index) increased by 5.3 points, to an average of 140.7 points in February 2022, 24.1 points above its level a year ago. This represents a new all-time high, exceeding the previous peak in February 2011 by 3.1 points (Figure 9.2). Similarly, international metals and minerals prices have reached historically high levels in recent months. The World Bank composite index of metals and minerals was 32.3 percent higher in February 2022 compared to a year ago. Prices of aluminum, tin, zinc, and

Figure 9.1. Growth projections were revised downward



Source: World Bank staff calculations.

Figure 9.2. Food prices reached an all-time high, as did metals and minerals, while oil prices increased sharply, too



Sources: UN Food and Agriculture Organization; World Bank.

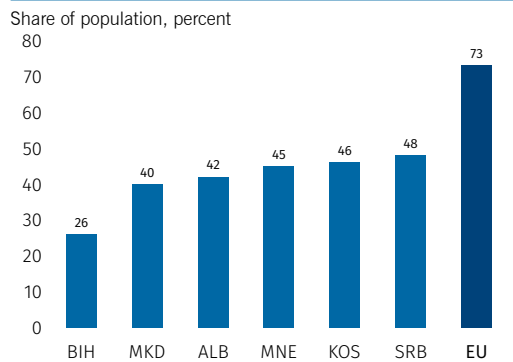
nickel increased most by February 2022. The significant increase in commodity prices, including metals, was due to a stronger-than-expected recovery in growth across the world, especially in advanced economies, as a result of fiscal stimulus and pent-up demand. Finally, oil prices have increased significantly recently. After reaching a bottom in April 2020, crude oil prices increased by 344 percent (that is, from US\$21.0 per barrel to US\$93.5 per barrel in February 2022).

The impact of the Ukraine war will be significant across the region because of the expected increase in commodity and energy prices, but some countries will be hit more than others since channels of transmission differ from country to country. Higher commodity prices and availability, particularly metals and grains, as well as higher energy prices, are expected to be the main transmission channel common to all countries in the region.³⁰ Direct trade, remittances, and investment linkages are low for Albania, Bosnia and Herzegovina, Kosovo, and North Macedonia, but are more important for Montenegro and Serbia. The main direct transmission channel to Montenegro's economy is tourism. In 2021, tourists from Russia, Ukraine, and Belarus accounted for 22 percent of total overnight stays. In the case of Serbia, the main channels are exports, foreign direct investment, remittances, and tourism, since Russia and Ukraine account for 5 percent, 6.5 percent, 3 percent, and 10 percent of the total, respectively.

COVID remains a concern. Western Balkans countries were among those most impacted by the spread of the Delta variant in the third quarter of 2021, with the number of new

COVID-19 cases approaching or surpassing previous peaks. Vaccination rates appear to have plateaued and continue to lag the world average of 57 percent, and clearly lag the EU average of 73 percent (Figure 9.3).

Figure 9.3. Vaccination rates have stagnated well below EU rates



Source: <https://ourworldindata.org/covid-vaccination-dataset>, accessed March 24, 2022.

Note: Total number of people who received vaccine dose per initial protocol divided by the total population of the country.

Inflationary pressures are expected to increase as the conflict in Ukraine causes a further increase in food and energy prices. As the economies have recovered faster, inflationary pressures started to build up in the second half of 2021. Average inflation in the region was 3.3 percent in 2021, compared to 0.9 percent in 2020. Energy price adjustments will push inflation up further when price controls effective since the last quarter of 2021 are lifted. Therefore, inflation is projected to reach 6.3 percent in 2022.

Fiscal deficits are expected to widen as both revenues and expenditures will be affected by international developments. After a significant reduction in deficits across the region in 2021, from 7.3 to 3.3 percent of GDP, on average, they will expand again in 2022. Governments

³⁰ Russia is the world's largest exporter of oil to global markets and the second-largest crude oil exporter behind Saudi Arabia. In addition, Ukraine and Russia account for about 30 percent of the world's traded wheat.

will need to provide additional support to households and the economy to tackle the ongoing energy and broader economic crises caused by the war in Ukraine. To create the fiscal space, some governments might opt for delays in starting new or completing existing infrastructure projects, which will further slow growth.³¹ Revenues will also be affected by the economic slowdown.³² Public and publicly guaranteed debt is expected to start to gradually decline, from 56.5 percent in 2021 to 55.7 in 2022, and to decline further over the medium term.

With increased energy, food, and raw material prices, external deficits are also expected to widen. On average, the merchandise trade deficit will increase from 19.4 to 20.6 percent of GDP. In addition, it is expected that remittances will fall, as will revenues from some services, tourism in particular. This in turn will lead to an increasing current account deficit (CAD). The CAD will on average increase from 4.9 to 6.3 percent of GDP. Consequently, external debt will increase significantly in 2022 to reach a new historical high of 92 percent of GDP.

The outlook for the Western Balkans is subject to a series of risks, mostly tilted to the downside (Box 9.1). A prolonged pandemic and the rise of new variants domestically and internationally could adversely affect growth and confidence. The war in Ukraine could bring further disruptions in global trade, which in turn may weaken domestic production and the export of goods and services. In the absence of fiscal consolidation, especially for countries with high debt, like Albania, Montenegro, and North Macedonia, refinancing risks could arise if external financial market conditions tighten. Debt sustainability may become a concern, while access to finance may become more expensive as monetary tightening accelerates due to higher inflation in advanced economies.³³ The risks of political polarization also remain high. In Bosnia and Herzegovina, the current political deadlock could be further amplified in the pre-election period, adversely affecting implementation of the adopted socioeconomic program needed to address the country's development challenges and pave the way for EU accession.

31 On the positive side, on February 25, 2022, the European Commission unveiled a €3.2 billion investment package to support 21 transport, digital, climate, and energy connectivity projects in the Western Balkans. This is the first major package of projects under the EU's Economic and Investment Plan for the Western Balkans, which the European Commission adopted in October 2020.

32 Although higher inflation will help to increase some revenues, at least in minimal terms.

33 On March 11, 2022, the U.S. Fed executed its final quantitative easing (QE) purchase, after adding more than US\$5 trillion of securities since the COVID-19 pandemic began. This was nearly 50 percent more than the amount added through three rounds of QE between 2009 and 2014 to combat the global financial crisis.

Box 9.1. Global economic recovery faces severe headwinds from war in Ukraine and COVID-19 pandemic

The global economic recovery was already decelerating prior to the Russian Federation's war with Ukraine, because of COVID-19 disruptions, diminished policy support, and lingering supply chain bottlenecks. Global growth was on track to ease from an estimated 5.5 percent in 2021 to 4.1 percent in 2022³⁴ the sharpest global slowdown in a post-recession recovery since at least the 1970s. The exceptional slowdown in growth anticipated before the war left the global economy vulnerable to adverse shocks, especially in emerging market and developing economies (EMDEs), where recoveries were already notably weaker and more fragile than those in advanced economies.

The war in Ukraine, however, has cast a further shadow over global growth prospects. The effects of Russia's invasion of Ukraine have rippled through multiple global channels, including commodity and financial markets, trade and migration links, and confidence. Since late January, private sector forecasts for global growth in 2022 have been revised downward by [0.5] percentage points and are likely to continue to fall as forecasters fully incorporate the war into projections. OECD model-based estimates suggest that global growth could be around 1 percentage point lower this year, placing global growth closer to 3 percent.³⁵ Moreover, rising COVID-19 cases in China and Europe could further hinder the global recovery, especially if pandemic-related disruptions further strain supply chains. The recovery could also be derailed by a sudden tightening of global financing conditions, triggered by the need for much tighter monetary policy in major economies, especially if the war de-anchors inflation expectations (Figure 9.4.A and B). For the Western Balkans, a sudden tightening of external financing could generate risks associated with debt rollover and currency mismatches, especially in those economies that have substantial upcoming redemptions or that borrowed heavily in foreign currency.

Global commodity prices have spiked further because of the war, pushing up inflation and sparking concerns about food security. Countries reliant on commodity imports, including those in the Western Balkans, are sensitive to global energy and food prices (Figure 9.4.C). Price increases this year have been particularly large for commodities where Russia and Ukraine are key exporters, including natural gas, coal, crude oil, wheat, aluminum, and palladium. Agricultural prices have increased over concerns that the war could further squeeze global grain supplies, as Russia and Ukraine account for a quarter of global wheat exports, and Russia and Belarus are key producers of fertilizer. Global food prices have reached a record high—exceeding the levels observed during the last two spikes in food commodity prices in 2007 and 2010—with higher natural gas prices doubling the price of fertilizer.³⁶ As a result of these price spikes, an estimated 40 million people could be pushed into extreme poverty globally.³⁷

Global goods and services trade are likely to come under additional pressure from the war. Although Russia and Ukraine account for less than 2 percent of global goods trade, the war and subsequent sanctions have frayed trade connectivity by disrupting transit routes, particularly for maritime container shipping and air freight traffic, while higher fuel prices have pushed up shipping

34 According to the January 2022 edition of World Bank's Global Economic Prospects

35 OECD. 2022. *OECD Economic Outlook, Interim Report March 2022: Economic and Social Impacts and Policy Implications of the War in Ukraine*. OECD Publishing, Paris.

36 United Nations. 2022. *Food price index hits record high in February, UN agency reports*. <https://news.un.org/en/story/2022/03/1113332>

37 Mitchell, I., S. Hughes, S. Huckstep. 2022. *Price Spike Caused by Ukraine War Will Push Over 40 Million into Poverty. How Should We Respond?*

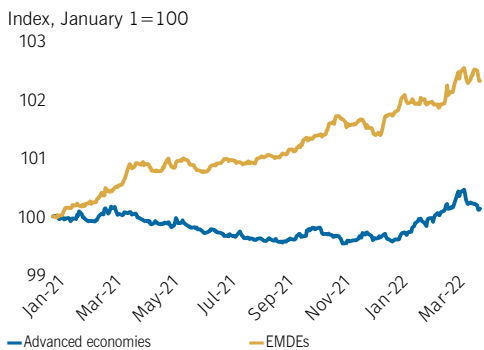
Box 9.1 continued

costs (Figure 9.4.D). The war is also likely to weigh on services trade and stall the post-pandemic recovery in international tourism, which was already anemic from ongoing COVID-19 disruptions. Outbound travel from Russia and Ukraine is expected to continue to be impacted by airspace closures, travel restrictions, sanctions, and increased fuel prices. The projected fall in tourists over security concerns and travel disruptions will further dampen the regional economy—tourists from Russia and Ukraine account for more than 10 percent of arrivals in about half of Europe and Central Asia’s economies, including those reliant on tourism in the Western Balkans, such as Montenegro and Albania.

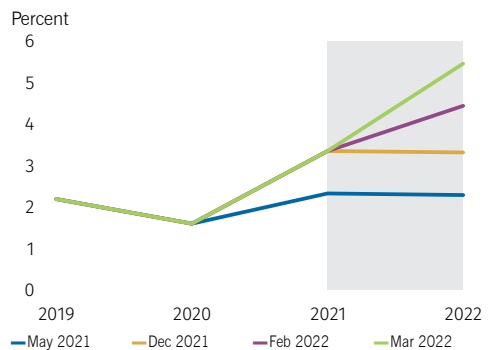
Activity in the euro area, the Western Balkans’ largest economic partner, was already expected to moderate in 2022 prior to the war. Even before the war, the euro area economy was facing headwinds due to a persistent drag from supply bottlenecks and stubbornly high oil and gas prices (Figure 9.4.E).³⁸ Rising COVID-19 cases and hospitalizations since mid-March could cause further disruptions to activity, while closures of key Asian ports from COVID-19 outbreaks could put additional pressure on supply chains. While economic exposures of the euro area to Russia are small, the region is particularly dependent on energy and metals imports from Russia. Should Russian exports of crude oil or natural gas to Europe be curtailed, regional prices would spike further and push inflation higher. Direct financial spillovers are limited but will be felt mostly in advanced economies with exposure to Russian financial assets, including some Italian, French, and Austrian banks. Still, several international banks have exposure to the Russian economy through business ties and local presence. The war poses a material downside risk to euro-area activity, which has already prompted the European Central Bank (ECB) to lower its growth forecast by 0.5 percentage points this year and raise its inflation projection by nearly 2 percentage points.³⁹ Although the conflict complicates monetary policy, market participants expect the ECB to delay rate hikes and proceed at a more gradual pace (Figure 9.4.F).

Figure 9.4. Global economic developments

A. Global financing conditions



B. Consensus inflation forecasts



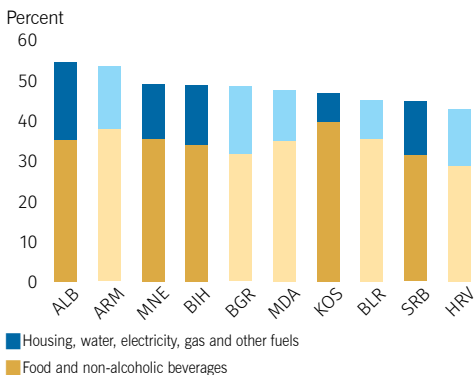
38 European Central Bank (ECB). 2022. *Economic Bulletin Issue 8, 2021*. ECB.

39 European Central Bank (ECB). 2022. *Economic Bulletin Issue 2, 2022*. ECB.

Box 9.1 continued

Figure 9.4. Global economic developments (continued)

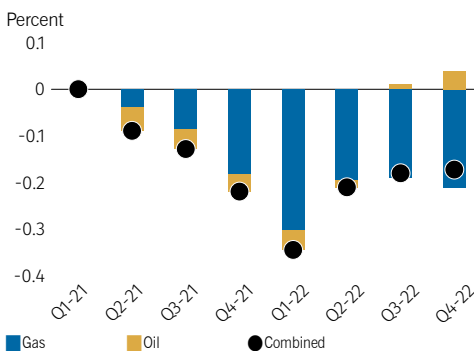
C. CPI basket of goods, percent weights by component



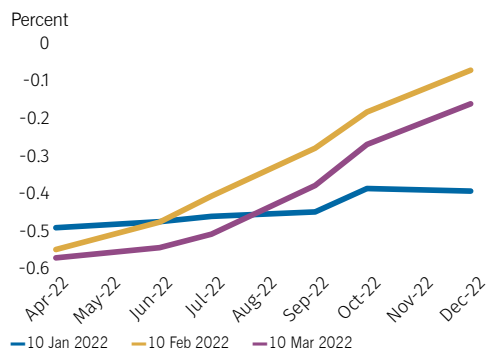
D. Global manufacturing PMI new export orders and shipping costs



E. Energy price impact on euro area growth



F. Market-implied expectations of euro area policy rate hikes



Source: Bloomberg; Consensus Economics; European Central Bank; Goldman Sachs; Haver Analytics; World Bank.

- A. Financial condition indices (FCI) are Goldman Sachs FCI constructed as a weighted average of short-term interest rates, long-term interest rates, the trade-weighted exchange rates, an index of credit spreads, and the ratio of equity prices to the 10-year average of earnings per share. Sample includes 10 advanced economies (including euro area) and 12 EMDEs (excluding China). Aggregates are calculated using 2021 GDP weights at average 2010–19 prices and market exchange rates. Last observation is February 23, 2022.
- B. Consensus Economics for median headline CPI inflation for 2021–22 using surveys for the months indicated. The sample includes 32 advanced economies and 50 EMDEs for December 2021 and May 2021 surveys, and 21 advanced economies and 38 EMDEs for the February 2022 survey.
- C. Data are as of January 2022.
- D. PMI manufacturing new export orders and Freightos global container shipping index. Last observation is February 2022.
- E. The impact of deviations in energy prices on euro area GDP net of exchange rate and policy effects, as calculated in ECB (2022).
- F. The projected policy rates for the euro area based on market-based expectations for hikes/cuts.

While the short-term policy effort should be focused on managing the unprecedented crises impact, regionwide efforts on advancing structural reforms and accelerating the low-carbon transition are needed. Addressing the low productivity, low labor force participation, a substantial lag in governance effectiveness compared to its peers during the pre-accession period, and proactively building up resilience

to climate and disaster risks, as well as ensuring energy security (see *Spotlight*) could help boost potential growth.

In addition, prudent fiscal management at the time when financial markets started tightening would reduce sustainability risks. On the revenue side, improving compliance and increasing progressivity could boost

revenues. On the expenditure side, enhancing targeting and efficiency of spending along with strengthening public investment management could help addressing sustainability but also strengthening the fiscal multiplier.

10. Spotlight: Managing the Energy Crisis in the Western Balkans

This *Spotlight* focuses on the current energy crisis in the Western Balkan countries (WB6) and outlines the policy responses adopted by the governments to deal with the crisis. The *Spotlight* first discusses the unfolding of the current energy crisis in Europe, its root causes, and the transmission mechanisms of energy price increases on governments and final consumers. It then provides an assessment of the vulnerability of WB6 countries to energy price shocks and describes the impact of the energy crisis in the WB6 countries, the measures adopted by the governments to mitigate it, and the fiscal impact of these measures. Finally, the *Spotlight* presents policy recommendations to governments in the context of the energy crisis that can be applied in the short, medium, and long term, and provides a qualitative assessment of how the current energy crisis can impact the green energy transition going forward.

An Extraordinary Energy Price Shock Hit Europe

After reaching nearly all-time lows in 2020, global energy prices climbed to unprecedentedly high levels in the second half of 2021, with Europe being especially hard hit due to its dependence on natural gas and close linkages between electricity and natural gas prices. Since March 2021, market prices of natural gas in the European trading

hubs⁴⁰ have increased more than fivefold, from about EUR 18 per megawatt hour (MWh) to above EUR 100 per MWh, with a daily peak of around EUR 227 per MWh on March 7, 2022.⁴¹ The day-ahead electricity prices on the Serbian Power Exchange (SEPEX) also increased more than fivefold between March 2021 and March 2022, from about EUR 50 to about EUR 270 per MWh, with a daily peak of around EUR 560 per MWh on March 8, 2022.⁴² Coal and oil prices have also been soaring. Thermal coal prices in Europe exceeded US\$450 per ton in March 2022 compared to about US\$50 per ton a year before.⁴³ Brent crude oil futures reached a 14-year high of US\$139 in March 2022 compared to about US\$30-US\$40 in March 2021.⁴⁴

The energy price hikes in Europe have been caused by a combination of short-term and long-term factors that have led to demand and supply shifts, especially in the natural gas market. Short-term trends that have been affecting energy prices include:

- The post-pandemic economic recovery, which was accompanied by a higher-than-expected surge in natural gas demand in Europe at a time when power generation from wind and hydro was unusually low due to weather conditions;

40 Dutch TTF.

41 Trading Economics, <https://tradingeconomics.com/commodity/eu-natural-gas> (accessed March 2, 2022).

42 SEPEX, Day-Ahead Electricity Prices.

43 Rystad Energy, [https://www.rystadenergy.com/newsevents/news/press-releases/old-king-coal-price-reaches-highest-level-in-more-than-200-years-on-track-for-\\$500/](https://www.rystadenergy.com/newsevents/news/press-releases/old-king-coal-price-reaches-highest-level-in-more-than-200-years-on-track-for-$500/).

44 Trading Economics, <https://tradingeconomics.com/commodity/brent-crude-oil> (accessed March 14, 2022).

- The surging global demand for liquefied natural gas (LNG), especially in Asia;
- Inadequate gas reserves, with levels well below the average of past years at the beginning of the heating season;⁴⁵
- The rising price of the European Union's (EU's) emission trading scheme allowances, which neared EUR 100 per ton of CO₂ in early February 2022 and are currently in the range of EUR 75–85 per ton of CO₂;
- The coupling of gas and electricity prices, as in many European countries the last marginal generation unit dispatched (that is the most expensive one setting the clearing price) runs on natural gas; and
- More recently, the instability caused by the war in Ukraine and the related sanctions against Russia that invoked risks of disruption to natural gas, oil, and coal supply.

Some longer-term trends are also playing a role in the recent energy price hikes in Europe, such as: (i) the declining production of natural gas in Europe (especially in the UK and the Netherlands), and the subsequent higher dependence of European countries on natural gas imports (primarily from Russia), which increased from 45 percent in 2015 to more

than 60 percent in 2021;⁴⁶ (ii) the coupling with the Asian gas market, due to the global surge in demand for liquefied natural gas and the shift from long-term gas contracts to a spot market, encouraged by the EU's Third Energy Package;⁴⁷ and (iii) the shift from oil indexation to gas-on-gas pricing, which exposes European consumers to market gyrations⁴⁸.

Natural gas and electricity prices are likely to remain high throughout 2022. Although the market remains clouded by significant uncertainties, even the seasonal decline in gas prices in the spring is likely to leave prices significantly higher in 2022 (roughly twice the average gas price observed in Europe in the recent past). Electricity prices are expected to continue to closely follow gas prices (whereby gas-fired generators could be joined as marginal units by coal-fired plants) and remain high throughout 2022. The main elements that could cause additional variability include: (i) a prolonged war in Ukraine, with the related potential disruption of natural gas, oil, and coal supplies; (ii) the need to replenish gas storage facilities in preparation for the next winter season;⁴⁹ (iii) further increases in gas demand as supply remains constrained; and (iv) changes in national energy policies (e.g., bans on Russian gas imports).

