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WESTERN BALKANS REGULAR ECONOMIC REPORT

Testing Resilience

No. 23 | Spring 2023

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1818 H Street NW
Washington DC 20433
Telephone: 202-473-1000
Internet: www.worldbank.org

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Acknowledgements

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

The report is produced twice a year by a team led by Sanja Madzarevic-Sujster, Richard Record, and Natasha Rovo (Task Team Leaders). This issue's core team included World Bank staff working on the Western Balkan countries (with additional contributions to specific sections): Marc Schiffbauer, Natasha Rovo, Leonardo Iacovone, Matias Belacin (Growth section), Sanja Madžarević-Šujster, Joana Madjoska (Labor section), Leonardo Lucchetti, Carlos Gustavo Ospino Hernandez, Anna Fruttero, Zurab Sajaia (Poverty section), Milan Lakićević, Besart Myderrizi, Stefanie Brodmann, Sarah Coll-Black, Zoran Anušić, Cornelius Von Lenthe (Fiscal section), Hilda Shijaku, Isolina Rossi, Sergiy Zorya, Silvia Mauri (Monetary section), Alper Oguz, Jane Hwang (Financial sector section), Sandra Hlivnjak, Tihomir Stučka (External section), Richard Record, Christos Kostopoulos, Collette Mari Wheeler, Daria Taglioni, Roman David Zarate Vasquez (Outlook section), Anita Hafner, and Marissa Santikarn (Spotlight).

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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

BAU	business as usual
BoA	Bank of Albania
CAD	current account deficit
CBAM	Carbon Border Adjustment Mechanism
CEE	Central and Eastern Europe
CO2	carbon dioxide
COL	cost of living
CPI	Consumer Price Index
ECAPOV	Europe and Central Asia Regional Collection
ECB	European Central Bank
EGD	European Green Deal
ETD	Energy Tax Directive
ETS	Emissions Trading System
EU	European Union
FDI	foreign direct investment
FX	foreign exchange
GDP	gross domestic product
GFC	global financial crisis
GJ	gigajoule
H1	first half
H2	second half
HBS	Household Budget Survey
ICT	information and communications technology
IMF	International Monetary Fund
KM	konvertibilna marka; the monetary unit of Bosnia and Herzegovina
MRV	Measurement, Reporting and Verification
MTRS	Medium-Term Revenue Strategy
NECPs	National Energy and Climate Plans
PMI	Purchasing Managers Index
pp	percentage point
PPG	public and publicly guaranteed
Q3	third quarter
Q4	fourth quarter
R&D	research and development
rhs	right-hand scale
SILC	Survey of Income and Living Conditions
SOEs	state-owned enterprises
3mma	three-month moving average
WTO	World Trade Organization
y/y	year over year

Balkan Country Abbreviations

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

Other Country Abbreviations

ARM	Armenia
AZE	Azerbaijan
BGR	Bulgaria
BLR	Belarus
CZE	Czech Republic
ECA	Europe and Central Asia
EST	Estonia
GEO	Georgia
HRV	Croatia
HUNG	Hungary
KAZ	Kazakhstan
KGZ	Kyrgyzstan
KSV	Kosovo
LTU	Lithuania
LVA	Latvia
MD	Moldova
MDA	Republic of Moldova
POL	Poland
ROU	Romania
RUS	Russia
SVK	Slovakia
TJK	Tajikistan
TUR	Turkey
UKR	Ukraine
UZB	Uzbekistan

Note: All comparisons are year on year unless otherwise stated.


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Testing Resilience

1. Overview

The six countries of the Western Balkans have seen their resilience tested over the last three years. After the economic activity bounced back in 2021, economic performance has been buffeted by a challenging external environment stemming from the fallout of Russia's invasion of Ukraine, higher energy and food prices, unfavorable weather conditions, tightening financial conditions, and significant uncertainty. That said, while growth continues to slow and prices continue to rise, the economies of the Western Balkans have shown resilience. Although risks remain heavily tilted to the downside, the most significant fears—such as persistent energy and food shortages or a recession in the Eurozone—have not materialized. The region now faces the challenges of rebuilding buffers in readiness for the next shock, and in undertaking supply-side reforms to lay the foundations for more sustainable and greener growth.