Higher natural gas prices can impact retail energy prices in several ways. In countries where natural gas is used for heating and

45 Storage sites owned or controlled by Russian Gazprom had particularly low storage levels at the start of the heating season (just 25 percent of their working storage capacity) and accounted for half of the EU's 5-year storage deficit while representing just 10 percent of the EU's total working storage capacity (source: IEA, <https://www.iea.org/reports/russian-supplies-to-global-energy-markets/gas-market-and-russian-supply-2>).

46 https://ec.europa.eu/commission/presscorner/detail/en/qanda_22_1512

47 See https://energy.ec.europa.eu/topics/markets-and-consumers/market-legislation/third-energy-package_en for more information. It should be noted that in the current context, the European Commission is encouraging a shift away from spot trade to long-term contracts to provide greater incentives for investment in LNG terminals.

48 Natural gas prices are more volatile because it is a highly seasonal and weather-dependent commodity which is used in many European industries which can in turn be affected by different macro- and sector-related shocks.

49 Under the newly issued EU gas storage policy, starting 1 October 2022, existing storage infrastructure in the EU territory should be filled up to at least 90 percent of their capacity by October 1 every year.

industrial applications, higher natural gas import prices directly translate into higher costs for gas-based utilities (notably district heating or combined heat and power plants) and large industrial consumers. In countries where natural gas is used for power generation, higher natural gas import prices can cause an increase in wholesale electricity prices when gas-fired plants are the marginal power plants; these higher prices imply higher power procurement costs for distribution utilities. Gas and power utilities often directly pass the higher costs on to their customers served in the open market, while for customers in the regulated market, tariff adjustments first need to be approved by the regulator.

Western Balkan Countries Have Different Degrees of Vulnerability to Energy Price Shocks

At the aggregate level, Western Balkan countries show limited vulnerability to direct natural gas price shocks, due to the relatively small role played by natural gas in their energy mix (Figure 10.1). All WB6 countries (except Albania) rely on domestic lignite for a large share of their total energy supply (from 34 percent for Montenegro to 56 percent for Kosovo in 2019),⁵⁰ while the role played by imported natural gas in their energy mixes is relatively small (or entirely absent in the case of Kosovo and Montenegro). Serbia and North Macedonia are the only two countries with a material share of natural gas in their total energy supply (13 percent and 9 percent in 2019, respectively) and are, therefore, the only

countries that show vulnerability to shocks in the price of imported natural gas.⁵¹ In the case of Serbia, natural gas is used mainly for industrial applications and heating (either in individual gas boilers or in district heating plants), while 84 percent of the gas consumed in North Macedonia is used in combined heat and power and district heating plants.⁵²

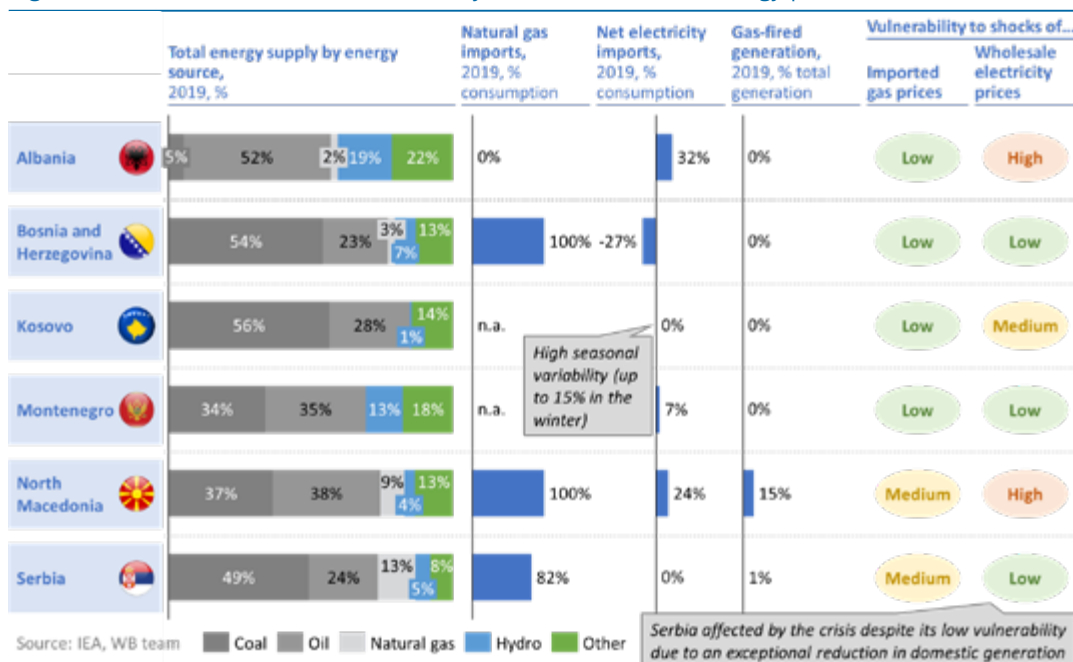
At the country level, several WB6 countries show a high degree of vulnerability to increases in the price of electricity imports.

Albania and North Macedonia rely on imports for a significant share of their total electricity consumption (32 percent and 24 percent in 2019, respectively), which makes them particularly vulnerable to price shocks in the regional wholesale electricity markets. And while Kosovo's domestic electricity supply essentially equals demand on average throughout the year, the country faces a surge in demand in the winter due to the widespread use of inefficient electric heating, which forces it to import significant amounts of electricity during the winter months and exposes it to risks related to fluctuations in wholesale electricity prices. In addition, it is worth noting the exceptional situation currently faced by Serbia: the country has historically been able to meet its electricity demand through domestic generation (mostly coal and hydro), but from late 2021, adverse meteorological conditions and accidents at several thermal power plants have significantly reduced domestic coal production and generation output and forced the country to import large amounts of electricity in late 2021 and early 2022. In 2019, Montenegro was a net importer of electricity

50 Domestic coal production is in line with domestic consumption in all WB6 countries (except Albania, whose reliance on coal is negligible). In recent years, North Macedonia has imported modest quantities of lignite to compensate for the reduction in domestic production.

51 In Bosnia and Herzegovina, natural gas is mainly used for district heating in Sarajevo, where the price impact is felt, but at country level the significance of gas is low.

52 ERC, 2020 Annual Report.

Figure 10.1. Assessment of the vulnerability of WB6 countries to energy price shocks

(for 7 percent of its consumption), but recent data suggest that in 2021 domestic supply and demand nearly matched,⁵³ so the country's level of vulnerability to increases in wholesale electricity prices remains relatively low.

All WB6 countries are vulnerable to fluctuations in the price of crude oil and oil products. Oil plays a significant role in the energy mix of all WB6 countries, due to its widespread use for transport. Oil and oil products account for a share of the total energy supply ranging from 23 percent in Bosnia and Herzegovina to 52 percent in Albania, but the only WB6 countries producing significant quantities of crude oil are Albania and Serbia.⁵⁴ As a consequence of the low domestic production and limited refining capacity, WB6 countries rely on imports of oil and oil

products for a large share of their consumption, which exposes them to risks related to price fluctuations. In addition, gasoline prices are already relatively high in the region, especially in Albania (about EUR 1.8 per liter) and Montenegro (about EUR 1.7 per liter).⁵⁵

Ability to Absorb Energy Price Shocks and Mitigate their Transmission to Consumers is Limited

Residential consumers in the WB6 countries have a limited ability to absorb higher energy prices. Energy vulnerability is widespread in the WB6. In 2019, North Macedonia had the highest share of households in Europe reporting that they could not keep their home adequately warm (33.1 percent), but Kosovo,

53 Energy Community, "Impact of the Electricity Price Surge in Energy Community Contracting Parties and Measures Undertaken" (December 2021).

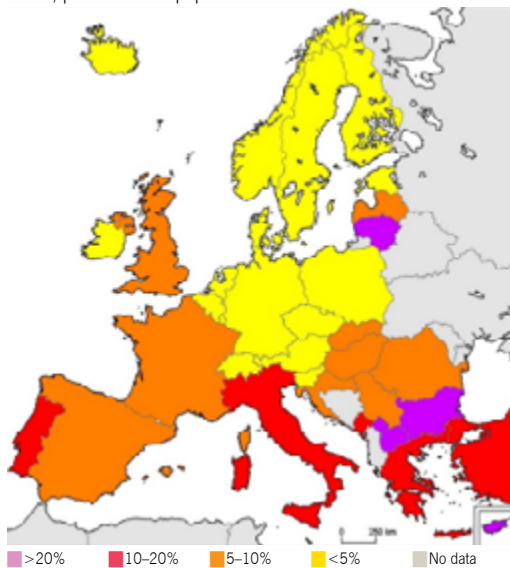
54 However, Albania exports a significant share of the crude oil it produces and imports most of the refined products that it consumes, which still exposes it to price fluctuations.

55 Global petrol prices for April 4, 2022, https://www.globalpetrolprices.com/gasoline_prices/ (accessed April 12, 2022).

Montenegro, and Serbia also rank among the top 10 countries (Figure 10.2).⁵⁶ The inability to keep their homes warm and the incidence of arrears and late payments of bills are more common among low-income households, suggesting that poor and vulnerable consumers often have more difficulty meeting their energy needs. For example, 48 percent of the lowest income decile households in Serbia and 65 percent in Montenegro have arrears in utility services, compared to only 8 and 17 percent, respectively, in the top decile. Forty-three percent of low-income households in Albania, 68 percent in Kosovo, and 68 percent in North Macedonia were in arrears on utility bills compared to 27 percent, 49 percent, and 34 percent on average in the country, respectively.⁵⁷ The relatively high spending on energy makes households in the

Figure 10.2. Inability to keep the home adequately warm

2019, percent of the population

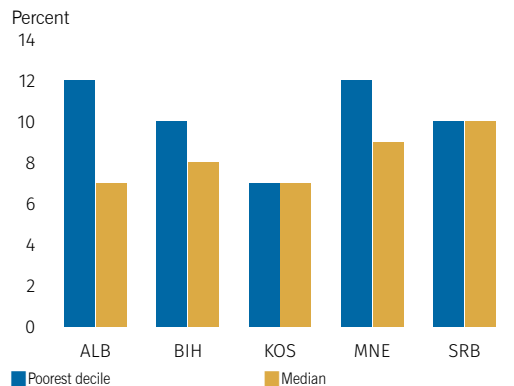


Source: Energy Community, Study on Addressing Energy Poverty in the Energy Community Contracting Parties.

Note: Kosovo, UK, and Iceland data from 2018.

region particularly vulnerable to tariff increases. According to available Household Budget Survey figures, the median household in the Western Balkan countries spends between 7 and 10 percent of their total budget on energy. In addition, when facing higher energy prices, households in WB6 countries (especially the low-income ones) often switch to cheaper energy sources, such as firewood or waste, for heating thereby exacerbating negative local air pollution and health impacts.

Figure 10.3. Share of household consumption expenditure on electricity, gas, and other fuels is high, but even higher among the poor in some countries



Sources: Household Budget Surveys, state statistical offices. Survey years: ALB (2020), BIH (2015), KOS (2017), MNE (2015), SRB (2019).

Industrial customers in the WB6 countries are also vulnerable to higher energy prices, especially the ones in energy-intensive sectors.

An indication of the higher vulnerability of industrial customers in the WB6 compared to other European countries is given by the energy intensity of the economy at purchasing power parity (PPP) exchange rates. According to Eurostat, in 2019 all WB6 countries (except Albania) had a higher energy intensity of the economy than the EU27, the highest-ranked countries being Bosnia and Herzegovina and

56 EUROSTAT, EU-SILC Survey. Data for Albania and Bosnia and Herzegovina not available.

57 Energy Community report on Energy Poverty.

Kosovo (0.093 and 0.078 tons of oil equivalent (toe) per US\$1,000 of GDP at PPP, respectively, compared to 0.055 toe for the EU27). High energy intensity can itself be a consequence of persistently low energy prices, and the low-cost domestic electricity supply based on lignite and hydro, which has enabled WB6 countries to maintain low prices for many years, results in higher vulnerability at this time of crisis. Countries that have attracted high-energy industries such as aluminum, steel, or fertilizer production (e.g., Bosnia and Herzegovina or Serbia) see a higher share of their economy affected severely. In addition, low energy prices create long-term disincentives that hamper short-term energy conservation measures, operational improvements, and investments in energy efficiency.

Energy Prices Are Increasing Across the Western Balkans

The different levels of vulnerability to energy price shocks are translating into different impacts on energy utilities and consumers across WB6 countries. A synthetic assessment of the impacts of the increases in electricity and natural gas prices in WB6 countries, without considering the emergency measures adopted by governments to alleviate such impacts, is described in this section (see next section for a discussion of Government interventions).

Electricity

Table 10.1. summarizes the impact of electricity price increases on different categories of sector stakeholders, with notable variation

in the degree of exposure between utilities, households, and industrial consumers.

The higher wholesale electricity prices are having a significant impact on power utilities in all WB6 countries except Bosnia and Herzegovina and Montenegro. Electricity suppliers in *net importing* countries (Albania, Kosovo, North Macedonia, and, exceptionally in late 2021/early 2022, Serbia) are incurring huge losses and liquidity issues due to skyrocketing costs of supplies purchased on the competitive market. In North Macedonia, it is reported that the government is subsidizing imports, or domestic electricity production in the amount of EUR 171 million of budgetary funds as of April 1, 2022. In Albania, the government has said that it will have to inject around EUR 550 million in 2022 to cover imported power. In Kosovo, unplanned outages resulting in seasonal imports during December 2021 and January 2022 increased system costs by EUR 55 million. In Serbia, the Deputy Prime Minister and Minister of Mining and Energy estimated that the additional costs of emergency electricity imports would be measured in the hundreds of millions of euros for the whole season⁵⁸, with up to EUR 500 million estimated to have been spent by end February 2022. In addition to electricity suppliers, in several countries transmission and distribution system operators (TSOs and DSOs), which need to purchase electricity to cover losses in their networks, are facing exceptionally high costs. The notable exception is Bosnia and Herzegovina, which is a *net exporting* country; its electricity producers (especially coal generators) are reaping profits from electricity exports, also thanks to the fact that they are not subject to a carbon price.

58 Balkan Green Energy News, <https://balkangreenenergynews.com/new-troubles-for-serbias-eps-coal-plant-tent-b-is-offline-amid-breakdown-fire/>.

Table 10.1. Assessment of the impacts of electricity price increases in WB6 countries on sector stakeholders

Impact by Stakeholder	Albania	Bosnia and Herzegovina	Kosovo	Montenegro	North Macedonia	Serbia
Utilities and Network Operators	Universal supplier OSHEE incurring losses due to the very high import prices	Electricity producers reaping profits thanks to electricity exports (and the absence of carbon pricing)	Universal supplier KESCO incurring losses due to the very high import prices. TSO KOSTT facing high costs to cover network losses	TSO and DSO facing high costs to cover network losses	Generation company ESM facing higher costs due to increased gas prices. TSO (MEPSO) and DSO (ENV) facing high electricity import prices	Power utility EPS facing higher costs due to increased reliance on expensive electricity imports (caused by unplanned outages)
Household consumers (incl. low-voltage commercial consumers)	No impact so far, but potential tariff increases under consideration	No changes in electricity tariffs	Regulator approved tariff reform, but shielding households with lower consumption levels from the increases	No changes in electricity tariffs	Regulator (ERC) increased electricity tariffs for households by 9.5%	No changes in electricity tariffs
Industrial consumers (served in the open market)	Directly hit by price increases	No changes in electricity tariffs	Directly hit by the price increases	No changes in electricity tariffs	Directly hit by price increases	Directly hit by price increases

Note: DSO = distribution network operators; TSO = transmission system operators.

Still, domestically, the increase in the cost of production has not been compensated by matching tariff increases and a sector-wide loss of EUR 50 million is forecasted.

Residential consumers have been protected to some extent from the increase in wholesale electricity prices, but pressure for tariff adjustments in this segment is rising. Table 10.1 shows that regulated electricity tariffs for households have been kept mostly unchanged, though in some countries, regulators have approved special tariff adjustments or are planning to do so. In North Macedonia, at the

end of 2021, the regulator (ERC) increased household electricity prices by 9.5 percent. In February 2022, the Kosovar energy regulator (ERO) adopted a tariff reform that increased residential tariffs for electricity consumed above 800 kWh/month by about 80 to 100 percent (depending on the time of use), while tariffs for consumption levels below 800 kWh/month remained unchanged.⁵⁹ In Montenegro, the retail electricity market is deregulated for households and small commercial consumers, but specific provisions in its energy law limit the potential increase in tariffs for these categories to 6 percent until the end of 2022, due to the

59 ERO, "Consultation Report on the Review of the Tariff Structure for Regulated Household Customers Supplied by USS" (January 17, 2022); Press review.

lack of competition in the market. However, tariffs have remained unchanged since 2019.⁶⁰

The persistently high electricity prices on wholesale markets and the additional uncertainty related to the war in Ukraine are putting increasing pressure on regulators in the regions to allow tariff adjustments to pass at least a share of the higher costs on to residential consumers. If and when that happens, households in the Western Balkans would feel an impact on energy affordability since they already spend a high share of household expenditure on energy (Figure 10.3). The poor may be particularly hurt, given the limited room for them to immediately adjust consumption and fuel sources. For example, a previous simulation analysis for Serbia suggests that an electricity tariff increase by 16.3 percent can lead to an increase in the household budget share for electricity by 0.5 percentage points and an increase in the overall poverty rate by 1 percentage point. Previous analysis for North Macedonia suggests that poverty could go up by 1.4 percentage points if electricity tariffs increase by 10 percent. Previous simulation analyses for a potential increase in the electricity tariff by 24 percent in Albania and 25 percent in Kosovo suggest that the household budget share devoted to electricity will increase by 1.1 and 1.3 percentage points for the poorest quintile, respectively.⁶¹

Industrial consumers are served in the open market in all WB6 countries, so they are being directly hit by the price increases.

Non-residential consumers in net importing countries (Albania, Kosovo, North Macedonia, and, exceptionally in the last months, Serbia) are the ones facing the highest increases in their electricity bills, especially when they have to renew their supply contracts. In Kosovo, several industrial customers have reported delays in payments, while one (the largest industrial consumer) has temporarily ceased activity.⁶²

Natural Gas

North Macedonia is feeling the greatest impacts of natural gas price increases. Combined heat and power and district heating plants in the Skopje area account for most of the gas consumed in the country and are currently facing steep cost increases (Table 10.2). At the end of 2021, ERC, the energy regulator, approved an increase in district heating tariffs of 14 percent. While further increases are not confirmed, tariffs for both household and industrial consumers are likely to increase significantly in the coming months to reflect the higher gas import prices (end-user gas prices are deregulated for all consumers in North Macedonia, and as of March 1, 2022, the imported gas price increased by about four times). Serbia has been only partially affected by the skyrocketing wholesale natural gas prices since most of its imports come from Russia through a long-term contract between Srbijagas and Gazprom. While the details of the supply contract are not public, in November 2021, Serbia and Russia agreed to maintain the

60 Energy Community, “Impact of the Electricity Price Surge in Energy Community Contracting Parties and Measures Undertaken” (December 2021).

61 World Bank (2016). “Serbia First Public Expenditure and Public Utilities Development Policy Loan”; World Bank (2019). “North Macedonia: Energy Affordability”; World Bank (2017). “Poverty and Distributional Impact of Electricity Tariff Reform on Vulnerable Households in Albania,” unpublished presentation; World Bank (2019). “Poverty and Distributional Analysis of Electricity Poverty and Protection of Vulnerable Customers in Kosovo,” unpublished report.

62 Energy Community, “Impact of the Electricity Price Surge in Energy Community Contracting Parties and Measures Undertaken” (December 2021).

natural gas price unchanged throughout the heating season.⁶³ Serbia expects to sign a new 10-year gas supply arrangement with Russia by mid-2022.⁶⁴ However, partial exposure exists already: the share of imports through the long-term contract with Russia has decreased over the last few years, from 80 to 85 percent of gross natural gas consumption in 2015–16, to 75 percent in 2019 and 55 percent in 2020. This decrease has been offset by an increase in gas purchases on the regional wholesale natural gas markets, whose share has increased from zero percent in 2015–16 to 19 percent in 2019

and 30 percent in 2020.⁶⁵ While more recent official data are not yet available, this trend seems to have continued in 2021 and into 2022, exposing Srbijagas to significant losses in recent months due to the exceptionally high wholesale natural gas prices.