Growth in the Western Balkan economies started strong in early 2022, before moderating toward year-end, but the impact of major shocks, such as electricity and heating outages, has been less severe than expected. The economic performance of the region reflects synchronization with the European Union (EU), the effect of rising energy and food prices on consumption and investment, and the weather-induced impact on agriculture and energy production, due to a particularly dry year. Despite having avoided a recession in the last quarter, the EU27 is estimated to have grown at a pace of 3.7 percent in 2022, leading to a pause in the Western Balkans convergence. All six economies have now surpassed their pre-pandemic levels in terms of GDP, although at different speeds.

Inflation surged to a two-decade high in 2022 in almost all economies, and price pressures remain elevated in early 2023. In most countries of the Western Balkans, consumer price inflation peaked in late 2022 and now shows signs of easing. Energy and food price increases have driven inflation upward throughout 2022, but with external drivers now dissipating due to slowing global growth. Trends in core inflation suggest that price pressures remain broad-based and sticky. In countries with an independent monetary policy, central banks have taken steps to tighten it. However, conditions remain accommodative as real policy rates remain negative due to rising inflation and price expectations.

Higher food and energy prices have affected low-income households especially severely, resulting in a much slower pace of poverty reduction in 2022 despite universal government support. Due to lower economic growth and higher inflation, poverty is estimated to have decreased by just 1 percentage point in 2022, a much lower poverty reduction pace than in the pre-pandemic period. This is equivalent to 160,000 individuals moving out of poverty in 2022. Households at the bottom end of the distribution of income spend a much higher proportion of their income on food and energy, the two items in the consumption basket with the highest price increase, compared to those at the top of the income distribution. This means that the increases in the actual cost of living faced by the poor in the Western Balkans are much higher than official consumer price inflation figures suggest. To design effective policies to protect the less well-off and promote economic growth, it is important to consider the variability of inflation rates across different household types.

Despite seeing a positive rate of employment growth, the pace of job creation lost strength across all Western Balkan countries in the second half of 2022. By year-end, employment in the Western Balkans contracted by over 1 percent, equivalent to 72,000 fewer jobs. Albania and Montenegro are the only countries where employment levels continued to grow. However, employment levels across all countries except North Macedonia are still above pre-crisis levels despite the slowdown. While the unemployment rate declined across all countries to 13.2 percent by end-2022, the youth unemployment rate is still double the overall rate, although it is declining. There were 878,000 people unemployed in the region at end-2022, a contingent that needs to be mobilized to address labor shortages articulated by firms. The regional disparities in unemployment persisted throughout the crises and recovery, suggesting low labor mobility.

Fiscal deficits have narrowed in most Western Balkan countries despite persistent social spending pressures against record inflation. In four of the six Western Balkan countries, fiscal deficits narrowed by an average of 1 percentage point of GDP during 2022. Yet, in Montenegro and Bosnia and Herzegovina, fiscal balances deteriorated compared to 2021, though less than previously expected. Across the six economies, nominal revenues have performed well, helped by higher inflation. As a share of GDP, public expenditure was broadly stable, as higher social spending and transfers were offset by declining real public wages and under-execution of capital spending. As a result, the Western Balkan average deficit level remained constant from a year before at 3.0 percent of GDP and still higher than its pre-pandemic level. While public debt has declined below pre-pandemic peaks, except in Kosovo and North Macedonia, it remains elevated in general, amid tightening financing conditions. As the region begins to look beyond the crises, countries will need to shift away from broad-based subsidies toward more targeted approaches. Pent-up pressures on public sector wage bills are also expected to grow.

The financial sector in the Western Balkans continued to be stable, but its resilience is being tested by pressures on financial stability posed by multiple factors. The ongoing war in Ukraine, sharply higher interest rates and inflation are now coupled with a deterioration of economic sentiment across the region. While asset quality continues to improve, there are concerns that rising interest rates and the tightening of credit supply might accentuate borrowers' vulnerabilities. Credit risks from energy-intensive corporate sectors, residential and commercial real estate, uncollateralized consumer finance, interest rate-sensitive portfolios, and sovereign exposures will need to be closely monitored. High frequency data points to signs of higher credit risk, despite decreasing NPL ratios.