In addition to wholesale natural gas and electricity prices, the prices of other energy products (especially coal and oil) are also rising on the regional wholesale markets. The impact of international coal price increases in WB6 countries is minimal, due to the almost

Table 10.2. Assessment of the impacts of direct natural gas price increases in WB6 countries on sector stakeholders

Impact by Stakeholder	Albania	Bosnia and Herzegovina	Kosovo	Montenegro	North Macedonia	Serbia
Utilities and Network Operators	Limited impact	Significant impact in selected areas with a higher reliance on gas (e.g., Sarajevo, where gas prices went up 37% in Q1 2022)			Significant cost increase for district heating and combined heat and power plants relying on natural gas	Utility incurring losses when buying gas on the wholesale market. Potential contractual price increase for imports after June 2022
Household consumers (incl. small commercial consumers)			No reliance on natural gas	No reliance on natural gas	Regulator increased district heating tariffs by 14%. Gas tariffs for HHs are deregulated and likely to increase significantly	Regulated tariffs have so far remained unchanged
Industrial consumers (served in the open market)					Gas tariffs likely to increase significantly	Limited impact so far. Potential price increase after June 2022

63 According to the latest statement by the Director of Srbijagas, Dusan Bajatović, Serbia will import Russian gas at US\$270 per 1,000 m³ until June 1, 2022.

64 Politika, <https://www.politika.rs/scc/clanak/500961/Bajatovic-Ako-bi-neko-sad-zavrnuo-slavinu-imamo-rezerve-gasa-za-60-dana> (accessed on March 3, 2022).

65 AERS, Annual Reports.

perfect balance between domestic production and consumption. Increases in the prices of crude oil and refined products, however, have a significant impact on the economy, since they cause cost increases for transport, agriculture, manufacturing, and other sectors, pushing up the price of consumer goods and inflation.

Policy Responses by Some Governments are Substantial

The governments of WB6 countries have taken action to mitigate the impact of the energy price hikes, but to different extents, depending on the specific country's situation. For example, while Albania, Kosovo, and North Macedonia have declared a state of emergency, the governments of Bosnia and Herzegovina and its federal entities have undertaken very limited measures so far. The measures adopted by the governments of the WB6 countries in the context of the current energy crisis fall into three main categories: (i) measures to provide financial support to the power sector; (ii) measures to mitigate the impact of energy price increases on consumers, especially the most vulnerable ones, and firms; and (iii) measures to reduce energy demand.

Several governments (for example in Albania, Kosovo, North Macedonia, and Serbia) have provided financial support to the energy sector. In October 2021, the government of Albania established a EUR 100 million fund (corresponding to 0.7 percent of GDP) to provide liquidity and guarantees to the DSO

OSHEE until the end of the year, with a plan to increase the fund by an additional EUR 100 million in 2022.⁶⁶ In November 2021, the government of North Macedonia approved the injection of EUR 65 million into energy companies, mainly the generation company ESM and the TSO MEPSO, to increase their liquidity and subsidize increasing costs. At the end of 2021, total budget transfers to the power sector already amounted to EUR 86 million (0.7 percent of GDP), and in February 2022 the government of North Macedonia estimated that an additional EUR 193 million (1.5 percent of GDP) would be needed in 2022.⁶⁷ Furthermore, the government took over the heating provider until the end of the heating season via the state-owned electricity producing company ESM. It also covered the cost between the current and actual heating prices. In December 2021, the government of Kosovo provided a EUR 20 million direct subsidy to the state-owned generation company KEK and returned the EUR 20 million in dividends announced at the beginning of the year by the TSO KOSTT. In February 2022, the government of Kosovo committed to allocating EUR 100 million (about 1.3 percent of GDP) to subsidize electricity import costs and reduce the tariff increases proposed by the regulator.⁶⁸ In Serbia, the government provided cash subsidies (in December 2021 totaling 0.5 percent of GDP) and extended lending to the natural gas import and distribution company Srbijagas (in January 2022 in the amount of 0.4 percent of GDP). In addition, the authorities extended state guarantees for loans to Srbijagas from commercial banks,

66 Balkan Green Energy News, <https://balkangreenenergynews.com/albania-declares-energy-emergency-as-response-to-energy-crisis/> (accessed March 7, 2022).

67 Ministry of Finance, Republic of North Macedonia, "Economic and Fiscal Implications of the Energy Crisis on the Economy of North Macedonia (2021–2022)" (February 2022).

68 The regulator, ERO, had initially proposed an increase in residential electricity tariffs of 9 percent up to 600 kWh/month and more than 200 percent above 600 kWh/month. The government offered subsidies to keep tariffs unchanged up to 800 kWh/month and increase them by 80–100 percent above 800 kWh/month.

totaling up to EUR 200 million (about 0.4 percent of GDP).

Governments have also adopted measures to address affordability concerns and mitigate the impact of the energy price increases on the most vulnerable consumers.

The government of North Macedonia, for example, has taken action to reduce taxes on electricity, expand social assistance programs, and offer subsidized credit lines to companies. In July 2021, the government reduced the VAT rate on electricity from 18 percent to 5 percent, and plans to increase it to 10 percent by the end of 2022 and back to 18 percent in July 2023.⁶⁹ The government also expanded the coverage of financial support for energy expenditures offered to vulnerable households and beneficiaries of social pensions (with an expected cost of EUR 5 million in 2022 compared to EUR 4 million in 2021). In addition, the Ministry of Economy allocated EUR 1 million for 2022 for an Energy Poverty Program.⁷⁰ The government of North Macedonia is also directly supporting companies through liquidity loans and through loans for energy efficiency through the Macedonian Development Bank. In Montenegro, in 2021, the government approved a temporary increase in the coverage and subsidy amounts of the bill discount program, with a total cost of EUR 3 million provided by the state-owned power utility. The government later approved the extension of the special subsidy program throughout 2022. In January 2022, the Government of Serbia reissued a recommendation to the state-owned power utility EPS (originally introduced in November 2021) to cap the price

for companies at EUR75 per MWh (excluding the VAT) through June 2022. In addition, the government is working on a revised Decree on Energy Vulnerable Consumers that will expand the coverage of the energy benefits, leading to an estimated increase in the number of beneficiary households from about 62,000 to 200,000.⁷¹ Meanwhile, in February 2022, the authorities in Kosovo provided direct subsidies for electricity imports introduced to mitigate the tariff increase on households and firms. Specifically, prices of household consumption under 800 MWh and commercial consumption were kept unchanged, and prices for household consumption above 800 MWh increased at a lower rate than import prices. For these measures, the government has committed EUR 90 million (or 1.2 percent of GDP) in the budget.

To reduce the impact of the high prices of energy imports, some governments have also adopted measures aimed at reducing electricity demand in the short term.

For example, in order to reduce electricity demand, the government of Kosovo has adopted a set of measures including: (i) the launch of an awareness-raising campaign to promote energy savings, (ii) the reintroduction of block tariffs to discourage the use of electricity for heating, and (iii) a ban on cryptocurrency mining. In addition, in December 2021, Kosovo was forced to briefly resort to power rationing, also due to a drop in domestic generation: the distribution company KEDS introduced power outages of two hours' duration every day for a few days to curb electricity demand.⁷²

69 The expected cost is EUR17 million in 2021, EUR31 million in 2022, and EUR11 million in 2023.

70 Ministry of Finance, Republic of North Macedonia, "Economic and Fiscal Implications of the Energy Crisis on the Economy of North Macedonia (2021–2022)" (February 2022).

71 Balkan Green Energy News, <https://balkangreenenergynews.com/ts/manji-racuni-za-struju-gas-i-grejanje-za-200-hiljada-domacinstava-u-srbiji/>.

72 Reuters, <https://www.reuters.com/markets/commodities/kosovo-introduces-power-cuts-due-energy-crisis-2021-12-22/>.

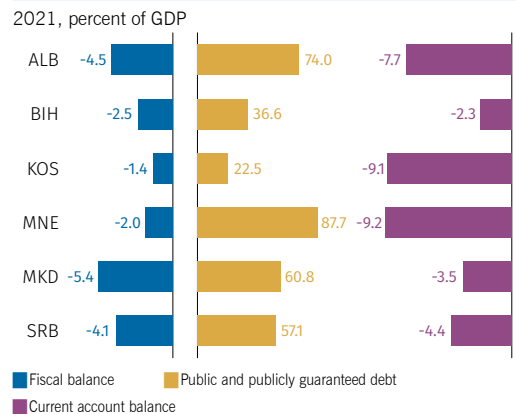
Government Support Further Narrowed Fiscal Space in Some Countries

Governments across the Western Balkans have implemented a variety of measures with respect to oil, electricity, and gas price hikes, in addition to food price hikes. The support packages range from 0.2 percent of GDP in Montenegro to 4.9 percent of GDP in North Macedonia. To cushion the impact of rising energy prices, authorities have implemented measures on the supply and demand side.

- On the supply side**, policies have taken the form of fuel subsidies to farmers and public transport companies, price controls of oil products, cuts in VAT rates on energy products, and cuts in excises on oil derivatives. In Albania, tax expenditures on farmers' fuel consumption have been extended, while in the Federation of Bosnia and Herzegovina farmers will receive 1.4 million liters of diesel fuel (50 liters per hectare) from existing stocks of commodity reserves at subsidized rates, together with other agricultural subsidies. Agricultural subsidies also feature prominently in Montenegro. Meanwhile, in Kosovo, agricultural diesel fuel is subsidized per acre planted, together with subsidies for wheat, corn, and potato fertilizers. In Albania, public transport companies received subsidies to prevent a sizable price hike in bus fares. In Bosnia and Herzegovina, the governments in both entities limited retail and wholesale margins on oil and other products, while North Macedonia cut the VAT and excises on electricity, gas, and oil derivatives. In Kosovo, profit margins on diesel fuel were temporarily frozen, whereas in Serbia a maximum fuel price has been introduced and is adjusted monthly.

- On the demand side**, measures largely focused on supporting pensioners and other vulnerable groups, firms, and energy efficiency and installation of solar rooftops (in North Macedonia for example). Across the region, authorities increased the minimum wage and pensions.

Figure 10.4. Key macroeconomic indicators for WB6 countries



Source: MOF, Central banks, World Bank staff estimates.

A few Western Balkan countries have limited fiscal space and will need to revise their fiscal plans to accommodate the energy crisis support. Two years into the extraordinary pandemic shock, the size of the new supply- and demand-side measures builds on already large fiscal deficits in 2021 in some countries. Three countries stand out—Albania, Montenegro, and North Macedonia—and are expected to run a fiscal shortfall of over 5 percent of GDP in 2022, adding to the elevated debt levels.

Policy Options to Mitigate the Impact of the Crisis and Build Resilience

Reviewing the measures implemented by the governments of the WB6 countries over the past few months, the policy options

available to governments in the context of the energy crisis are twofold. There are short-term mitigation measures governments can take immediately to ensure energy affordability for vulnerable consumers and address the negative effects of energy price hikes on energy-intensive industries. There are also medium- to long-term actions that can build resilience against energy price fluctuations while reducing dependence on fossil fuels. While the urgency for governments to act in the face of increasing energy prices is understandable, the efficacy, efficiency, and sustainability of different measures vary and should be considered when adopting mitigating measures.

Short-term measures that governments have adopted or could adopt to mitigate the impacts of the energy crisis in the short term include:

- *Promoting energy conservation and accelerating energy efficiency measures* for both heating and electricity demand through awareness campaigns and financial incentives;
- *Providing targeted social protection* (e.g., emergency income support, cash transfers) to vulnerable consumers;
- *Implementing liquidity programs* through public banks to support SMEs and critical industries (or extend and expand existing ones);
- *Introducing temporary tax breaks, price caps, or discounts/deferrals on utility bills* for vulnerable households and industrial customers;
- *Stepping up market surveillance* to ensure the transparency and integrity of the energy markets' functioning.

Among the short-term measures that have a significant fiscal impact, governments should prioritize the ones aiming at expanding targeted social protection for vulnerable consumers, which have proven to be more cost-effective and avoid distortionary effects.

On the other hand, measures that shield consumers from the energy price increases by keeping prices artificially lower than market prices or true costs (e.g., caps on energy prices or generalized tax breaks) have several drawbacks that governments should be aware of, including (i) they put significant strain on the financial viability of the utilities and the fiscal budget; (ii) they tend to be regressive, benefitting the wealthy who consume more energy than others; and (iii) they cause distortions in consumption and the overall economy, disincentivizing investments in energy efficiency and clean energy, prolonging the vulnerability of economies to future price shocks. For these reasons, when they cannot be avoided, these measures should at least be designed in a way to be time-bound, fully budgeted, and transparent.

In the medium to long term, to build resilience against future energy price shocks, the governments of WB6 countries could adopt measures aimed at:

- *Improving energy security*, such as (i) diversifying the sources of natural gas imports and the supply routes involved; (ii) expanding investments in energy storage capacity (including natural gas storage capacity, pumped hydro storage, battery energy storage systems); and (iii) designing and implementing hydropower risk mitigation strategies to reduce risks of supply disruption related to climate change;

- *Fostering regional integration and cooperation*, such as (i) signing bilateral agreements with neighboring countries to share gas reserves and promote electricity trade; and (ii) accelerating the creation of regional energy markets in the Western Balkans or coupling existing markets to take advantage of complementary firm and intermittent energy sources;
- *Reducing domestic energy demand*, by scaling up investments in energy efficiency (which should be viewed as the “first fuel of choice”), continuing efforts in the public sector and introducing new initiatives to incentivize energy efficiency in the residential sector;
- *Diversifying the energy supply mix*, by (i) scaling up investments in renewable energy (including bioenergy) and battery energy storage, and tapping the potential of decentralized renewables (e.g., the installation of roof-top solar PV on residential and commercial buildings), (ii) further transitioning from feed-in tariffs to auction systems to harness global competition and unlock lower-cost supply options, and (iii) exploring the potential for investments in new technologies such as green hydrogen and biomethane;
- *Improving energy sector performance*, by promoting sector reforms and enhancing the operational efficiency and financial sustainability of utilities and service providers;
- *Protecting the most vulnerable*, by ensuring that assistance programs are in place to support vulnerable consumers at risk of energy poverty.

Across Europe and the whole world, there are signs that in the short and medium term, the current energy crisis might slow down the green energy transition.

The crisis has prompted governments to take emergency actions to ensure the security and affordability of energy supply. However, in several cases, these measures reverse previous policy decisions and hamper efforts related to the green energy transition. Among these emergency measures, two that may have a significant impact on slowing the green energy transition are the short-term return to coal and the delay of coal phase-out plans, which several governments across Europe (including Germany, the UK, and Italy) are now resorting to. This trend can be seen in the Western Balkans as well, where some countries are either considering postponing their coal phase-outs (e.g., in North Macedonia) or might feel affirmed in their opposition to set clear timelines for abandoning coal (e.g., in Bosnia and Herzegovina and Serbia). In December 2021, the government of North Macedonia launched negotiations to buy 3 million tons of lignite from Kosovo to feed its coal power plants and restarted the Negotino fuel oil-fired power plant, which had been dormant for twelve years.⁷³ More recently, the government has decided to delay the coal phase-out deadline from 2027 to 2030.⁷⁴ In Bosnia and Herzegovina, the government of the Federation of Bosnia and Herzegovina has decided to extend the operations of two units in the Tuzla and Kakanj coal plants, citing the

73 Reuters, <https://www.reuters.com/markets/commodities/north-macedonia-eyes-3-million-tons-kosovo-coal-2021-12-10/>. SeeNews, <https://seenews.com/news/n-macedonia-starts-up-tec-negotino-power-plant-report-765898>.

74 Balkan Green Energy News, <https://balkangreenenergynews.com/north-macedonia-delays-coal-exit-deadline-to-2030/>.

need to limit the increase in electricity prices and preserve the stability of the power system.⁷⁵ In January 2022, Albania's state-owned generation company KESH issued a call for expression of interest for a contractor that would deploy and operate a thermal power plant (TPP) with an installed capacity of 110-130 MW near the Vlora TPP, in order to guarantee the security of the power supply.⁷⁶

In addition, the energy crisis could make Western Balkan governments reluctant to proceed with introducing some form of carbon pricing as a means to account for the environmental cost of fossil fuels and to set clear incentives to decarbonize and spur innovation, productivity growth, and diversification through the deployment of renewable energy and energy efficiency. However, this could perpetuate a condition (common in Western Balkan countries) in which low domestic energy prices (especially for coal and electricity) reduce the incentives to improve energy efficiency and sector performance, and countries are exposed to greater risks associated with future energy price volatility because of the high energy intensity of their economies.

Looking at longer-term trends, coal generation is becoming increasingly hard to defend even in the coal-rich WB6 countries, due to growing concerns about the environment and air pollution, external pressure (including the EU Carbon Border Adjustment Mechanism), as well as analytical evidence showing that renewable energy is becoming (or already is) the least-cost generation option. Moreover, utilities

face disproportionately higher risks related to climate change. In Serbia, for example, lignite is mined in open-cast operations surrounded by hills that shed large quantities of floodwaters into the mines. In the case of another catastrophic flood, similar to the one that occurred in 2014, the national utility EPS will likely suffer dire consequences.

To make the transition away from coal possible, WB6 countries should first carry out comprehensive pre-closure activities. These activities include: (i) diversifying the economies around the mines, (ii) planning for potential labor redundancies with workers and communities, (iii) performing the environmental remediation of a vast acreage of land, and (iv) crowding in new investments through the repurposing of land and infrastructure assets on already abandoned mines. All this should happen before transitioning away from coal production.

At the same time, the energy crisis has strengthened the interest in clean energy sources and energy efficiency as a means of diversifying the supply mix and enhancing energy security. As signatories to the *Soňa Declaration on the Green Agenda for the Western Balkans*, aligned with the EU's Green Deal, WB6 countries have committed to working toward the 2050 target of a carbon-neutral continent together with the EU. In recent years, all WB6 countries have shown a commitment to stepping up efforts to address several challenges related to the decarbonization of the energy sector. All WB6 countries have taken action to strengthen their regulatory frameworks and set up financial mechanisms to support the

⁷⁵ Balkan Green Energy News, <https://balkangreenenergynews.com/government-of-fbih-intends-to-extend-operation-of-two-units-in-coal-power-plants-kakanj-tuzla/>.

⁷⁶ Euractiv, https://www.euractiv.com/section/politics/short_news/albania-seeks-to-restart-thermal-power-plant-amid-energy-crisis/.

deployment of utility-scale renewable energy, different forms of distributed clean generation such as rooftop solar photovoltaics (PV), and the adoption of sustainable heating systems and energy efficiency measures. Despite the current challenging context in the energy sector, there is hope that the scale-up of clean energy and energy efficiency will keep gaining momentum over the next years and decades.

Country Notes

Albania

- Growth in 2021 fully recovered from the recession caused by the pandemic. At preliminary 8.5 percent, growth turned out to be considerably stronger than anticipated due to policy stimulus and resumption of travel, construction, and extractives.
- At the same time, aligned with global developments, inflation has increased above the central bank's target.
- Due to a large nominal growth of GDP and a strong revenue performance, higher public spending was not translated into a higher debt-to-GDP ratio.
- Employment and labor force participation have yet to catch up with their pre-pandemic levels, notwithstanding the strong growth outcome.
- The short-term outlook deteriorated, and downside risks intensified. Uncertainty with regard to the war in Ukraine is affecting price stability and growth, which is expected to decelerate to 3.2 percent in 2022 if the acute phase of the crisis eases in Q2 2022.

Recent Economic Developments

In 2021, the recovery gained speed. Real GDP increased by 8.5 percent, fully recovering from the recession caused by the pandemic. Government spending and strong private demand led growth, stimulated by continued monetary and fiscal policy support. Domestic demand contributed 9.4 percentage points to growth, of which private consumption contributed 4.7 percentage points, as consumer confidence improved, uncertainty regarding the pandemic was reduced, and disposable income increased through higher wages and bank lending. Gross fixed capital formation added 4.8 percentage points to growth, through both higher public and private investments. While exports expanded by 61.8 percent in 2021, the contribution of net exports was negative due to the high import content of growth.

Growth in 2021 was broad-based. However, post-earthquake reconstruction, a strong recovery of tourism and extractives, and favorable hydrological conditions for energy production were key factors determining the

sectoral composition of growth. Construction contributed 1.9 percentage points to the growth, supported by reconstruction and government infrastructure spending. Of all sectors, agriculture had the least contribution, due to increases in production costs.

Growth has not brought employment to the precrisis level. There were 16,800 fewer employed people in 2021 than in 2019. All sectors except ICT, construction, transport, retail and wholesale, and utilities have reduced employment since 2019. At the same time, average labor force participation fell for the second consecutive year among all age groups. Wage pressures intensified: the formal real wage increased by 3.7 percent in 2021, close to the 2019 increase, while the minimum wage increased by 13.1 percent in real terms. The average unemployment rate remained stable at 11.5 percent in 2021.

Inflationary pressures have risen since late 2021. Consumer price inflation reached 3.7 percent in January 2022, led by wage pressure from the domestic demand expansion

and the hike in food, energy, transport, and commodity prices in world markets. Food prices increased by 6.8 percent year-on-year in December 2021, close to double the increase of the overall basket. This will hurt most households as food comprises over half of total consumption for the median household.

The central bank has increased the policy rate by 0.5 percentage points in March 2022, and announced further tightening in 2022.