In 2022, the regional current account deficit exhibited its highest level in the last decade, with the exception of the pandemic year. Specifically, the regional external deficit soared to 6.9 percent of GDP in 2022 from 4.8 percent the year before. The widening of the external deficit was mainly driven by Montenegro and North Macedonia, while

Albania remained an exception. Merchandise trade deficits widened due to both the terms-of-trade shock raising the cost of imports, and consumption and investment growth outpacing export growth. Net service exports, including tourism, in particular, picked up in 2022, helping in part to offset the widening current account deficit. Remittances have also held steady reflecting a continued tight labor market in the EU. Regional external imbalances were largely funded by net inflows of foreign direct investment. These rose by 1.2 percent of GDP (to 7.0 percent of GDP) and may give some credence to the argument of nearshoring of global value chains and/or relocation of businesses from Ukraine and Russia benefiting the Western Balkans.

The outlook for the Western Balkans remains subdued and uncertainty remains high. In the short term, growth outcomes are expected to be driven by economic performance in the EU, the course of energy and food prices, and the fight against inflation. All these factors are affected by Russia's invasion of Ukraine and persistent impacts of the pandemic, which prompted shifts in demand and revealed supply bottlenecks. The outlook for the EU remains challenging, although the latest forecasts suggest that the Eurozone will avoid a recession. Energy prices are driven by continued supply uncertainty, although price forecasts are now lower than anticipated last year owing to the milder European winter and receding fears regarding gas storage stocks. However, natural gas prices are proving sticky, especially in Europe, given the critical role Russia has played in this market. Food prices are expected to remain high and look to be resulting in a pass-through to higher core inflation. Finally, monetary tightening led by advanced economies is both compressing demand and raising financing costs for sovereigns, corporates and households.

Against this backdrop, the resilience of growth in 2023 will be tested further. GDP growth is expected to moderate to 2.6 percent in 2023 mainly driven by consumption, though public investment is expected to play an important role in Bosnia and Herzegovina, Montenegro, and North Macedonia. While several countries are expecting a continued recovery in tourism revenues, as well as further growth in merchandise exports, external demand may weaken, and domestic demand is expected to remain an important growth factor. For the most part, GDP growth forecasts for 2023 have been revised downward since the last edition of the *Western Balkans Regular Economic Report* on account of the weaker external environment, which affects export growth, inflation, and financing costs (Table 1.1).

In the medium term, the Western Balkans continues to have a positive outlook, but reforms are needed to rebuild buffers, accelerate the green transition, and to address key structural challenges. The ongoing energy crisis has highlighted the need to accelerate the green transition across Europe, including in the Western Balkans. A key starting point in this regard is to accelerate the move toward carbon pricing and to increase the use of environmental fiscal measures that incentivize households and firms to shift toward lower carbon intensity with respect to economic activity (the Spotlight in this edition of the *Western Balkans Regular Economic Report* investigates this issue in more depth). Further, as governments across the region look toward rebuilding their fiscal buffers, there are high returns to no-regret reforms that would boost productivity over the medium term, such as accelerating regional integration, increasing levels of market competition, attracting higher quality investments, and addressing barriers that limit labor force participation (especially among women). Finally, securing alternative energy resources, including through the acceleration of investment in renewables, needs to be a priority ahead of the next winter.