The exchange rate remained stable over 2021 with a slight appreciation toward the end of the year. However, with the start of the war in Ukraine and the rapid increase in commodity and energy prices, there were some short-lived depreciation pressures for the domestic currency which, as of now, have faded away completely.

Credit to the private sector grew strongly during 2021 for both enterprises and households.

Credit to the private sector increased by 8.5 percent in nominal terms in 2021. Similarly, bank deposits continued to expand by 10.3 percent, with household savings forming around two-thirds of growth of total deposits in the system.

The current account deficit narrowed to 7.7 percent of GDP in 2021 from 8.5 percent of GDP in 2020.

The rebound in exports at 61.8 percent y/y was sizable after their decline in 2020, and led to a significant narrowing of the trade deficit by 1.1 percentage points of GDP. The services account (at 11.5 percent of GDP) and remittances (at 4.9 percent of GDP) helped narrow the current account deficit in 2021. Net foreign direct investment increased in 2021 reaching 6.4 percent of GDP on the

back of investments into extractives, banking, and telecommunications. This, together with government borrowing, financed most of the current account deficit. The reserve coverage stands at 8.2 months of imports of goods and services.

The fiscal deficit has declined to 4.5 percent of GDP in 2021 due to strong revenues.

Fiscal revenues rose to 27 percent of GDP in 2021, in line with stronger economic activity and the abolishment of temporary tax relief measures that were put in place during 2020. The main contribution came through the VAT collected on imported goods. Higher fiscal revenue collection and new debt allowed the government to increase infrastructure spending. In addition, to ensure stable energy supply during the last quarter of the year, the government increased subsidies to the energy state-owned enterprises (SOEs) to cover increased energy import costs. Contingent liabilities from SOEs represent a source of risk for the budget as guarantees for the SOEs in the energy sector are expected to increase further as the international prices increase and there is no planned increase in tariffs for the regulated customers (households and small businesses).

Public debt declined in 2021 reaching 74 percent of GDP.¹

A Eurobond amounting to EUR 650 million was issued in November 2021 to pre-finance the gross financing needs in 2022. The rating for the country was confirmed at B1/stable by Moody's and B+/Stable by S&P at the start of 2022.

¹ Includes the stock of arrears to the private sector reported as per December 2021 in the amount of 15.4 billion lek.

Outlook and Risks

Economic growth is expected to decelerate to 3.2 percent in 2022 under the baseline scenario. This rests on the assumption that the acute phase of the crisis eases in Q2 2022 even if effects of sanctions persist through 2022 and even into 2023.

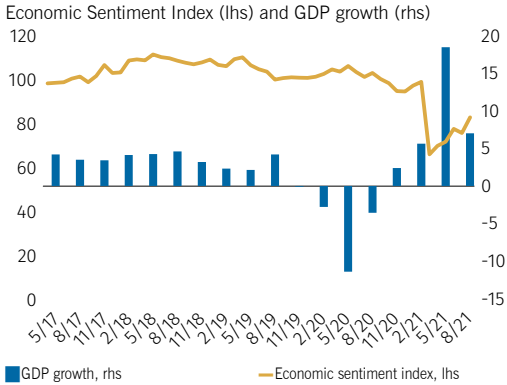
However, the war in Ukraine, if prolonged, could affect the Albanian economy through several channels. Higher commodity prices, in particular oil and grains, are expected to be the main transmission channel. In general, direct trade, remittance, and migration linkages with Russia and Ukraine are small, accounting for less than 3 percent of the total. However, Russia and Ukraine are key producers and exporters of several commodities which are of vital importance for Albanians including grains. Higher energy prices are expected to drive up prices in transport, and lead to second round effects in other goods of the consumption basket. Inflation is expected to increase to 5.5 percent in 2022 from a pre-conflict scenario of 3 percent. With higher import costs, the current account deficit is likely to grow to 7.9 percent of GDP. As higher costs reduce household purchasing power and raise the costs of businesses, growth prospects are also lower. If higher energy prices translate into higher electricity import prices, the shock could also deteriorate the financial situation of Albania's electricity SOEs. This could heighten fiscal risks from the energy SOEs.

The public debt is expected to stabilize at 73.9 percent of GDP in 2022, before declining gradually over the medium term. Fiscal space could further deteriorate in a downside scenario where prolonged war further decelerates EU growth and thereby lower

Albanian exports to key EU trading partners that account for 60 percent of its exports. In this case, the government may need to cut capital spending to prevent an increase of the debt-to-GDP ratio. Moreover, with more reliance on external financing, the exchange rate, interest rate, and refinancing risks remain elevated. A key medium-term reform priority is the need to boost revenue collection and achieve fiscal consolidation, while allowing for significant growth-enhancing spending.

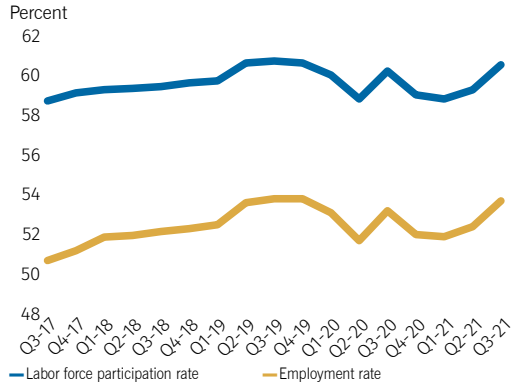
Over the medium term, growth is projected to accelerate to 3.5 percent. Private consumption is projected to return as the primary driver of GDP growth. Private investment could provide further support to growth if business climate reforms are implemented. The current account deficit is expected to narrow over the medium term, as service exports, including tourism and fast-expanding business process operations, are expected to grow in line with pre-pandemic trends.

The GDP recovered well in 2021, but the speed of recovery moderated toward year-end.



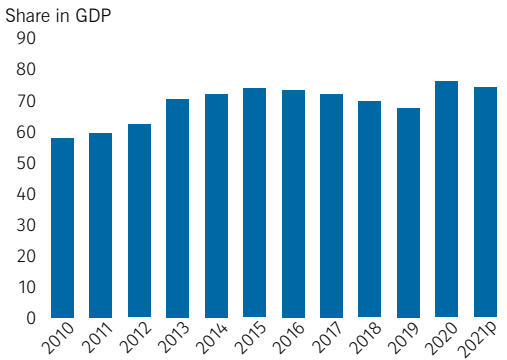
Source: INSTAT and Bank of Albania.

Despite higher growth, labor markets are yet to recover.



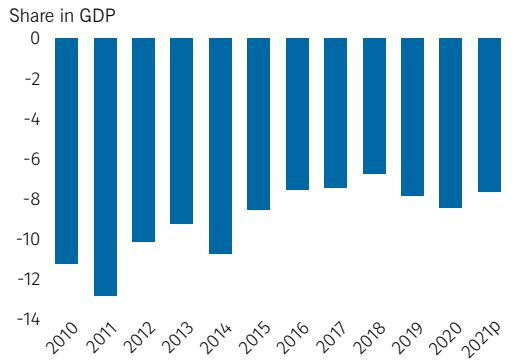
Sources: INSTAT.

The public debt decreased...



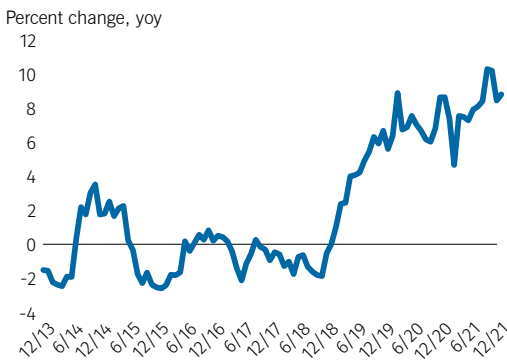
Source: Ministry of Finance.

...while the current account deficit narrowed.



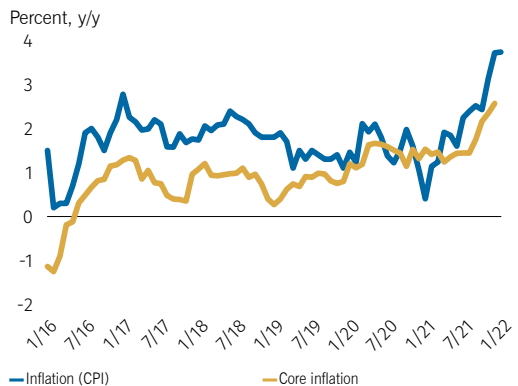
Source: Bank of Albania.

Credit to the economy has supported growth.



Source: Bank of Albania.

Headline and core inflation have accelerated since April.



Source: Bank of Albania.

ALBANIA	2019	2020	2021p	2022f	2023f	2024f
Real GDP growth (percent)	2.2	-3.5	8.5	3.2	3.5	3.5
Composition (percentage points):						
Consumption	2.5	-2.6	4.5	2.0	2.4	2.0
Investment	-0.9	-0.9	4.8	0.3	0.1	1.1
Net exports	0.6	0.0	-0.9	0.9	1.0	0.4
Exports	2.0	-9.4	11.5	1.5	2.4	2.1
Imports (-)	1.4	-9.3	12.4	0.6	1.4	1.7
Consumer price inflation (percent, period average)	1.4	1.6	2.6	5.5	4.0	3.0
Public revenues (percent of GDP)	27.2	25.9	27.0	27.1	27.2	27.3
Public expenditures (percent of GDP)	29.2	32.6	31.5	32.1	29.9	29.6
Of which:						
Wage bill (percent of GDP)	4.6	4.7	4.4	4.4	4.4	4.2
Social benefits (percent of GDP)	11.9	12.9	12.6	11.8	11.7	11.4
Capital expenditures (percent of GDP)	4.5	6.2	6.8	5.4	4.6	4.6
Fiscal balance (percent of GDP)	-1.9	-6.7	-4.5	-5.0	-2.6	-2.4
Primary fiscal balance (percent of GDP)	0.1	-4.6	-2.6	-2.5	-0.1	0.1
Public debt (percent of GDP)	63.7	74.0	72.1	72.0	70.2	69.0
Public and publicly guaranteed debt (percent of GDP)	67.4	75.9	74.0	73.9	72.1	70.9
Of which: External (percent of GDP)	29.1	35.9	37.8	37.0	37.0	37.0
Goods exports (percent of GDP)	6.6	6.0	8.2	6.8	6.7	6.7
Goods imports (percent of GDP)	29.7	28.4	33.0	30.2	29.8	29.5
Net services exports (percent of GDP)	9.3	8.1	11.5	11.3	12.6	13.3
Trade balance (percent of GDP)	-13.8	-14.4	-13.3	-12.1	-10.5	-9.5
Net remittance inflows (percent of GDP)	5.2	5.1	4.9	4.8	4.8	4.8
Current account balance (percent of GDP)	-8.0	-8.5	-7.7	-7.9	-6.4	-5.3
Net foreign direct investment inflows (percent of GDP)	7.6	6.7	6.4	6.4	6.3	6.3
External debt (percent of GDP)	60.0	65.6	58.1	56.7	57.0	56.9
Real private credit growth (percent, period average)	1.5	5.2	5.5	-	-	-
Nonperforming loans (percent of gross loans, end of period)	8.4	8.1	5.7	-	-	-
Unemployment rate (percent, period average)	11.5	11.7	11.5	-	-	-
Youth unemployment rate (percent, period average)	21.5	20.9	20.9	-	-	-
Labor force participation rate (percent, period average)	60.4	59.5	59.8	-	-	-
GDP per capita, PPP (current international \$)	15,393	14,888	17,245	18,369	19,487	20,576
Poverty rate (percent of population)	28.1	31.3	22.0	19.4	16.9	-

Sources: Country authorities, World Bank estimates and projections.

Note: Youth unemployment rate is for labor force aged 15–29. Statistical discrepancy contribution is divided at the ratio of 80 percent and 20 percent between Consumption and Investment respectively. Change in inventories is included in Investments. Poverty rate calculations based on ECAPOV harmonization using SILC-C data. Nowcasted/projected values start in 2020. Income measures in the SILC and consumption measures in the HBS are not strictly comparable. Poverty is defined as living on less than \$5.5/day per person in revised 2011 PPPs.

Bosnia and Herzegovina

- While political tensions stalled reforms, economic growth in 2021 reached 7.1 percent, outperforming expectations, after a short-lived recession the year before.
- Headline inflation, meanwhile, accelerated fueled by food and transport prices.
- Despite the surge in real growth, employment improved only marginally; unemployment remains elevated and is especially high among youths.
- Fiscal revenues benefited from the strong rebound in growth, but the fiscal stance recorded a deficit of roughly 2.5 percent of GDP.
- Under the baseline, real output growth is preliminary assessed at 2.7 percent in 2022 and is expected to increase over the medium term as the implementation of structural reforms slowly takes off; in the downside scenario of extended crisis, growth would decline further due to a dampening effect of lower business and consumer confidence, a slowdown in EU export demand, and more persistent inflation reducing disposable income.

Recent Economic Developments

Following a contraction in 2020 of 3.1 percent, the rebound in real GDP growth surprised on the upside in 2021. Economic growth accelerated to 7.1 percent (preliminary) largely driven by the low base from the previous year marked by the pandemic crisis. Nonetheless, this is an exceptional growth performance, which helped real GDP exceed the precrisis level. Real growth was driven by a surge in exports, and robust growth in private consumption. On the production side, wholesale and retail trade rebounded strongly from the large decline in activity seen in the second and third quarters of 2020, while real growth in manufacturing accelerated in response to higher export demand.

In tandem with growth, inflation accelerated. In 2021, headline inflation in Bosnia and Herzegovina rose to 2 percent compared to a deflation rate of 1.1 percent the year before and an inflation rate of 0.6 percent in 2019.

The consumer price index (CPI) soared to 6.3 percent in December (y/y), continuing upward inflationary pressures that started around mid-2021 due to strong consumer demand, global supply bottlenecks, and a high passthrough effect given the currency board arrangement. Food price inflation, meanwhile, skyrocketed to 10.8 percent in December (y/y) resulting in an annual food inflation rate of 3.7 percent in 2021, by far the highest rate since 2016. Vegetable prices rose over 40 percent and edible oils rose close to 30 percent (y/y) in December 2021. In parallel, transport prices accelerated to over 14 percent toward the end of 2021 as prices of diesel and super petrol grew just over 30 percent (y/y) in the fourth quarter of 2021, with spillover effects to other products bolstering inflationary pressures in early 2022.

The labor market improved, but the unemployment rate remains elevated. The unemployment rate fell from a 19.1 percent in Q1 2021 to 16.4 percent in Q3 2021, driven by a rise in demand for labor.² Job

² The methodology of the Labor Force Survey was changed in 2021, which somewhat distorts direct comparisons between 2021 and 2020 data.

gains in agriculture and construction drove up the employment rate to 40.4 percent in Q3 2021, which nevertheless remains at low levels compared to other Western Balkan countries. In parallel to the tightening of the labor market, net nominal salaries rose about 4.3 percent in 2021, yet the swift rise in consumer prices in the fourth quarter of 2021 has eaten into households' real incomes.

Buoyant indirect revenues and sluggish capital spending were insufficient to return the fiscal balance to a surplus in 2021, after the pandemic-induced deficit. The latest preliminary consolidated data indicate a 2.5 percent of GDP fiscal deficit in 2021, compared to a deficit of 1.8 percent in 2020.³ In 2021, revenues rose on the back of stronger collection of the VAT. Meanwhile, higher expenses on goods and wages, as well as social transfers, such as pensions and veteran benefits raised expenditures, while capital spending remained low. Implementation delays in public investments were triggered by difficulties in forming the government in the Federation (FBiH) and country-level BiH Institutions (IBiH). Specifically, both the BiH Fiscal Council and FBiH Parliament adopted with a significant delay the Global Fiscal Framework for 2022–24 and the FBiH budget, respectively. The budget for IBiH for 2022 has not yet been adopted, which means that IBiH is operating based on the temporary financing schedule, which limits the scope of spending. FBiH was operating under a temporary financing schedule in the first quarter of 2022. Total public debt remains moderate at around 34.4 percent of GDP at end-2021, and predominantly consists of loans from international financial institutions.

The sharp rise in exports narrowed the traditionally large, structural merchandise deficit, and helped narrow the current account deficit (CAD). The CAD narrowed from 3.9 percent in 2020 to a preliminary 2.3 percent in 2021 as the merchandise trade deficit narrowed, while the services surplus widened compared to the year before. The sharp rise in exports benefited from strong demand and a rise in terms of trade for base metals (steel, iron, and aluminum), mineral and wood products, machinery, and furniture. Meanwhile, stronger tourism receipts and remittances helped finance the trade deficit. Close to 80 percent of the CAD is expected to be financed by net direct investments, while the total external debt-to-GDP ratio is projected to remain below 66 percent in 2021.

Except for one bank, the banking sector is liquid and well-capitalized. The market share of the Russian-owned Sberbank in BiH, that came under pressure following the introduction of sanctions against Russia, is 6.8 percent (in FBiH 6.3 percent and in the Republika Srpska 11.7 percent). Recently imposed sanctions entail, among others, the removal of selected Russian banks, from the SWIFT messaging system, disconnecting them from the international financial system and limiting their ability to operate globally. In light of resulting liquidity difficulties, on March 1, ASA Finance Group (ASA Bank) bought Sberbank in FBiH, and a day later Nova Banka bought Sberbank in Republika Srpska. Thus, potential risks for the financial sector stemming from difficulties with Sberbank have been rapidly contained. The banking system is well equipped to cope with the shock as the systemwide nonperforming loan ratio has declined to 5.5 percent of total

³ See global fiscal framework for 2022–24, BiH Ministry of Finance and Treasury.

loans in 2021Q3, and profitability improved with a return on equity of 11.5 percent, up from 6 percent at the end of 2020. The capital-to-asset ratio remained unchanged, while capital buffers are within regulatory requirements.

Outlook and Risks

Real GDP is projected to decelerate to 2.7 percent in 2022, and average below 3.5 percent over the medium term. According to the baseline scenario, which considers a contained war in Ukraine, BiH will not catch up with the pre-pandemic growth trajectory over the medium term. Output growth is expected to be driven by investment and a more moderate rise in exports, which in turn are likely to be more than offset by imports as infrastructure projects ensue. Announced investments in energy and infrastructure are envisaged to lead the recovery phase together with a further pickup in private consumption fueled by remittances, a tightening labor market, and domestic lending. As the impact of the pandemic and hostilities in Ukraine subside, the political paralysis in BiH is expected to be overcome in the post-election period. Thus, the Socio-Economic Program,⁴ fulfilling priorities for EU accession, is assumed to gain needed attention by end of 2022, accompanied by much-needed structural reforms.

With the global energy market disrupted over the short term under a scenario of contained war in Ukraine, inflationary pressures are assumed to subside in the second half of 2022, leaving inflation around 6.5 percent. Energy and food prices may destabilize over the next few months due to the war in Ukraine,

and therefore inflationary pressures may persist longer than previously anticipated.

The fiscal deficit in 2022 is expected to be driven by capital and pre-election spending, and a return to surplus is envisaged in 2023.

Without access to international markets, the authorities will continue relying on support from international financial institutions. The extent of this financial support will depend on internal political developments and the de-escalation of tensions, which have risen significantly over the past 10 months.

A downside scenario entails a more extended war in Ukraine, which could reduce real output growth in 2022 by 0.2 percentage points to 0.4 percentage points.

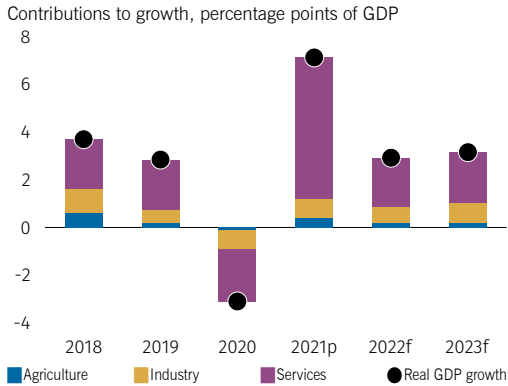
An extended crisis would have a negative impact on aggregate demand through lower business and consumer confidence in BiH and slower growth in the EU. The latter would have adverse spill-over effects for BiH's export demand. At the same time, however, price and volume effects for BiH's exports of iron and steel products and aluminium, which accounted for almost 15 percent of total exports in 2021, could help meet the shortages in the world market created by the hostilities in Ukraine, and in part offset the negative effects of a slowdown in EU growth. Slower growth in the EU would likely also slow remittances, with negative consequences for household incomes, thus dampening consumption in BiH over the medium term. In addition, the rise in main commodity prices traded internationally, such as wheat, oil, and natural gas, could prolong inflationary pressures in the EU, thus impacting inflation in BiH due to the currency board arrangement. As a result, inflation could remain elevated throughout

⁴ The country's medium-term development plan adopted in January 2020 to tackle key structural reforms and respond to EU accession priorities

the year, totalling 10 percent compared to the baseline of 6.5 percent, further slowing private consumption as real disposable income declines.