Table 1.1. Western Balkans Outlook, 2020–25

	2020	2021	2022e	2023f	2024f	2025f
Real GDP Growth (percent)						
Albania	-3.3	8.9	4.8	2.8	3.3	3.3
Bosnia and Herzegovina	-3.0	7.4	4.0	2.5	3.0	3.5
Kosovo	-5.3	10.7	3.5	3.7	4.4	4.2
North Macedonia	-4.7	3.9	2.1	2.4	2.7	2.9
Montenegro	-15.3	13.0	6.1	3.4	3.1	2.9
Serbia	-0.9	7.5	2.3	2.3	3.0	3.8
WB6	*-3.0*	*7.8*	*3.2*	*2.6*	*3.1*	*3.5*
Real GDP Components Growth (percent)						
Consumption	-1.1	4.6	3.3	1.9	2.1	2.6
Investment	-1.6	2.0	2.5	0.9	0.9	1.2
Net exports	-0.3	-0.1	-2.7	-0.2	0.2	-0.3
Exports	-5.9	9.7	7.7	2.3	2.8	3.4
Imports (-)	-5.6	9.8	10.4	2.5	2.6	3.6
Consumer Price Inflation (percent, period average)	1.0	3.3	11.8	7.0	3.4	2.9
External Sector (percent of GDP)						
Goods exports	27.2	32.5	36.8	37.0	37.0	37.1
Trade balance	-14.0	-13.0	-15.3	-14.7	-14.1	-13.7
Current account balance	-5.5	-4.8	-6.9	-6.3	-5.8	-5.5
Foreign direct investment	5.2	5.8	7.0	5.8	5.7	5.8
External debt	88.9	83.8	78.4	75.6	73.8	72.3
Public Sector (percent of GDP)						
Public revenues	34.7	36.0	35.6	35.9	35.6	35.7
Public expenditures	42.5	38.9	38.6	38.7	38.1	37.9
Fiscal balance	-7.9	-3.0	-3.0	-2.7	-2.4	-2.0
Public and publicly guaranteed debt	60.5	56.6	51.0	50.9	51.3	50.7

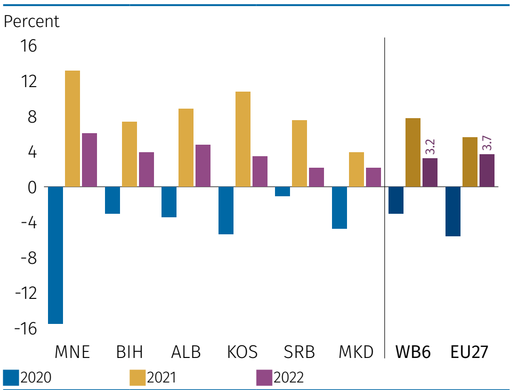
Sources: National statistical offices; Ministries of Finance; central banks; World Bank staff estimates.
Note: e = estimate; f = forecast.

2. The recovery proved resilient despite global headwinds and unfavorable weather conditions

Growth in the six Western Balkan economies started strong during the year before moderating toward end-2022, but the impact of major shocks, such as electricity and heating outages, has been less than expected. The economic performance of the WB6 countries reflects synchronization with the European Union (EU), which, having avoided a recession in the last quarter, is estimated to have grown at 3.7 percent in 2022; and despite the effect of rising energy and food prices on consumption and investment and the weather-induced impact on agriculture and energy production due to a particularly dry year. Overall growth for the year came in at 2.1 percent in North Macedonia, 2.3 percent in Serbia, 3.5 percent in Kosovo, 4.0 percent in Bosnia and Herzegovina, 4.8 percent in Albania, and 6.1 in Montenegro (Figure 2.1). All six economies have now surpassed their pre-pandemic levels in terms of GDP, although at different speeds (Figure 2.2).

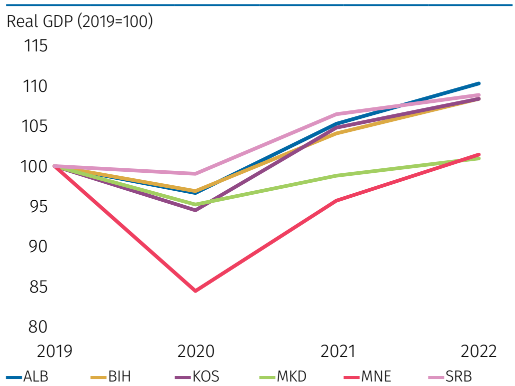
Growth was driven by two countervailing forces: (i) a robust increase in domestic demand owing to private consumption and, in some countries, a surge in public investment; and (ii) an adverse terms-of-trade shock (Figure 2.3). Private consumption, exports, and investment drove growth, despite increasing energy and food prices. Part of it is policy induced—still accommodative monetary and fiscal policy in the first half of the year; tightening that followed lead to lower growth at the end of 2022. Increases in remittances, credit growth, fiscal support measures, minimum wage hikes, and public sector wage increases helped support household consumption. Where real net wages softened, such as in Bosnia and Herzegovina, this was offset by higher remittances and drawdowns in household deposits, largely foreign currency long-term deposits. Public investment helped the recovery in Bosnia and Herzegovina, largely supported by infrastructure works boosted by elections held in October 2022. In

Figure 2.1. Real GDP growth slowed in 2022...