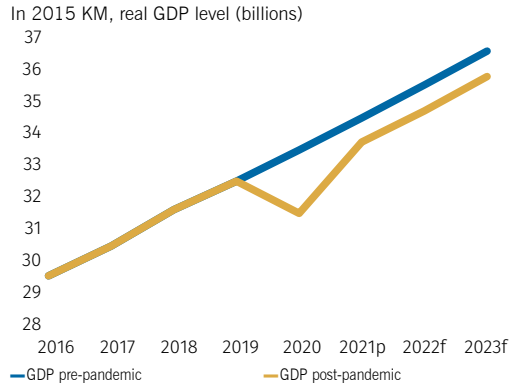
Beside the risks associated with the war in Ukraine, two other risk factors continue to dominate the BiH outlook. First, a prolonged impact of the pandemic as the virus continues mutating could adversely affect economic activity, and second, the existing political frictions could aggravate post-election difficulties in forming governments. Political frictions could even further intensify if geopolitical tensions shift to the Western Balkans. This would result in a more sustained detrimental impact on the implementation of structural reforms needed for EU accession.

GDP growth expanded in 2021.



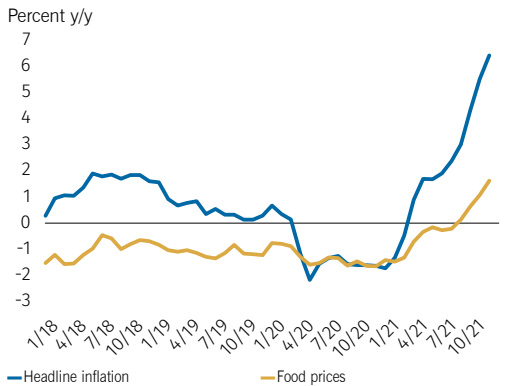
Sources: BiH Agency for Statistics; World Bank.

Post-crisis growth trajectory unlikely to close gap with respect to precrisis growth path.



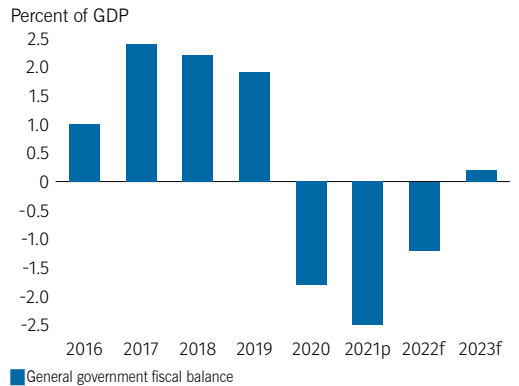
Source: World Bank staff estimates.

Consumer price and food inflation accelerated in 2021.



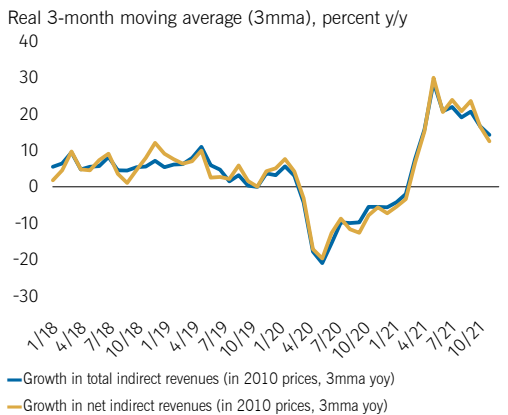
Sources: BiH Agency for Statistics; World Bank.

The fiscal balance remained in deficit in 2021.



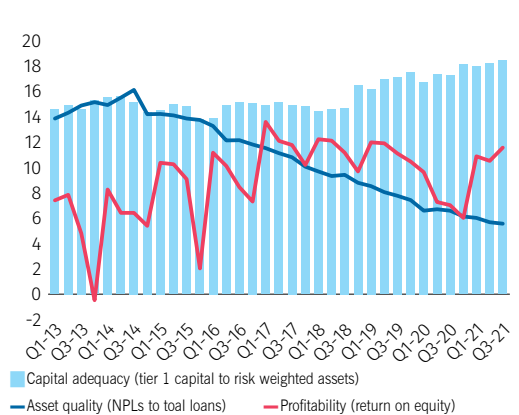
Sources: BiH fiscal authorities; World Bank staff estimates.

Indirect tax revenues continue to increase with slight slowdown toward end-2021.



Sources: BiH Indirect Tax Office; World Bank.

Nonperforming loans in commercial bank portfolios remain high.



Sources: Central Bank of BiH; World Bank calculations.

BOSNIA AND HERZEGOVINA	2019	2020	2021p	2022f	2023f	2024f
Real GDP growth (percent)	2.8	-3.1	7.1	2.7	3.1	3.5
Composition (percentage points):						
Consumption	-	-	4.9	2.4	2.8	3.1
Investment	-	-	1.0	-0.3	0.7	0.5
Net exports	-	-	1.2	0.6	-0.3	-0.1
Exports	-	-	14.2	3.8	3.2	3.8
Imports (-)	-	-	13.0	3.1	3.5	3.9
Consumer price inflation (percent, period average)	0.6	-1.1	2.0	6.5	2.3	0.5
Public revenues (percent of GDP)	42.6	42.2	42.3	40.5	40.4	40.5
Public expenditures (percent of GDP)	40.6	44.0	44.8	41.7	40.2	39.4
Of which:						
Wage bill (percent of GDP)	10.6	11.5	11.2	10.7	10.3	10.2
Social benefits (percent of GDP)	14.8	20.0	19.8	18.2	17.9	17.7
Capital expenditures (percent of GDP)	2.9	3.2	3.7	3.5	3.0	2.7
Fiscal balance (percent of GDP)	1.9	-1.8	-2.5	-1.2	0.2	1.1
Primary fiscal balance (percent of GDP)	2.6	-1.1	-1.7	-0.4	1.1	2.1
Public debt (percent of GDP)	32.8	36.6	34.4	33.2	34.0	35.3
Public and publicly guaranteed debt (percent of GDP)	34.5	38.8	36.6	35.1	36.0	37.5
Of which: External (percent of GDP)	28.4	30.8	28.8	27.4	27.8	28.4
Goods exports (percent of GDP)	28.8	27.5	34.1	34.1	34.5	36.2
Goods imports (percent of GDP)	51.4	45.9	53.3	54.6	54.9	57.2
Net services exports (percent of GDP)	7.9	4.4	6.9	7.6	7.8	8.4
Trade balance (percent of GDP)	-14.7	-14.0	-12.3	-12.8	-12.5	-12.6
Net remittance inflows (percent of GDP)	8.5	7.4	8.2	7.7	7.4	7.6
Current account balance (percent of GDP)	-2.9	-3.9	-2.3	-3.2	-3.0	-2.6
Net foreign direct investment inflows (percent of GDP)	1.5	1.7	2.1	2.0	1.9	2.0
External debt (percent of GDP)	65.6	70.7	65.4	60.3	58.1	58.7
Real private credit growth (percent, period average)	5.2	1.3	-0.3	-	-	-
Nonperforming loans (percent of gross loans, end of period)	7.4	6.1	5.8	-	-	-
Unemployment rate (percent, period average)	15.7	15.9	17.4	-	-	-
Youth unemployment rate (percent, period average)	33.8	36.6	38.2	-	-	-
Labor force participation rate (percent, period average)	42.1	47.7	48.0	-	-	-
GDP per capita, PPP (current international \$)	13,775	13,424	14,110	14,710	15,260	15,800

Sources: Country authorities, World Bank estimates and projections.

Kosovo

- Kosovo's economy experienced a full recovery in 2021, supported by private consumption and record export growth.
- Inflation intensified by the second half of 2021, driven by record increases in import prices.
- Against a strong rebound in revenue, the fiscal balance improved and public debt growth decelerated.
- Recent external challenges have significantly increased inflationary risks to the short-term outlook, with growth expected to decelerate in 2022 due to the spillover effects from the war in Ukraine.

Recent Economic Developments

Kosovo's economy experienced a stronger-than-expected recovery in 2021. Real output grew⁵ by a record 12.1 percent for the first three quarters of 2021, driven by strong domestic and external demand. Economic growth for the year stood at preliminary 9.1 percent. From the second quarter of 2021, an accelerated vaccination rollout has taken place, which helped remove mobility restrictions and bolstered economic activity. The ongoing energy crisis reached Kosovo in late 2021, however, bringing nickel exports to a halt and highlighting the country's vulnerability from outdated energy production capacity and high import prices.

Consumption and export growth led the recovery. Private consumption grew robustly, supported by restored consumer confidence and relaxed mobility restrictions, double-digit credit expansion, higher remittances, and significant fiscal stimuli. Private investment also added to growth, spurred in part by credit expansion but also higher real estate FDI inflows. A very high contribution from a strong rebound in diaspora-related exports of travel services and a record increase in goods exports was offset by an equally substantial increase in imports.

On the production side, services provided the highest contribution, reflecting the increase in consumption and service exports. Industrial activity also added to growth driven, in part, by higher investment in response to stronger export demand. Agriculture, in contrast, subtracted from growth on account of higher input prices and worse weather conditions.

Labor formalization advanced, but information on labor market outcomes in 2021 remains limited. Official employment in the private and public sectors rose close to 10 percent, on average, in 2021, compared to the year before, according to the Kosovo Tax Administration. At the same time, registered jobseekers dropped by almost a third in 2021 compared to the year before, but their level still remains 10 percent higher than in 2019. The latest available Labor Force Survey data of Q1 2021 show that less than a third of working-age (15–65) Kosovars were working. This was, however, before the recovery was in full swing.

Heightened inflationary pressures accompanied the recovery. Consumer price inflation, driven primarily by higher import prices, surged to 3.4 percent in 2021, from 0.2 percent a year ago. Consumer prices started increasing by more than 2 percent from July

5 All comparisons are year on year unless otherwise indicated.

2021, peaking at above 6 percent in December and rising to 7.5 percent in February 2022. Food and transport prices in February increased by 10.5 and 22.6 percent, respectively. Averaging 11.1 percent, import price inflation intensified from the second quarter of the year onward, reaching 14.7 percent and 19.7 percent during the third and fourth quarter of the year, respectively. The increase in the fourth quarter was driven by higher international prices for commodities and manufactured goods. In response, production, construction, and agricultural input prices recorded increases throughout the year.

Export growth experienced record highs, yet the current account deficit (CAD) deteriorated because of a corresponding growth in imports. Merchandise exports soared by almost 70 percent driven by exports of manufactured goods rather than the traditional, lower-value-added base metal exports. Meanwhile, imports also grew by almost 50 percent from the year before, reflecting the high import content of domestic demand and exports. Driven by a stronger-than-expected increase in diaspora visits to Kosovo, exports of services more than doubled in 2021, exceeding 2019 levels by 22 percent. Factor incomes also rose significantly, primarily reflecting a 26 percent increase in net remittance inflows. Nevertheless, the CAD deteriorated from 7 percent in 2020 to 9.1 percent of GDP in 2021. Almost half of the CAD was financed by net non-debt-creating FDI, primarily through equity, while reinvested earnings dropped sharply against higher dividend payouts. Loans and trade credit to the private sector financed the rest of the CAD, while public debt increases financed less than one-tenth of the CAD in 2021.

The fiscal balance improved significantly in 2021. The fiscal deficit dropped from 7.6 percent in 2020 to 1.4 percent of GDP in 2021, supported by higher tax revenues and sluggish public investment. Tax revenues jumped by 29 percent, driven by a rebound in economic activity and imports, higher inflation, and a tighter labor market. Current spending, in the meantime, grew 7 percent in nominal terms. The government implemented a sizable fiscal stimulus program of 3.2 percent of GDP, which included targeted private sector and social transfers, but also universal child allowances and additional maternity benefits. Public capital expenditures increased in nominal terms but remained subdued relative to output, at 5.5 percent of GDP, and just above three-fourths of the capital budget. As a result of the drop in the fiscal deficit, public and publicly guaranteed debt, according to the preliminary data, has remained broadly unchanged at 22.5 percent of GDP at end-2021, compared to the previous year.

The financial market remains stable. Credit increased by 15.5 percent during 2021, with household loans increasing by 18.6 percent and corporate loans by 13.6 percent by year end. The credit interest rate marginally decreased from 6 percent in December 2020 to 5.8 percent in December 2021. Deposits experienced double-digit growth, increasing by 12.4 percent in 2021. Capital adequacy and liquidity remained above regulatory requirements, while nonperforming loans amounted to 2.3 percent of total loans in December 2021. The Kosovo Credit Guarantee Fund continued to expand its coverage, including through government-subsidized guarantee fees, and bolstered credit growth.

Outlook and Risks

Growth in 2022 is projected to decelerate to 3.9 percent, affected by the economic consequences of the Russian invasion and the war in Ukraine and associated sanctions. Inflationary pressures will reduce real disposable income and impact consumer confidence. Nevertheless, business investment is expected to drive growth in 2022 due to the continuation of ongoing construction projects and higher manufacturing investment linked to the recent surge in manufacturing exports. Public investment is expected to be solid, financed through concessional financing from international financial institutions and improved execution against more efficient procurement. Net exports will remain negative, as imports rise to meet the increase in domestic demand and to respond to higher private investment. As a result, the CAD is projected to exceed 9 percent of GDP in 2022.

Over the medium term, the outlook remains positive, but downside risks are elevated. Growth is projected to average above 4 percent, but the persistence of scarring from the ongoing energy crisis and global inflationary pressures may deteriorate the outlook. The ongoing domestic energy crisis is a pressing concern. While the increase in energy consumption is significant, outdated domestic electricity production capacity can result in supply disruptions and a large demand for electricity imports. Such exposure to unplanned imports of electricity at spiraling import prices remains high, and could impact both consumer and producer prices alike as well as government expenditure. At the same time, a prolonged impact of the war in Ukraine could more significantly impact real disposable income and incomes of the diaspora mainly living in the

European Union, affecting remittances, travel exports, and real estate FDI.

Kosovo is a net importer of food and energy, and the war in Ukraine is amplifying inflationary pressures. Under the baseline scenario, headline inflation is expected to accelerate to 5.4 percent in 2022. Price levels are projected to remain elevated but to gradually normalize under the assumption of subsiding global inflationary pressures from the second part of the year. While direct trade links with Russia and Ukraine are limited and concentrated on base metals and mineral products, the indirect impact from international commodity prices, including food commodities, is already affecting inflation. Kosovo imports an average of 40 percent of its wheat needs and has an even higher import dependence on select agricultural products. Bans on exports of agricultural products including from Serbia could significantly aggravate inflationary pressures. Kosovo also imports fuel and electricity, especially during the winter season, and the persistency of high electricity prices could exacerbate the ongoing energy crisis. At the same time, exports of base metals could benefit from the global shortages triggered by the war in Ukraine and accelerate export volumes and prices.

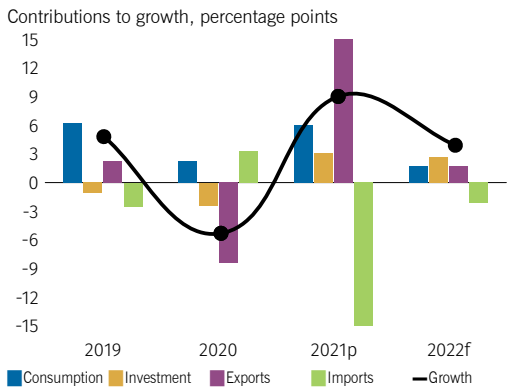
The fiscal deficit is expected to widen in 2022. Revenues are expected to decelerate but remain strong in 2022, with tax revenues increasing by close to 10 percent compared to 2021. Robust revenue performance is based on the contribution from inflation and a full-year effect of formalization gains. Expenditure growth is expected to outpace revenues due to a strong rebound in capital expenditure, increasing by almost a third, as well as higher current spending, with full-year effects of new

social benefits programs. Furthermore, in response to the energy crisis and the revision of energy tariffs, the government has already committed close to 1.2 percent of GDP in electricity subsidies for households. As a result, the fiscal deficit is expected to increase from 1.4 percent to 2.2 percent of GDP. Over the medium term, the deficit is expected to remain below 3 percent of GDP, and in line with the fiscal rule, which the authorities are committed to formally reimpose from 2023. Total public and publicly guaranteed debt is expected to reach 24.3 percent of GDP in 2022, with an increase in concessional external debt and slower accumulation of domestic debt.

Financial sector performance is expected to support growth. Exposure to Ukraine and Russia is limited, but costs of financing are set to grow. Further capitalization of the Kosovo Credit Guarantee Fund is expected to enhance access to credit in 2022. Credit growth is expected to remain strong given the significant scope for credit deepening. However, global finance tightening and inflationary pressures are likely to exert upward pressures on interest rates.

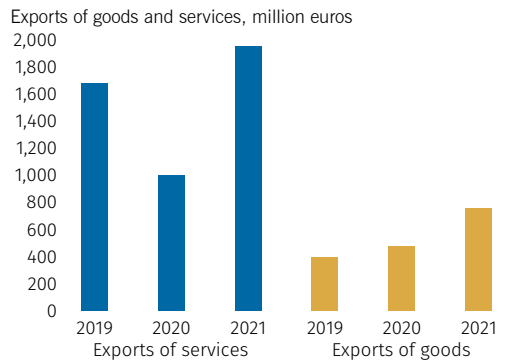
Maintaining fiscal space to respond to the changing macroeconomic environment remains crucial. This calls for particular caution toward policies that may have high long-term fiscal costs, such as public sector compensation reform. Over the medium term, there is a pressing need to use the momentum for higher exports and focus policies on enhancing competitiveness, including by tackling constraints to higher productivity growth and human capital investment.

Economic activity fully recovered.



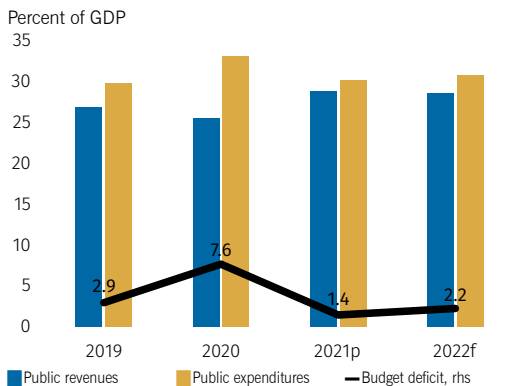
Sources: Kosovo Statistics Agency; World Bank staff calculations.

Exports experienced record growth.



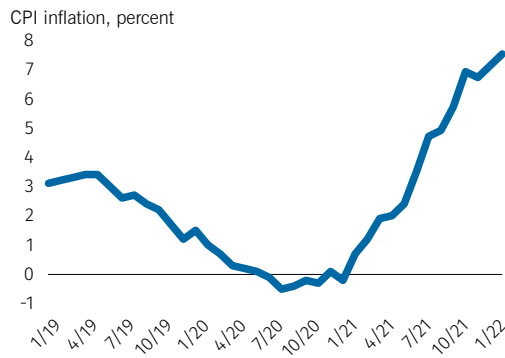
Source: Central Bank of Kosovo; World Bank staff calculations.

Strong revenue performance narrowed the deficit.



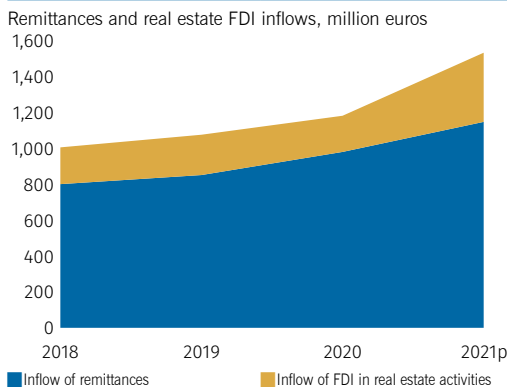
Sources: Ministry of Finance; World Bank staff calculations.

Inflation increased in 2021 and early 2022.



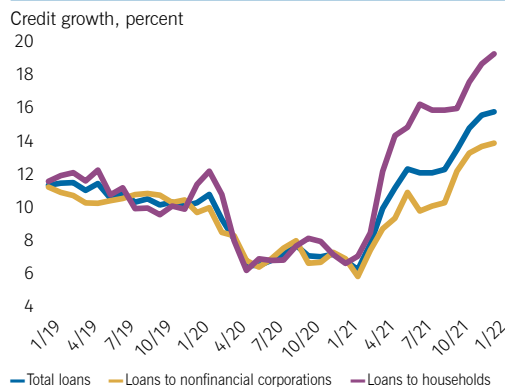
Source: Kosovo Statistics Agency.

Remittances and real estate FDI spurred the recovery.



Source: Central Bank of Kosovo.

Credit experienced double-digit growth.



Source: Central Bank of Kosovo.