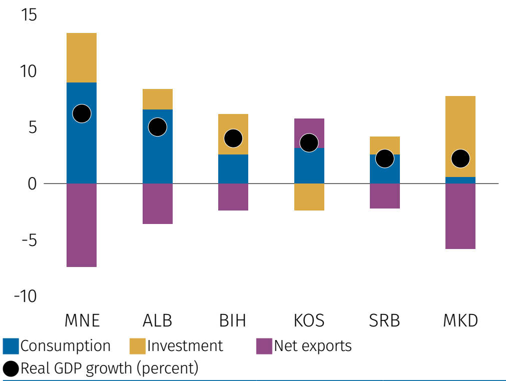
Sources: National statistical offices; IMF; World Bank staff.

Figure 2.2. ...but it surpassed 2019 levels in all Western Balkan countries.



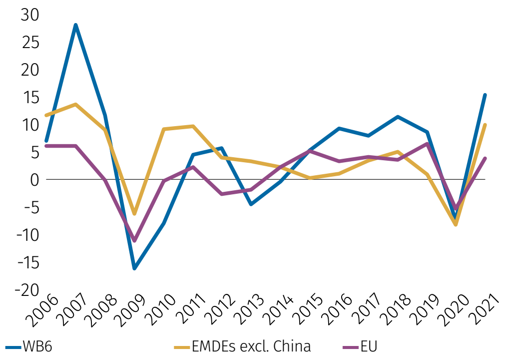
Sources: National statistical offices; World Bank staff.

Figure 2.3. Growth was led by domestic demand in 2022.



Sources: National statistical offices; World Bank staff.

Figure 2.4. Investment growth has been resilient.



Sources: World Bank 2023; World Development Indicators.

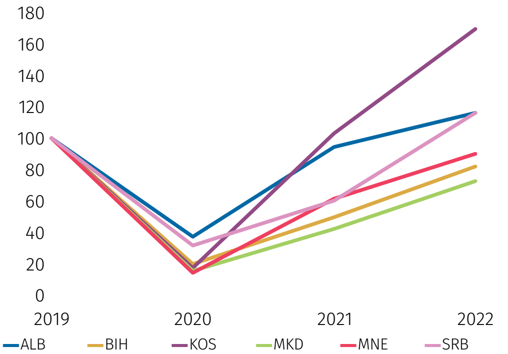
Albania and Montenegro, instead, gross fixed capital formation slowed, due to a decline in government capital spending and following the completion of the first section of the highway, respectively. Imports, especially of electricity, offset export growth in almost all countries; only in Kosovo was the net export contribution to growth positive.

Investments in the Western Balkans have also been resilient (Figure 2.4). This contrasts with a majority of emerging markets and developing economies (EMDEs), where the investment recovery following the COVID-19 pandemic has proceeded slowly, especially compared to the years following the global financial crisis (GFC). In addition, the decline observed for investment growth in EMDEs over the past two decades reflects in large part the path of output, changes in the capital flow-to-GDP ratio, and low private sector real credit growth. For the Western Balkans, the contribution of investment to growth was higher in 2021 and 2022, at 2.0 and 2.5, respectively, compared to the years immediately after the GFC and differently from the EMDEs average, where the investment growth was sluggish in the aftermath of the GFC. This may also reflect the benefits of the proximity of the six countries to the EU, and opportunities associated with nearshoring of global value chains.