KOSOVO	2019	2020	2021p	2022f	2023f	2024f
Real GDP growth (percent)	4.8	-5.3	9.1	3.9	4.3	4.2
Composition (percentage points):						
Consumption	6.2	2.2	6.0	1.7	2.3	1.8
Investment	-1.1	-2.4	3.1	2.7	2.4	2.5
Net exports	-0.3	-5.1	0.0	-0.5	-0.4	-0.1
Exports	2.2	-8.4	15.0	1.7	1.9	2.1
Imports (-)	2.5	-3.3	15.0	2.1	2.3	2.2
Consumer price inflation (percent, period average)	2.7	0.2	3.4	5.4	1.6	2.2
Public revenues (percent of GDP)	26.8	25.4	28.7	28.4	28.2	28.2
Public expenditures (percent of GDP)	29.7	33.0	30.1	30.6	30.9	30.7
Of which:						
Wage bill (percent of GDP)	8.7	9.8	8.8	8.5	8.9	8.8
Social benefits (percent of GDP)	6.3	7.7	7.4	7.2	7.0	6.6
Capital expenditures (percent of GDP)	7.5	5.6	5.5	6.5	6.8	7.0
Fiscal balance (percent of GDP)	-2.9	-7.6	-1.4	-2.2	-2.6	-2.5
Primary fiscal balance (percent of GDP)	-2.6	-7.2	-1.0	-1.7	-2.2	-2.2
Public debt (percent of GDP)	17.0	22.0	22.1	24.0	25.3	26.9
Public and publicly guaranteed debt (percent of GDP)	17.6	22.4	22.5	24.3	25.4	27.0
Of which: External (percent of GDP)	5.8	7.8	7.6	9.2	9.9	10.6
Goods exports (percent of GDP)	5.6	6.9	9.9	9.8	9.8	9.9
Goods imports (percent of GDP)	45.8	44.2	56.7	55.2	55.0	54.7
Net services exports (percent of GDP)	13.1	5.7	14.2	12.6	13.5	14.4
Trade balance (percent of GDP)	-27.1	-31.6	-32.7	-32.9	-31.7	-30.4
Net remittance inflows (percent of GDP)	11.6	13.8	15.7	14.7	14.1	13.9
Current account balance (percent of GDP)	-5.6	-7.0	-9.1	-9.7	-9.0	-8.0
Net foreign direct investment inflows (percent of GDP)	2.7	4.2	4.2	4.2	4.0	4.0
External debt (percent of GDP)	31.2	37.2	37.3	-	-	-
Real private credit growth (percent, period average)	7.8	7.6	7.5	-	-	-
Nonperforming loans (percent of gross loans, end of period)	1.9	2.5	2.3	-	-	-
Unemployment rate (percent, period average)	25.7	24.5	-	-	-	-
Youth unemployment rate (percent, period average)	49.4	49.4	-	-	-	-
Labor force participation rate (percent, period average)	40.5	37.8	-	-	-	-
GDP per capita (US\$)	4,416	4,350	5,058	5,281	5,657	5,967
Poverty rate (percent of population)	21.1	23.2	19.4	17.6	15.8	14.4

Source: Country authorities, World Bank estimates and projections.

Note: Poverty rate calculations based on ECAPOV harmonization using HBS data. Nowcasted/projected values start at 2018. Income measures in the SILC and consumption measures in the HBS are not strictly comparable. Poverty is defined as living on less than US\$5.5/day per person in revised 2011 purchasing power parity. e = estimate; ECAPOV = ECA Poverty, a harmonization effort for Eastern Europe and Central Asia countries based on available household budget surveys and Living Standards Measurement Surveys; f = forecast; HBS = household budget surveys; SILC = Survey on Income and Living Conditions.; - = not available.

Montenegro

- Montenegro's economic recovery in 2021 was stronger than expected, supported by a rebound in tourism; in parallel, inflation surged to 6.7 percent in February 2022, a 10-year high.
- The labor market responded to economic recovery and returned to pre-pandemic trends, with unemployment dropping to close to 15 percent.
- The fiscal deficit fell from 11 percent of GDP in 2020 to 2 percent in 2021.
- Montenegro adopted a landmark reform program, Europe Now, which carries many opportunities but also significant fiscal risks.
- The outbreak of war in Ukraine has worsened the otherwise positive outlook for Montenegro, with risks tilted to the downside.

Recent Economic Developments

The rebound in tourism paved the way for a robust economic recovery in 2021. The economy bounced back strongly, recording a preliminary growth rate of 12.4 percent, but real GDP still remained below the 2019 level. Reviving tourism, exports, and private consumption have led growth, with tourism revenues reaching 70 percent of their 2019 level from just 13 percent in 2020. Exports added 25.5 percentage points (pp) to growth. Tourism, together with the recovery in employment and an increase in household lending, supported the strong private consumption rebound, which added 4.2 pp to growth. Government consumption added another 0.3 pp. Delays in public investments, higher costs of materials, and continued supply-chain disruptions slowed gross fixed capital investments, which dragged growth by 4.8 pp, also adversely impacting the pace of imports.

In contrast to the robust rebound in services, agriculture and construction contracted. In 2021, the number of overnight stays of international tourists more than tripled

compared to a year earlier, supporting retail and wholesale trade, which expanded by 17 percent and 24 percent, respectively. Industrial production strengthened by 4.9 percent, driven by increases in both manufacturing and energy production, and despite a decline in the mining sector. Meanwhile, construction declined by 5 percent, as did the number of issued construction permits, which could be a signal of a continued decline in the construction sector.

Job creation gained momentum in the third quarter of 2021. Labor force survey (LFS)⁶ data show an increase in employment in the third quarter by 21 percent compared to the first quarter (Q1), which remained at similar level in the fourth quarter (Q4). Such job creation equally benefited male and female employees. The activity rate rose to 54.4 percent in Q4 from 47.6 percent in Q1, while at the same time the unemployment rate fell to 15.4 percent from 19.4 percent. The revised administrative data show steady employment gains in the last quarter of 2021 across all sectors, with employment starting to rise above its pre-pandemic level in October 2021. The

⁶ The change in the 2021 LFS methodology does not allow for comparisons with previous years' LFS data.

government phased out wage subsidies in July 2021. The Parliament adopted an increase in the net monthly minimum wage from €250 to €450, as part of the Europe Now reform program, effective January 1, 2022.

Global inflationary pressures are accelerating domestic inflation, given the unilateral euroization. In 2021, inflation averaged 2.4 percent, with year-end inflation totaling 4.6 percent and rising further to 6.7 percent (y/y) in February 2022, a 10-year high. The increase in inflation was led by rising food, beverage, and transportation prices. Real disposable income was nevertheless largely preserved through the increase in disposable incomes due to the Europe Now reform, which resulted in the average net monthly wage increasing from €537 in December 2021 to €686 in January 2022, an increase of 22.7 percent y/y in real terms.

The financial sector has remained robust so far. In February 2022, outstanding loans were up by 6.9 percent, driven by lending to the private sector and non-resident lending. At the same time, deposits were up by 25.6 percent, reaching record levels, led by increases in private sector and household deposits. The lending-to-deposits ratio declined to 79 percent, its lowest level ever. In 2021, new loans surged by 23 percent, though that remained below the 2019 level. The December average capital adequacy ratio was a healthy 18.5 percent, well above the regulatory minimum, while nonperforming loans increased to 6.8 percent of total loans from 5.9 percent in December last year. The Central Bank has commissioned an Asset Quality Review to identify stressed assets and make necessary provisions in banks' balance sheets. After delays due to the pandemic, the Asset Quality Review was

published in September 2021 and indicated that the banking sector was in a good position prior to the crisis, although there may have been a deterioration in asset quality that will be visible after all support measures are withdrawn.

Strong net service exports and remittances significantly narrowed the current account deficit. In 2021, the current account deficit narrowed to 9.2 percent of GDP, the lowest since 2004. With a growth rate of 95 percent, exports of goods and services outpaced imports, which increased 21 percent, narrowing the trade and services deficit to 19.6 percent of GDP. Strong net exports were supported by a strong recovery of tourism and transport services, metals, and electricity exports, but also slower imports growth due to declining investments. Net primary and secondary incomes have further reduced the current account deficit, primarily due to strong net remittances, which increased by 35 percent. The current account deficit was entirely financed by net foreign direct investment, which amounted to 11.2 percent of GDP. In January 2022, international reserves stood at €1.7 billion, covering eight months of merchandise imports.

The fiscal deficit fell from 11 percent of GDP in 2020 to 2 percent in 2021. The fiscal consolidation was supported by a rebound in revenues, under-execution of capital expenditures, and a reduction in current spending. The latter occurred despite Covid-related support provided in the first half of the year. Central government revenues increased by 16.5 percent, driven by the VAT and excises, and surpassed the revenues collected in 2019 by 1.3 percent. At the same time, central government expenditures declined by 2.3 percent, primarily due to lower capital spending by 9 percent, but also lower spending

on goods and services, which declined by 16 percent. The Parliament adopted the 2022 budget with the fiscal deficit at 5 percent of GDP, as the government plans to ramp up capital spending and has widened social transfers. The Parliament introduced benefits for all children until age 18, reintroduced mothers' benefits for former beneficiaries, and increased minimum pensions to €200, further worsening pension system sustainability and equity.

Public debt declined to 85 percent of GDP in 2021 from 105 percent in 2020. The 2021 gross financing needs were largely covered by the €750 million Eurobond placed in 2020. Net debt in 2021 was reduced by over €330 million, including a repayment of €227 in Eurobonds in March 2021. The central government fiscal balance was positive in four months over the last year, which further supported the buildup of government deposits, amounting to 9.5 percent of GDP in 2021, which will be financing a significant share of financing needs in 2022.

Montenegro adopted a landmark reform program, Europe Now, which carries many opportunities, but also risks. The key elements of the reform program are the abolition of healthcare contributions, introduction of a personal income allowance for wages up to €700, progressive personal and corporate income taxation, and an increase in the net monthly minimum wage. The program has the potential to reduce inequalities and increase formal employment and growth over the medium term, especially if complemented by additional structural reforms, but also poses fiscal risks. The Parliament rejected several measures of the program to offset the loss in revenues from the abolished health

contributions. These include increases in excises on tobacco, alcohol, and sugary beverages; and introduction of excises on sugary products and single-use plastic. The Parliament also maintained the reduced VAT rate of 7 percent for the hospitality industry, introduced as a crisis mitigation measure. Failure to adopt compensating revenue measures is likely to result in a wider-than-planned fiscal deficit in 2022, with possible adverse consequences for the following years. In addition, due to the pension indexation formula, spending on pensions is expected to increase strongly in 2023, further widening the fiscal deficit. Finally, administrative capacity challenges are a risk to the successful implementation of the reform.

In February 2022, there was a vote of no confidence in the government, and a new government is yet to be formed. A turbulent political environment is adding to already high uncertainty, putting at risk, or slowing the implementation of structural reforms (such as public administration reform and tax, pension, and healthcare reforms).

Outlook and Risks

The outlook is fragile in an environment of increasing uncertainty. The outbreak of the war in Ukraine and the associated developments have significantly worsened the outlook for Montenegro, the economy of which is now expected to grow by 3.6 percent in 2022, down from an estimated 5.9 percent before the start of the war. The main direct transmission channel of the war to Montenegro's economy is tourism. In 2021, tourists from Russia, Ukraine, and Belarus accounted for 22 percent of total overnight stays. Assuming a

continuation of the strong recovery of tourism receipts from other countries (to 90 percent of their 2019 level) and a decline of overnight stays from Russia, Ukraine, and Belarus by 75 percent, total tourism receipts remain at levels similar to those in 2021. The expected decline in tourism due to the war slows exports and private consumption. Consumption is expected to remain strong, however, due to the positive effects of higher disposable incomes, the employment recovery, and higher-than-expected inflation. Investments are expected to pick up as the works on the highway completion are resumed and other capital spending increases, while in parallel, private investments in the tourism and energy sectors continue, but at a slower pace.

Inflation is expected to remain elevated.

Global inflationary pressures and, to a lesser extent, domestic pressures stemming from an increase in wages after implementation of the Europe Now program, will push inflation to an estimated 5 percent in 2022. Price spikes of key commodities and food will directly impact households, though the impact will be offset by the increase in wages for formally employed through the Europe Now program. However, more adverse impacts on the tourism sector pose a risk to household budgets.

Utmost fiscal prudence is needed to return public debt to Montenegro's fiscal rule of 60 percent of GDP. Contrary to previous plans, the fiscal balance is now not expected to turn into a surplus until 2025, and a primary surplus is likely only in 2024. Public debt is expected to decline from 77 percent of GDP in 2022 to 73 percent of GDP in 2024. With the expected monetary tightening in the United States and global geopolitical uncertainties weighing on the risk appetite of investors, Montenegro must

be fiscally vigilant as the 2018 Eurobond of €500 million comes due in 2025. Given the incomplete implementation of the Europe Now revenue measures, further fiscal adjustments are needed to avoid a significant increase in the fiscal deficit in 2022 and enable the return to primary fiscal surpluses over the medium term, which is critical for debt reduction.

The current account deficit is expected to widen and remain at around 12 percent of GDP over the medium term.

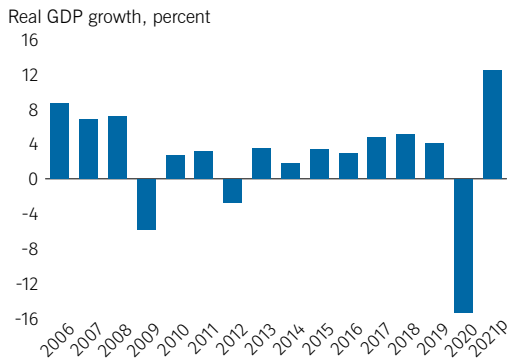
A pause in the tourism recovery in 2022 and an increase in commodity prices will result in a wider current account deficit. At the same time, merchandise exports, particularly exports of aluminum and electricity, will partly offset the negative effects. In January 2022 alone, Montenegro exported 25 percent and 40 percent of the total value of aluminum and electricity exported in 2021, respectively. Assuming a resumption in the tourism recovery in 2023 and a further increase in energy exports, exports are expected to recover. At the same time, the announced investments in these two sectors will keep import levels elevated at around 64 percent of GDP in 2023–24. Net primary and secondary incomes are estimated to partially offset the trade deficit, assuming net remittances remain at 90 percent of their levels observed in 2020–21. Net foreign direct investment is expected to decline to 8 percent of GDP in 2022 but rebound to 8.7 percent in 2023 and continue financing the current account deficit.

The deteriorating environment poses further significant risks to the outlook.

Risks stem from both the external and domestic environments. A prolonged war in Ukraine and related sanctions on Russia directly weigh on Montenegro's recovery through reduced tourism and investments, which could further

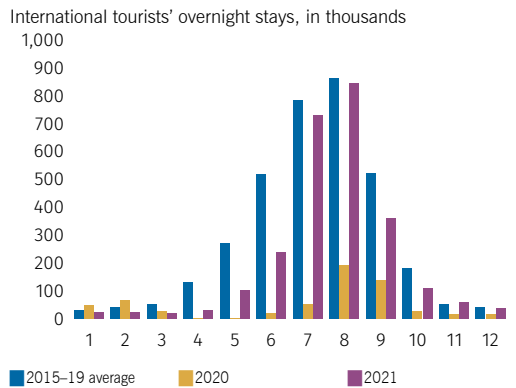
reduce growth. In addition, the impact of the conflict on Montenegro's key trading partners (namely, the Western Balkans and the EU) would have negative spillovers on growth, but also remittances. Risks also come from monetary tightening, which would translate into more expensive external financing. Political instability is the main domestic risk. Other risks stem from the administrative capacity challenges to implement the Europe Now program and the impact the program will have on the fiscal deficit in the medium term, which may risk derailing medium-term debt reduction plans. Acceleration of structural reforms (including pension reforms) and fiscal prudence are needed to mitigate increasing risks and uncertainties.

The 2021 recovery was robust...



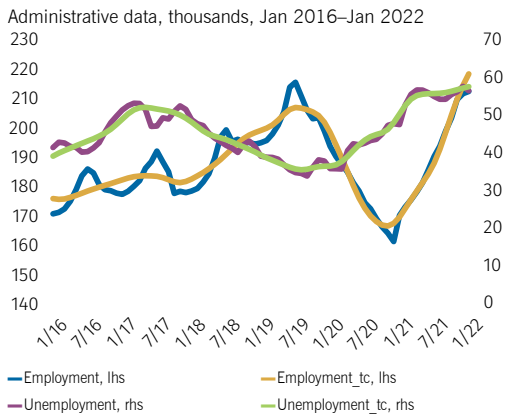
Sources: MONSTAT data; World Bank staff calculations.

...largely driven by reviving tourism.



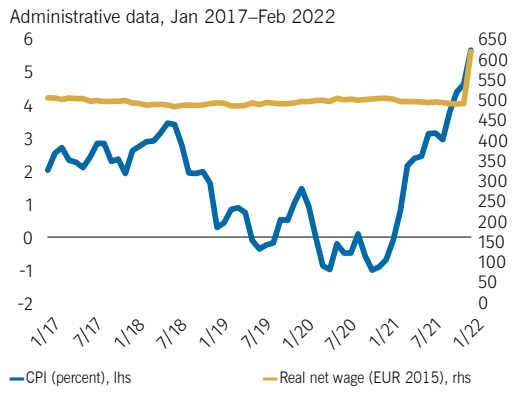
Sources: MONSTAT; World Bank staff calculations.

The labor market rebounded strongly...



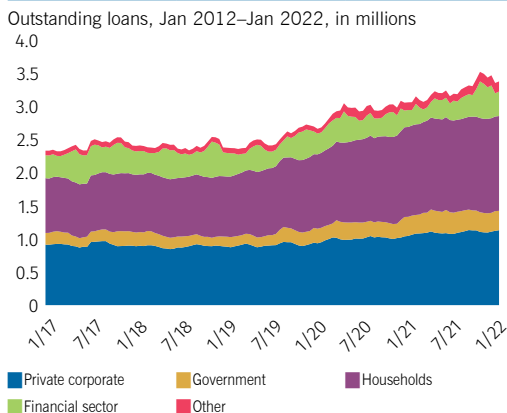
Source: MONSTAT data. tc=trend cycle.

... and inflation continued surging.



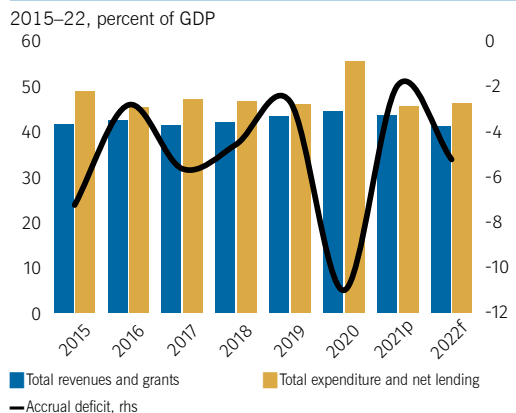
Source: MONSTAT data; World Bank staff calculations.

Outstanding loans have been increasing.



Sources: Central Bank; World Bank staff calculations.

The fiscal deficit is widening again.



Sources: Ministry of Finance; World Bank staff calculations.

MONTENEGRO	2019	2020	2021p	2022f	2023f	2024f
Real GDP growth (percent)	4.1	-15.3	12.4	3.6	4.7	3.7
Composition (percentage points):						
Consumption	2.9	-3.9	4.5	3.8	3.3	2.6
Investment	0.9	-5.9	-5.5	1.9	2.5	2.8
Net exports	0.3	-5.5	13.4	-2.2	-1.1	-1.7
Exports	2.9	-24.2	25.5	1.1	3.7	3.0
Imports (-)	2.6	-18.7	12.0	3.3	4.9	4.7
Consumer price inflation (percent, period average)	0.4	-0.3	2.4	5.0	2.3	1.6
Public revenues (percent of GDP)	43.3	44.4	43.6	41.1	40.9	40.7
Public expenditures (percent of GDP)	46.0	55.5	45.6	46.3	43.9	42.4
Of which:						
Wage bill (percent of GDP)	11.0	13.5	12.2	11.6	11.0	10.6
Social benefits (percent of GDP)	11.2	13.4	11.6	12.5	13.2	12.6
Capital expenditures (percent of GDP)	8.7	7.5	5.2	6.6	5.8	6.2
Fiscal balance (percent of GDP)	-2.7	-11.0	-2.0	-5.2	-3.0	-1.7
Primary fiscal balance (percent of GDP)	-0.5	-8.3	0.4	-3.4	-1.4	-0.2
Public debt (percent of GDP)	76.5	105.3	84.9	77.4	75.2	73.1
Public and publicly guaranteed debt (percent of GDP)	80.0	108.7	87.7	80.1	77.6	75.4
Of which: External (percent of GDP)	68.1	97.3	80.0	73.6	69.1	67.1
Goods exports (percent of GDP)	9.4	9.8	10.7	11.5	11.1	11.1
Goods imports (percent of GDP)	51.1	49.0	49.7	50.5	50.7	51.2
Net services exports (percent of GDP)	20.6	4.2	19.4	18.3	19.9	20.7
Trade and services balance (percent of GDP)	-21.1	-35.0	-19.6	-20.7	-19.7	-19.4
Net remittance inflows (percent of GDP)	4.0	5.3	6.1	5.0	4.6	4.4
Current account balance (percent of GDP)	-14.3	-26.1	-9.2	-12.6	-12.1	-12.0
Net foreign direct investment inflows (percent of GDP)	6.2	11.2	11.2	8.1	8.7	8.7
External debt (percent of GDP)	169.0	224.1	199.0	194.8	190.9	188.4
Real private credit growth (percent, period average)	5.5	6.4	-0.2	-	-	-
Nonperforming loans (percent of gross loans, end of period)	5.1	5.9	6.8	-	-	-
Unemployment rate (percent, period average)	15.1	17.9	16.6	-	-	-
Youth unemployment rate (percent, period average)	25.2	36.0	37.1	-	-	-
Labor force participation rate (percent, period average)	57.4	53.3	50.9	-	-	-
GDP per capita, PPP (current international \$)	23,097	20,030	22,128	23,760	25,276	26,668
Poverty rate (percent of population)	15.6	19.9	16.2	15.6	14.8	-

Sources: Country authorities, World Bank estimates and projections.