On the supply side, the hospitality sector has rebounded strongly and even outperformed the pre-pandemic levels in Albania, Kosovo, and Serbia (Figure 2.5). International tourism receipts accounted for up to more than 50 percent of total exports in Albania and Montenegro in 2019, before COVID-19 hit, which led to a large fall in arrivals in the two countries and across the region. In 2022, tourism, proxied by the number of nights spent by nonresidents, has fully recovered and has surpassed the 2019 level in Kosovo, followed by Albania and Serbia. In contrast, in Montenegro, North Macedonia, and Bosnia and Herzegovina, even though tourism has continued to see a steady recovery, the number of arrivals and nights spent have still not yet returned to the levels observed before the pandemic.

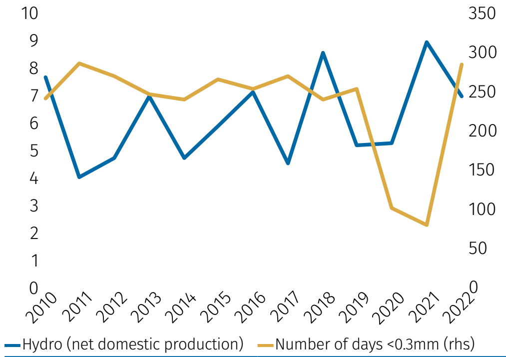
The service sector continues to lead the growth recovery, while industrial activity lags, except in Kosovo. Construction has subtracted from growth across the region,

Figure 2.5. Tourism outperformed 2019 levels in several countries.



Sources: National statistical offices; World Bank staff.

Figure 2.6. Dry days and hydro production in Albania.



Sources: www.meteotirana.al; INSTAT.
Note: Dry days are days with precipitation less than or equal to 0.3 millimeters.

except in Albania, where construction, together with trade, have been the main drivers of growth. While in Montenegro an increase in the number of building permits issued toward the end of the year points to a likely resumption of construction activity in the near term, the 12 percent decline in construction permits issued in December suggests prolonged weaker construction activity in Serbia. Across the six countries, industrial production also contracted in 2022, except in Kosovo, where it expanded. In Serbia, after a slowdown in the third quarter, industrial production bounced back in the last quarter, primarily supported by the mining sector.

Unfavorable weather negatively impacted electricity production and agriculture across the region. Unfavorable hydrometeorological conditions in the region, with 2022 reaching a new record-high number of dry days (Figure 2.6), affected electricity generation, negatively impacting overall industrial production in Albania and Montenegro. Investments in energy efficiency would help cope with the increasing frequency and severity of such energy shocks and would significantly reduce the negative impact of energy price shocks on firms' profits, especially in Albania and Montenegro (Box 2.1). The agriculture sector also suffered from unfavorable weather conditions, with agricultural production declining in Serbia for the second year in a row, while in Albania it grew by only 0.13 percent in the second quarter. The agricultural sector in Albania accounts for almost 18 percent of GDP, more than double the average share for other Western Balkan countries.

Box 2.1. Energy efficiency gains imply large savings in energy consumption and greenhouse gas emissions by firms, but have only a relatively small impact on corporate profits.

Substantial savings in energy-related greenhouse gas emissions would be generated by even moderate improvements in the energy efficiency of Western Balkan firms. Energy requirements vary among sectors and among firms within sectors. For example, in high energy-dependent sectors such as transport, energy expenses in electricity and fuels account for 45 percent of total costs, while in low energy-dependent industries such as textiles, the average share of energy in total costs is 7 percent. But there are also large differences in the energy efficiency among firms operating in the same sector, reflecting differences across firms in green technology investment and green management practices. That is, even in the least energy-intensive sector—textiles—differences range from 4 percent to 10 percent of total costs. If all energy-inefficient firms—namely, those below the 50th percentile in energy efficiency of their sector—adopted the industry's median efficiency, energy consumption required for producing the same amount of output would decline between 14 percent and 36 percent for the average firm in the Western Balkans (Figure 2.7, Panel A).