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

North Macedonia

- As the economy gradually rebounded from the pandemic-induced recession, the energy crisis and the war in Ukraine brought new challenges. The Covid-19 support needs to be replaced with targeted fiscal support to the most energy vulnerable households and firms as public debt increases further.
- Consumer price increase accelerated from late 2021, fueled by energy and food prices, while a double-digit minimum wage increase would add to inflationary pressures from March 2022.
- The labor market is slowly improving, but high youth unemployment calls for policy intervention.
- The short-term outlook deteriorated: the 2022 growth projection was reduced to 2.7 percent, while downside risks intensified. Over the medium term, the outlook remains positive, subject to setting public finances back on a sustainable path, accelerating human capital development, a green transition, and competitiveness reforms.

Recent Economic Developments

Economic growth rebounded to 4 percent in 2021, following a deep contraction in 2020. After falling by 6.1 percent in 2020, growth in 2021 was driven by a surge in pent-up private consumption, amidst still strong government consumption, and a growing investment contribution. Exports and imports bounced back, but the trade balance worsened. On the production side, growth was driven by services (trade, ICT, transport, and tourism), as industrial production struggled with supply-chain interruptions and reduced export orders. Construction saw a further decline.

The end of 2021 saw a slowdown in growth, with a modest recovery at the beginning of 2022. Real growth declined to 2.3 percent in Q4 2021. Manufacturing recorded a 5.2 percent drop y/y in Q4 2021, with energy production and mining slightly cushioning the blow, but it bounced back to 4 percent in February 2022. Agricultural production dropped by 3.6 percent in Q4 2021. Meanwhile, real retail trade growth decelerated to only 1.2 percent y/y in December 2021 from 15.7 percent in August.

It recovered slightly with 3.8 percent growth on average in the first two months of 2022. Tourism improved as movement restrictions waned, but the pace slowed by January 2022 and tourism arrivals have not yet reached the pre-pandemic level.

The labor market witnessed a very slow improvement despite government support.

The unemployment rate decreased to 15.2 percent in Q4 2021, but not due to a rise in the employment rate, which stagnated at 47.3 percent, but on account of a lower activity rate (down by 0.1 pp y/y to 55.7 percent in Q4 2021). The activity rate is still hovering below the pre-pandemic level. Although the employment rate rose 0.7 pp from the low in Q3 2020, at 47.3 percent it remains below the pre-crisis peak of 48.1 percent, due to a fall in private sector employment. At the same time, unemployment decreased to a historically low rate, driven by a drop in female and youth unemployment. The youth unemployment rate, however, at 34.9 percent remains high. Per Employment Agency data, the number of new employment contracts in 2021 increased by nearly 15 percent, suggesting a recovery

of labor demand. However, there has been a greater use of fixed-term contracts (58 percent of all new employment) as uncertainty about the growth recovery still looms.

With increased labor demand, wages continued to steadily grow in 2021. Real net wage increased by 2.3 percent, led by food and accommodation services, trade, transport, professional services, and ICT. In February 2022, the government increased the minimum wage by 18.5 percent (to be applied for March wage onwards) and introduced the mandatory annual indexation of the minimum wage with consumer prices and average national wage growth. The rise in labor costs prompted the government to subsequently provide temporary compensation to firms through the contribution subsidy support program.

As the merchandise trade deficit deteriorated, the external imbalance worsened, too. The current account deficit slightly worsened to 3.5 percent of GDP in 2021, owing to a deterioration in the trade balance. This is despite a rise in remittances and service exports. The merchandise trade deficit widened to 20.2 percent of GDP (from 17 percent a year ago), as energy balance worsened and firms in the car supply chain struggled with declining orders, while the services balance improved to 4.3 percent of GDP, boosted by a recovery in tourism. At the end of Q3 2021, gross external debt stood at 84.1 percent of GDP, up from 80.3 percent at end-2020. The public sector contributed most to the rise.

Global supply shortages and surging demand resulted in rising energy and food prices that reached a decade high, and spilled

over to North Macedonia, a net food and energy importer. The inflation rate averaged 3.2 percent in 2021, with prices accelerating in the second half of the year. The producer price index increased by 16.4 percent in January 2022 and spilled over to inflation that stood at 8.8 percent in March 2022. Inflation is also becoming more broad-based, with core inflation rising to 5.2 percent. Energy prices rose 14.4 percent y/y, while food prices increased by 11.7 percent y/y in March 2022 despite the government decision to freeze basic foodstuff prices, and agricultural inputs, including fertilizers. In March 2022, the government adopted several additional measures to alleviate the inflationary pressures: it reduced the VAT on petrol and gas to 10 percent, reduced excises on oil derivatives if prices hit a threshold, and exempted the basic foodstuff and imported energy from VAT.

Monetary policy remained accommodative throughout 2021 and in early 2022 before started tightening in April. The policy rate was increased to 1.50 percent, while liquidity in the domestic market remains high. Specifically, the banking sector liquidity ratio stood at 23 percent in Q4 2021, while the capital adequacy ratio increased to 17.3 percent. Credit growth to the private sector continued at an accelerated pace of 8 percent, led by foreign exchange (FX)-denominated mortgage lending, and accompanied by a surge in real estate prices. The non-performing loans ratio dropped to 3.1 percent in Q4 2021, but banks' expectations remain subdued, according to the Autumn 2021 EIB CESEE⁷ Bank Lending Survey. On April 1, 2022 the National Bank reduced the reserve requirement ratio for deposits in domestic currency from

⁷ European Investment Bank Central, Eastern and South-Eastern Europe Bank Lending Survey.

8 to 6.5 percent and increased the reserve requirement ratio for deposits in foreign currency from 15 to 16.5 percent in order to stimulate domestic currency savings.

The fiscal deficit declined in 2021 led by buoyant revenue performance that continued in early 2022. The fiscal deficit narrowed to 5.4 percent (or 5.8 percent including the State Enterprise for Roads) in 2021, below the latest budget rebalance target. Tax revenues increased by 1.8 pp of GDP, driven by VAT collection as consumption surged. Capital spending increased by 1 pp of GDP and its execution rate reached 80 percent compared to the 2021 plan, indicating improved performance. As crisis-related support decelerated, current spending declined. Yet, expenditure arrears increased by 0.6 pp to 3.3 percent of GDP on account of overdue payments in the health sector, state enterprises, and local governments, raising the deficit on an accrual basis to 6 percent of GDP. In November 2021, the government declared an energy crisis, temporarily taking over the private heating company to avoid outages,⁸ and transferred around 0.7 percent of GDP to cover the losses of energy companies. A new support package was announced in early 2022 that includes reduction in VAT and excises for electricity, gas, and oil derivatives, liquidity credit lines for firms through the Development Bank, social benefits to pensioners and vulnerable households, an exemption from VAT for basic foodstuff and importers of electricity, heat, cooling energy and gas, energy efficiency measures. The overall package for 2022 amounts to 3.2 percent of GDP which will require the 2022 budget revision.

Public and publicly guaranteed debt stabilized in 2021. Reaching 60.8 percent of GDP, public and publicly guaranteed debt declined by 0.2 percent of GDP in a year but remained elevated at 11.6 percentage points of GDP above the pre-crisis 2019 level. Payment arrears increased significantly to 3.3 percent of GDP by year-end calling for strengthening fiscal discipline and clearing the arrears in the short term. This may limit the fiscal space for crisis response going forward.

Outlook and Risks

Economic growth is expected to decelerate to 2.7 percent in 2022, with real GDP reaching the pre-pandemic level by mid-year. The baseline scenario rests on the assumption that the acute phase of the crisis eases in Q2 2022 even if effects of sanctions persist through 2022 and even into 2023. Energy, agriculture, and car-supply manufacturing sectors will be more affected than the others. However, the Ukraine war, if prolonged, would further reduce external demand, increase key commodity and energy prices, hamper mobility, and result in investment delays. This scenario would result in even lower growth and fiscal revenues, as well as rising requests for fiscal support and a surge in financing costs.

The fiscal deficit is expected to remain high in 2022, due to the continued support to firms and households to alleviate the impact of the energy and war-related crises. It will very gradually subside only by 2024, leaving the public debt at above 64 percent of GDP. A delivery of the ambitious Growth Acceleration Plan rests on strengthening the implementation capacity,

⁸ The Balkan Energy Group company (BEG).

and securing affordable financing, which is getting tighter. In the context of eroded fiscal space and rising public debt, the continuous and generous fiscal support, through subsidies, broad and widening tax exemptions, and frequent changes of pension policy with sizeable budget implications, is not sustainable and could derail macroeconomic stability going forward.

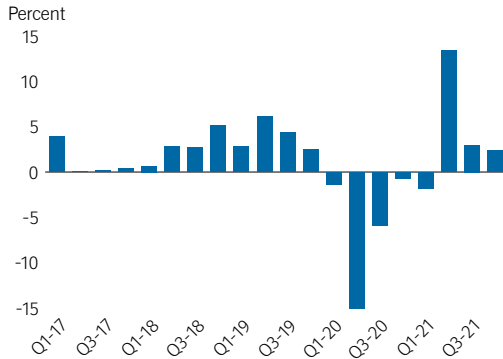
The medium-term outlook remains positive, but risks are largely tilted to the downside and accentuated.

Disruptions related to the protracted pandemic shock, the war in Ukraine, prolonged supply chain disruptions, rising minimum wage pressures adding to other inflationary pressures, weak domestic political stability, including the de-facto paralysis in the parliament, and the looming energy crisis continue to weigh on the outlook. Heightened political uncertainty, and delayed EU accession negotiations, amidst an energy and health crisis, may lead to a weaker reform appetite needed to boost potential growth and consolidate public finances. Furthermore, the tightening of global financial conditions may affect financing options and costs for North Macedonia in the near future. On the positive side, delivery of the Growth Acceleration Plan that targets human capital development, the green transition, and digitalization may boost potential growth.

In the medium term, the country will need to strengthen the sustainability of public finances and shift its focus to resolving structural challenges, including low and declining human capital, weak regulatory frameworks, poor competition policy, judiciary, declining productivity, and rising migration. In addition, the government will need to rethink and rationalize state aid to address fiscal sustainability concerns and provide more

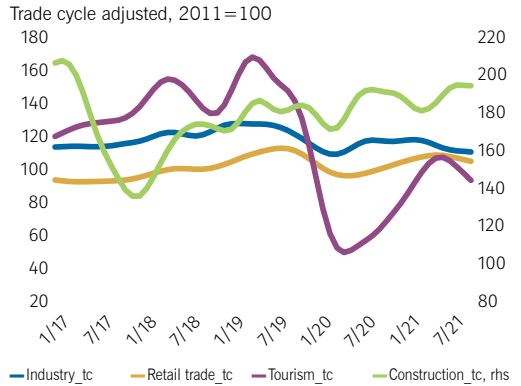
targeted support to the domestic economy. Structural reform efforts need to be aligned with the green agenda and enable the low-carbon transition and reduced greenhouse gas emissions.

The economy is slowly recovering from the pandemic-induced recession...



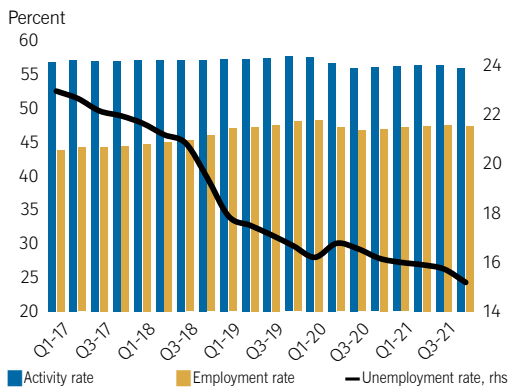
Source: State Statistics Office.

...as evidenced by high-frequency indicators.



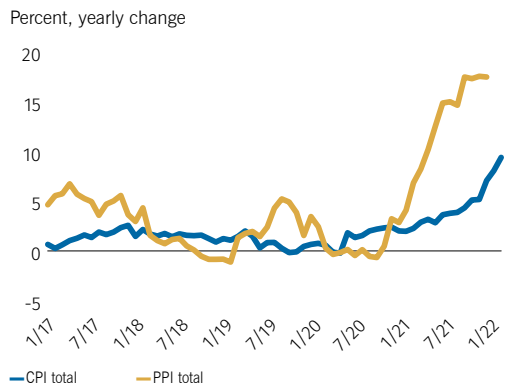
Source: State Statistics Office and World Bank staff calculations.

The labor market is gradually recovering.



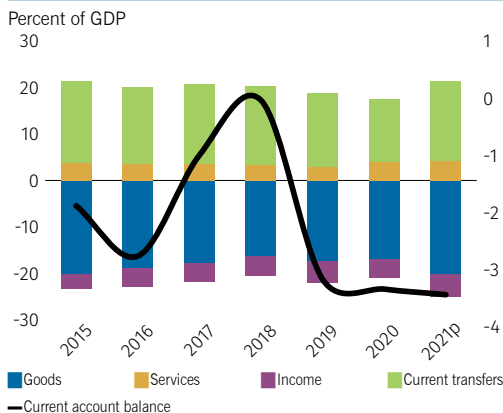
Source: State Statistics Office.

Inflationary pressures continue to accumulate.



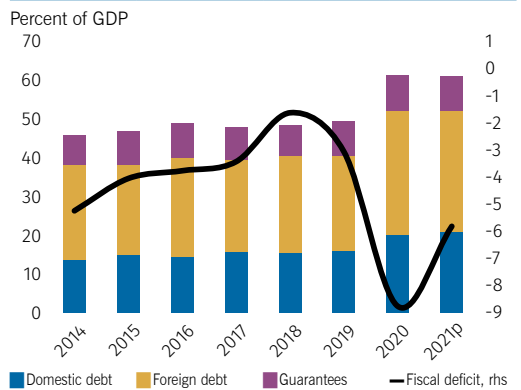
Source: State Statistics Office.

External imbalances widened.



Source: Central Bank.

Public debt growth stabilized in 2021.



Source: Ministry of Finance and World Bank staff estimates.

NORTH MACEDONIA	2019	2020	2021p	2022f	2023f	2024f
Real GDP growth (percent)	3.9	-6.1	4.0	2.7	3.1	3.2
Composition (percentage points):						
Consumption	3.1	-2.4	5.0	2.3	2.0	2.5
Investment	3.3	-5.3	2.2	1.5	2.1	2.2
Net exports	-2.4	1.7	-3.3	-1.1	-1.0	-1.5
Exports	5.8	-7.4	7.9	5.0	5.1	4.5
Imports (-)	8.2	-9.1	11.2	6.1	6.1	6.0
Consumer price inflation (percent, period average)	0.8	1.2	3.2	5.5	2.0	1.8
Public revenues (percent of GDP)	31.4	30.5	32.3	33.1	33.2	33.5
Public expenditures (percent of GDP)	33.5	38.9	37.7	38.4	38.0	37.2
Of which:						
Wage bill (percent of GDP)	6.3	7.3	6.9	6.7	6.6	6.2
Social benefits (percent of GDP)	15.6	18.0	16.9	16.1	16.1	16.1
Capital expenditures (percent of GDP)	3.4	3.2	4.2	5.4	5.7	5.8
Fiscal balance (percent of GDP)	-2.1	-8.3	-5.4	-5.3	-4.7	-3.7
Overall fiscal balance with the Public Enterprise for State Roads included (percent of GDP)	-3.1	-8.8	-5.8	-5.7	-5.1	-4.0
Primary fiscal balance (percent of GDP)	-1.0	-7.1	-4.1	-4.0	-3.5	-2.5
Public debt (percent of GDP)	40.4	51.9	51.8	53.7	55.3	55.1
Public and publicly guaranteed debt (percent of GDP)	49.2	61.0	60.8	62.7	64.3	64.1
Of which: External (percent of GDP)	32.7	40.7	39.8	41.1	41.2	39.6
Goods exports (percent of GDP)	47.5	45.3	51.1	52.0	53.0	53.9
Goods imports (percent of GDP)	64.8	62.3	71.3	72.9	73.6	74.2
Net services exports (percent of GDP)	3.0	4.0	4.3	4.3	4.5	4.8
Trade balance (percent of GDP)	-14.3	-13.0	-15.9	-16.6	-16.1	-15.5
Net remittance inflows (percent of GDP)	1.7	2.7	2.9	3.1	3.1	3.1
Current account balance (percent of GDP)	-3.3	-3.4	-3.5	-4.0	-3.3	-2.9
Net foreign direct investment inflows (percent of GDP)	3.2	1.5	3.7	3.8	3.8	3.9
External debt (percent of GDP)	72.4	80.3	81.4	82.8	82.0	81.4
Real private credit growth (percent, period average)	6.5	5.7	2.8	-	-	-
Nonperforming loans (percent of gross loans, end of period)	4.6	3.3	3.1	-	-	-
Unemployment rate (percent, period average)	17.3	16.4	15.7	14.7	13.9	13.5
Youth unemployment rate (percent, period average)	35.6	35.7	36.3	-	-	-
Labor force participation rate (percent, period average)	57.2	56.4	56.0	-	-	-
GDP per capita, PPP (current international \$)	14,230	13,360	13,890	14,265	14,707	15,177
Poverty rate (percent of population)	16.5	18.3	17.2	16.4	15.9	15.1

Source: Country authorities, World Bank estimates and projections.

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

Serbia

- Growth in 2021 turned out stronger than expected, despite the weather-related underperformance in agriculture.
- Inflation accelerated more rapidly than projected, with the policy response encompassing central bank repo operations and selective price controls introduced by the government.
- The fiscal deficit turned lower than anticipated, while public debt plateaued at around 57 percent of GDP.
- Growth is projected to decelerate significantly in 2022 due to external developments, with risks to the outlook clearly tilted to the downside.
- Despite fiscal risks stemming from economic slowdown and the ongoing energy crisis, the fiscal deficit in 2022 is expected to remain unchanged compared to 2021.

Recent Economic Developments

After the pandemic-induced recession in 2020, real output grew by 7.4 percent in 2021. Economic growth was driven primarily by a surge in private consumption, but also an acceleration in total investment. A strong increase in salaries and in lending to households as well as transfers from the budget helped private consumption growth of 7.6 percent (y/y, in real terms). Meanwhile, investment soared by close to 15 percent in real terms. The main reason for the overall growth of investment is much higher government investment (up 49.8 percent in real terms). Government consumption rose 2.7 percent (in real terms). Although the export performance was strong (up 19.4 percent in real terms), the increase in imports was similar (up 19.3 percent in real terms in 2021, but from a higher level); thus, the net balance in goods and services made a negative contribution to growth of 2.1 percentage points. The economic recovery in 2021 was broad based seen from the production side, with the exception of the agriculture sector, where output declined by

5.4 percent in real terms. Agriculture output suffered from weather-related shocks, which had an impact across different agricultural subsectors and a significant increase in the cost of food used in livestock breeding and of fertilizers. Moreover, repeated breakdowns of EPS' electricity production and supply in Q4 and emergency imports of natural gas put a break on the otherwise strong rebound in real GDP growth in 2021.

While countercyclical fiscal measures helped mitigate the impact of the pandemic on the labor market in 2020, the situation deteriorated slightly in 2021 as some of the government support programs have been unwound and since there was an increase in labor force participation. According to the Labor Force Survey (LFS) data, the unemployment rate deteriorated slightly in 2021 climbing to 11 percent compared to 9.7 percent in 2020.⁹ The increase in the unemployment rate is in part explained by the closure of some large, foreign-owned manufacturers, resulting in significant layoffs,

⁹ The labor market improvement in 2020 (when the unemployment rate went down to 9.7 percent from 11.2 percent in 2019) was primarily the result of the fiscal stimulus program, since one of the requirements for firms to receive government support was to ensure that total employment remained unchanged or decreased by a maximum of 10 percent.

including in the footwear and garments industries. Wages kept rising by 9.6 percent in nominal terms in 2021, although the increase in real terms is less pronounced (5.4 percent, y/y) as inflation started to pick up in the second half of the year. Unlike in previous years, private sector wages increased faster than public sector wages (up by 11.2 percent in nominal terms, compared to a 7.0 percent increase in public sector wages). Despite such developments, on average, in 2021 wages in the public sector were still about 15.4 percent higher than in the private sector.

The consolidated fiscal deficit narrowed significantly to 4.1 percent of GDP in 2021, according to the preliminary data. General government revenues rose by 20.3 percent in nominal terms (y/y). While all sources of fiscal revenue increased, social insurance contributions and VAT have the largest contribution to the overall good performance of revenues. At the same time, government expenditures grew by 10.1 percent (in nominal terms), led by a significant increase in capital expenditures. Thanks to the smaller than expected fiscal deficit, gross financing needs decreased, leaving public debt at 57.1 percent of GDP at end-December 2021, roughly unchanged from end-2020.

Soaring merchandise exports and favorable terms of trade helped limit the deterioration in the current account deficit (CAD) stemming from the surge in private consumption and investment, on a demand side. The CAD stood at preliminary 4.4 percent of GDP for 2021, up from 4.1 percent in 2020. The trade deficit widened by about 14 percent as large merchandise exporters resumed operations after the pandemic, but this was more than

offset by imports driven by pent-up private consumption and investment (which in turn led to a fast increase in intermediate and capital goods). In euro terms, export of goods increased by 26.8 percent, y/y, while, imports increased by 24.6 percent, y/y, but from a higher base. Exports were also helped by an improvement in the terms of trade—export prices increased by 12.7 percent, whereas import prices grew 10 percent. Net foreign direct investment (FDI) inflows stood at 6.8 percent of GDP, thus fully financing the external shortfall, after growing 23.4 percent in 2021 (in euro terms). Most of the FDI went to manufacturing (37.9 percent of the total); followed by construction (20.1 percent) and transport (12.3 percent). Fitch Ratings affirmed Serbia's sovereign issuer rating at BB+, with a stable outlook.¹⁰

Inflation increased sharply, in line with developments in other CEE countries. Inflation in the first half of 2021 was low and stable, with prices growing by just 2.3 percent (y/y). However, during the summer a gradual increase in inflation took place as food and energy prices started to rise and the consumer price index (CPI) peaked at 7.9 percent (y/y) in December. This was the highest level of inflation since July 2013. In February 2022, prices continued to increase to 8.8 percent notwithstanding the selective Government price controls (of some of the core food items, electricity and fuel for motor vehicles). In response to mounting inflation pressures, the National Bank of Serbia (NBS) increased the volume and percentage of sterilized excess liquidity from the banking sector through repo operations increased the average repo rate, while the key policy rate has been left unchanged till April 2022, when it was increased by 50bps to 1.5 percent. The money

¹⁰ As of February 25th statement.

supply increase was also notable: by end-2021, M1 was 14.8 percent higher than a year before. As in 2020, the nominal dinar exchange rate was stable throughout 2021, with only a minor depreciation in late February 2022. In January 2022, the NBS held official foreign currency reserves in the amount of EUR 16.1 billion, which covers six months of imports.

Banking sector performance continued to be robust. Based on Q4 data, banks remained profitable in 2021 with both return on assets (ROA) and return on equity (ROE) increasing compared to 2020. In 2021, ROE increased to reach 7.8 percent in Q4 2021. Nonperforming loans (NPLs) continued to gradually decline and stood at 3.6 percent in December 2021. In 2022, a new challenge emerged, as the Russia/Ukraine crisis pushed the NBS to conclude, in line with domestic regulation and international resolution standards the process of Sberbank's takeover by the local AIK bank. There are two other banks with Russian owners (API and Expo bank) as well as one insurance company (Sogaz), which have not been affected by the sanctions introduced in late February.

Outlook and Risks

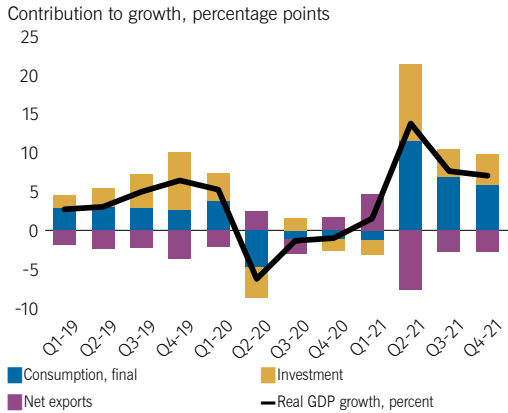
Following the outbreak of war in Ukraine, growth projections have been reduced to 3.2 percent in 2022 from the originally expected 4.4 percent. After better-than-expected growth in 2021, on the back of a significant yet declining fiscal stimulus, the Serbian economy was expected to continue to grow at around 4 to 4.5 percent annually. However, the Russia/Ukraine crisis will certainly have an impact on Serbia's exports, FDI, remittances, and tourism revenues. Exports to Russia and Ukraine combined are

about Euro 1 billion annually, FDI about Euro 220 million annually, remittances about Euro 80 million and tourism revenues about Euro 140 million annually. Further downward revisions are possible depending on the length of the conflict and the scope of sanctions toward Russia, as well as the implications on energy prices and availability. Finally, economic slowdown is expected among main Serbia's trade partners which will in turn lead to a slowdown in Serbian exports. Over the medium term, the economy is expected to grow steadily at around 3 percent annually, similarly to levels before the pandemic, as the economies of the main trading and investment partners rebound from the pandemic and the Ukraine war. The main driver of GDP growth over the medium term will be consumption (and to smaller extent investment), while net exports will make a negative contribution to growth. It is expected that the services sector will remain the main driver of economic growth going forward.

Macroeconomic stability will be maintained over the medium term despite several risks that could materialize in 2022. First, inflation is likely to increase further depending on international food and energy prices, which in turn depend on developments related to the Russia/Ukraine crisis. In addition, the 2022 fiscal deficit could be higher than the one projected under the base case scenario (4.1 percent of GDP). In addition to the crisis slowing down real GDP growth, and thus fiscal revenues, the government announced new spending not originally included in the budget. Furthermore, the crisis in the EPS and Srbijagas will most likely require significant additional subsidies and guarantees for liquidity and investment purposes. Consequently, public debt could start rising again as a share of GDP.

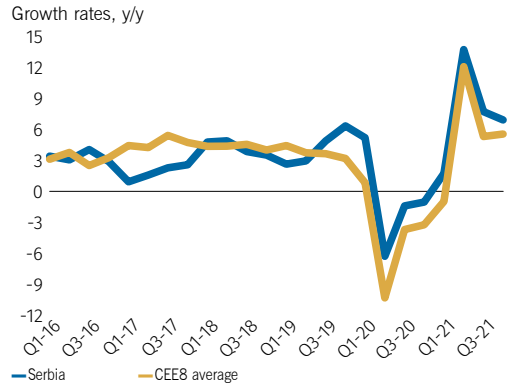
The outlook also crucially depends on the domestic reform agenda and its implementation. The ongoing crisis in the domestic energy sector emphasized once again the importance of improved management of SOEs. Reforms of Srbijagas and EPS have made only slow progress and the two companies have not had a permanent management for many years. In addition, contingent liabilities could affect public finances, particularly those related to the deterioration in the performance of SOEs. The government, therefore, needs to embark on a comprehensive and thorough reform of SOEs to make them financially sound and viable. In addition, the government could use the opening of new chapters of the EU accession to accelerate governance and green transition reforms and align the Serbian legal and institutional system to that of the EU.

The GDP recovered well in 2021...



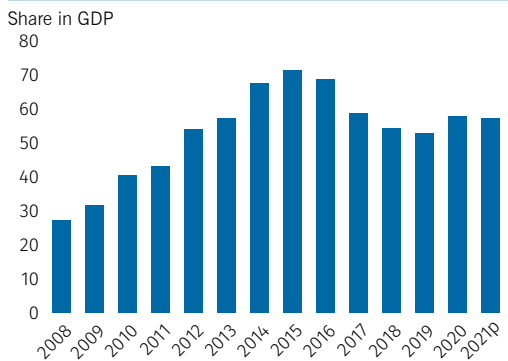
Source: Statistics Office of the Republic of Serbia.

...in line with developments among CEE countries.



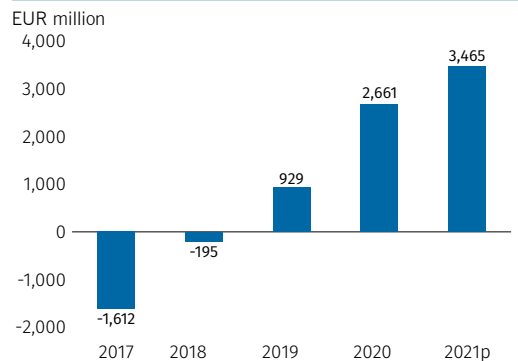
Source: Statistics Office of the Republic of Serbia and Eurostat.

The public debt stabilized...



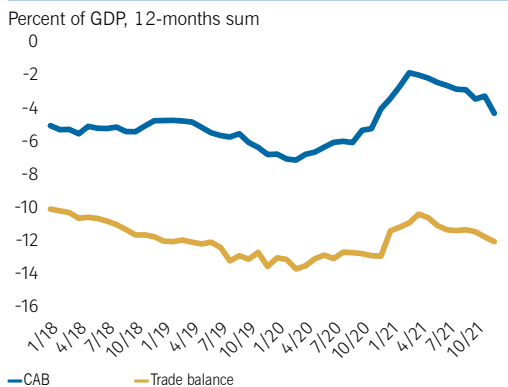
Source: Ministry of Finance.

...despite a significant increase of debt in euro terms



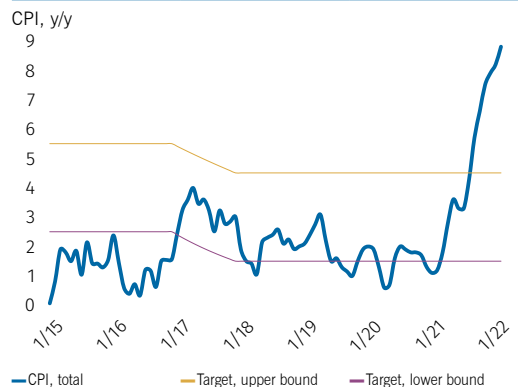
Source: Ministry of Finance.

The CAD and trade deficit recently started to increase.



Source: National Bank of Serbia.

Inflation has been increasing since April.



Source: National Bank of Serbia.

SERBIA	2019	2020	2021p	2022f	2023f	2024f
Real GDP growth (percent)	4.3	-0.9	7.4	3.2	2.7	2.8
Composition (percentage points):						
Consumption	2.9	-0.9	5.7	4.0	3.4	3.1
Investment	4.0	-0.1	3.8	1.1	0.9	1.0
Net exports	-2.6	0.1	-2.1	-1.8	-1.6	-1.4
Exports	4.1	-2.3	10.3	3.3	3.0	3.1
Imports (-)	6.7	-2.4	12.4	5.1	4.6	4.5
Consumer price inflation (percent, period average)	1.9	1.6	4.0	7.0	5.3	4.1
Public revenues (percent of GDP)	42.0	41.0	43.3	42.3	43.0	43.1
Public expenditures (percent of GDP)	42.2	49.0	47.4	46.3	46.0	45.3
Of which:						
Wage bill (percent of GDP)	9.5	10.5	10.0	10.1	10.2	10.3
Social benefits (percent of GDP)	14.4	14.7	13.6	14.0	14.0	14.2
Capital expenditures (percent of GDP)	4.9	5.3	7.4	7.4	7.0	7.2
Fiscal balance (percent of GDP)	-0.2	-8.0	-4.1	-4.1	-3.0	-2.2
Primary fiscal balance (percent of GDP)	1.8	-6.0	-2.4	-2.3	-1.0	-0.3
Public debt (percent of GDP)	48.8	53.9	53.9	52.8	53.2	51.8
Public and publicly guaranteed debt (percent of GDP)	52.8	57.8	57.1	58.2	58.9	56.8
Of which: External (percent of GDP)	30.3	33.4	37.0	38.0	40.0	40.0
Goods exports (percent of GDP)	35.7	34.4	38.9	38.0	38.6	39.9
Goods imports (percent of GDP)	47.9	45.5	50.1	49.9	49.8	50.1
Net services exports (percent of GDP)	2.3	2.4	2.7	2.4	2.1	2.6
Trade balance (percent of GDP)	-9.9	-8.8	-8.5	-9.5	-9.1	-7.6
Net remittance inflows (percent of GDP)	5.6	4.5	4.7	4.5	4.4	4.2
Current account balance (percent of GDP)	-6.9	-4.1	-4.4	-6.4	-5.8	-5.1
Net foreign direct investment inflows (percent of GDP)	7.7	6.3	6.8	5.8	6.3	6.2
External debt (percent of GDP)	61.8	65.8	68.6	65.3	63.1	61.0
Real private credit growth (percent, period average)	6.9	9.2	3.7	-	-	-
Nonperforming loans (percent of gross loans, end of period)	4.1	3.7	3.6	-	-	-
Unemployment rate (percent, period average)	11.2	9.7	11.0	10.0	9.5	9.5
Youth unemployment rate (percent, period average)	28.6	27.3	26.5	-	-	-
Labor force participation rate (percent, period average)	52.9	52.2	54.7	-	-	-
GDP per capita, PPP (current international \$)	19,025	19,168	21,243	22,901	24,599	26,271
Poverty rate (percent of population)	10.1	10.2	9.8	9.6	9.3	9.1

Source: Country authorities, World Bank estimates and projections.

Note: Poverty rate calculations based on ECAPOV harmonization using SILC-C data. Nowcasted/projected values start at 2020. Income measures in the SILC and consumption measures in the HBS are not strictly comparable. Poverty is defined as living on less than \$5.5/day per person in revised 2011 PPPs.

Key Economic Indicators

Key Economic Indicators	2019	2020	2021p	2022f	2023f	2024f
Real GDP growth (percent)						
Albania	2.2	-3.5	8.5	3.2	3.5	3.5
Bosnia and Herzegovina	2.8	-3.1	7.1	2.7	3.1	3.5
Kosovo	4.8	-5.3	9.1	3.9	4.3	4.2
North Macedonia	3.9	-6.1	4.0	2.7	3.1	3.2
Montenegro	4.1	-15.3	12.4	3.6	4.7	3.7
Serbia	4.3	-0.9	7.4	3.2	2.7	2.8
<i>WB6</i>	3.7	-3.2	7.4	3.1	3.1	3.2
Consumer price inflation (percent, period average)						
Albania	1.4	1.6	2.6	5.5	4.0	3.0
Bosnia and Herzegovina	0.6	-1.1	2.0	6.5	2.3	0.5
Kosovo	2.7	0.2	3.4	5.4	1.6	2.2
North Macedonia	0.8	1.2	3.2	5.5	2.0	1.8
Montenegro	0.4	-0.3	2.4	5.0	2.3	1.6
Serbia	1.9	1.6	4.0	7.0	5.3	4.1
<i>WB6</i>	1.5	0.9	3.3	6.3	3.8	2.8
Public expenditures (percent of GDP)						
Albania	29.2	32.6	31.5	32.1	29.9	29.6
Bosnia and Herzegovina	40.6	44.0	44.8	41.7	40.2	39.4
Kosovo	29.7	33.0	30.1	30.6	30.9	30.7
North Macedonia	33.5	38.9	37.7	38.4	38.0	37.2
Montenegro	46.0	55.5	45.6	46.3	43.9	42.4
Serbia	42.2	49.0	47.4	46.3	46.0	45.3
<i>WB6</i>	36.9	42.2	39.5	39.2	38.1	37.4
Public revenues (percent of GDP)						
Albania	27.2	25.9	27.0	27.1	27.2	27.3
Bosnia and Herzegovina	42.6	42.2	42.3	40.5	40.4	40.5
Kosovo	26.8	25.4	28.7	28.4	28.2	28.2
North Macedonia	31.4	30.5	32.3	33.1	33.2	33.5
Montenegro	43.3	44.4	43.6	41.1	40.9	40.7
Serbia	42.0	41.0	43.3	42.3	43.0	43.1
<i>WB6</i>	35.5	34.9	36.2	35.4	35.5	35.5

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

Key Economic Indicators (continued)	2019	2020	2021p	2022f	2023f	2024f
Fiscal balance (percent of GDP)						
Albania	-1.9	-6.7	-4.5	-5.0	-2.6	-2.4
Bosnia and Herzegovina	1.9	-1.8	-2.5	-1.2	0.2	1.1
Kosovo	-2.9	-7.6	-1.4	-2.2	-2.6	-2.5
North Macedonia	-2.1	-8.3	-5.4	-5.3	-4.7	-3.7
Montenegro	-2.7	-11.0	-2.0	-5.2	-3.0	-1.7
Serbia	-0.2	-8.0	-4.1	-4.1	-3.0	-2.2
<i>WB6</i>	-1.3	-7.3	-3.3	-3.8	-2.6	-1.9
Public debt (percent of GDP)						
Albania	63.7	74.0	72.1	72.0	70.2	69.0
Bosnia and Herzegovina	32.8	36.6	34.4	33.2	34.0	35.3
Kosovo	17.0	22.0	22.1	24.0	25.3	26.9
North Macedonia	40.4	51.9	51.8	53.7	55.3	55.1
Montenegro	76.5	105.3	84.9	77.4	75.2	73.1
Serbia	48.8	53.9	53.9	52.8	53.2	51.8
<i>WB6</i>	46.5	57.3	53.2	52.2	52.2	51.9
Public and publicly guaranteed debt (percent of GDP)						
Albania	67.4	75.9	74.0	73.9	72.1	70.9
Bosnia and Herzegovina	34.5	38.8	36.6	35.1	36.0	37.5
Kosovo	17.6	22.4	22.5	24.3	25.4	27.0
North Macedonia	49.2	61.0	60.8	62.7	64.3	64.1
Montenegro	80.0	108.7	87.7	80.1	77.6	75.4
Serbia	52.8	57.8	57.1	58.2	58.9	56.8
<i>WB6</i>	50.3	60.8	56.5	55.7	55.7	55.3
Goods exports (percent of GDP)						
Albania	6.6	6.0	8.2	6.8	6.7	6.7
Bosnia and Herzegovina	28.8	27.5	34.1	34.1	34.5	36.2
Kosovo	5.6	6.9	9.9	9.8	9.8	9.9
North Macedonia	47.5	45.3	51.1	52.0	53.0	53.9
Montenegro	9.4	9.8	10.7	11.5	11.1	11.1
Serbia	35.7	34.4	38.9	38.0	38.6	39.9
<i>WB6</i>	28.5	27.6	32.0	31.5	31.9	32.8

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

Key Economic Indicators (continued)	2019	2020	2021p	2022f	2023f	2024f
Trade balance (percent of GDP)						
Albania	-13.8	-14.4	-13.3	-12.1	-10.5	-9.5
Bosnia and Herzegovina	-14.7	-14.0	-12.3	-12.8	-12.5	-12.6
Kosovo	-27.1	-31.6	-32.7	-32.9	-31.7	-30.4
North Macedonia	-14.3	-13.0	-15.9	-16.6	-16.1	-15.5
Montenegro	-21.1	-35.0	-19.6	-20.7	-19.7	-19.4
Serbia	-9.9	-8.8	-8.5	-9.5	-9.1	-7.6
<i>WB6</i>	-13.6	-13.6	-12.8	-13.4	-12.7	-11.8
Current account balance (percent of GDP)						
Albania	-8.0	-8.5	-7.7	-7.9	-6.4	-5.3
Bosnia and Herzegovina	-2.9	-3.9	-2.3	-3.2	-3.0	-2.6
Kosovo	-5.6	-7.0	-9.1	-9.7	-9.0	-8.0
North Macedonia	-3.3	-3.4	-3.5	-4.0	-3.3	-2.9
Montenegro	-14.3	-26.1	-9.2	-12.6	-12.1	-12.0
Serbia	-6.9	-4.1	-4.4	-6.4	-5.8	-5.1
<i>WB6</i>	-6.2	-5.7	-4.9	-6.3	-5.6	-5.0
External debt (percent of GDP)						
Albania	60.0	65.6	58.1	56.7	57.0	56.9
Bosnia and Herzegovina	65.6	70.7	65.4	60.3	58.1	58.7
Kosovo	31.2	37.2	37.3	-	-	-
North Macedonia	72.4	80.3	81.4	82.8	82.0	81.4
Montenegro	169.0	224.1	199.0	194.8	190.9	188.4
Serbia	61.8	65.8	68.6	65.3	63.1	61.0
<i>WB6</i>	76.7	90.6	85.0	92.0	90.2	89.3
Unemployment rate (period average, percent)						
Albania	11.5	11.7	11.5	-	-	-
Bosnia and Herzegovina	15.7	15.9	17.4	-	-	-
Kosovo	25.7	24.5	-	-	-	-
North Macedonia	17.3	16.4	15.7	14.7	13.9	13.5
Montenegro	15.1	17.9	16.6	-	-	-
Serbia	11.2	9.7	11.0	10.0	9.5	9.5
<i>WB6</i>	16.1	16.0	-	-	-	-

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

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