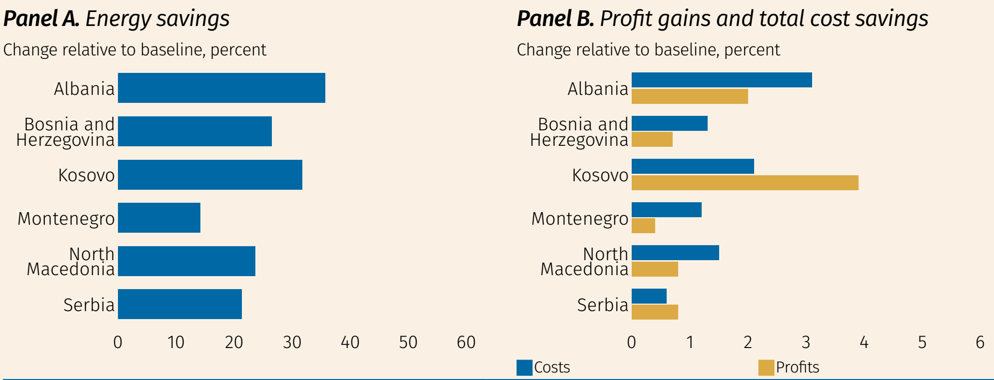
Improving energy efficiency has only modest effects on the average firm's costs and profitability, given their low energy dependence and comparatively lower energy costs, yet the social benefits are large. Given that average energy expenses do not exceed 9 percent of firms' total costs in Western Balkan countries, reflecting on average lower energy prices than in their EU peers, improving energy efficiency would have low impact on firms' total costs and profitability. That is, enhancing the energy efficiency of less-efficient firms would reduce total costs (including labor, raw materials, costs of goods sold, and energy items) between 0.6 percent and 3.1 percent, which implies profit gains ranging from 0.4 to 3.9 percent (Figure 2.7, Panel B). The relatively small size of the expected profit gains from energy improvements may thus explain why investments in green technologies and environmentally friendly management practices have been relatively limited in Western Balkan countries; that is, as the expected gains from green technology investments are limited, firms are less prone to invest money in green technologies or management practices. However, social benefits from increased energy efficiency are large. Policy incentives should be designed such that firms internalize the social benefits from investing in green technology and management practices.

Improving energy efficiency would, however, shield Western Balkans companies from future electricity and gas price shocks. Notably, during the energy crisis, firms in the Western Balkans have so far faced much lower electricity and gas price shocks than firms in the EU27 countries. If electricity and gas price shocks were as equally strong as those experienced by the average firm in the EU27 countries, total costs among Western Balkan firms would have risen between 3 percent and 9 percent. To quantify the extent to which energy efficiency improvements can reduce corporate costs after a surge in electricity and gas

(Box 2.1 continued)

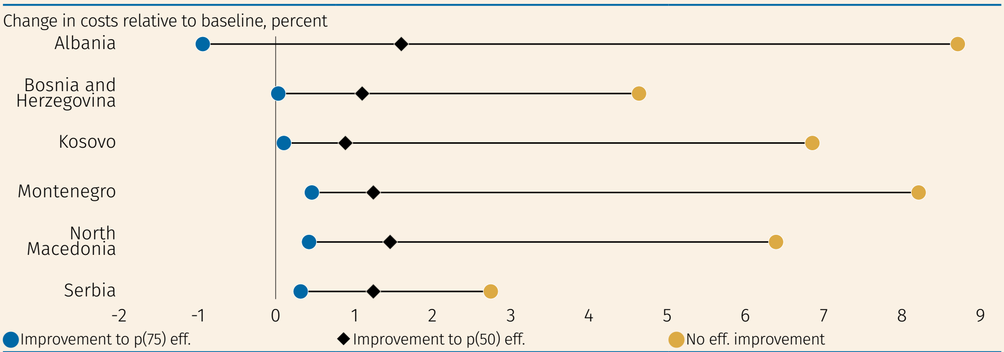
prices comparable to that observed in EU countries, Figure 2.8 reports the change in costs considering two scenarios: (a) there are no energy efficiency improvements; and (b) firms below the median energy-efficiency level compared to other firms of similar size in their sector are able to catch up to the efficiency level of the median firm. Moreover, as energy consumption depends on the price levels, we consider the average energy consumption of firms in the EU27 to simulate the impact of electricity and gas price changes at the country level. The results show that the rise in total corporate costs would be limited to only 1 to 2 percent instead of 3 to 9 percent if less energy-efficient firms improve their efficiency to the medium efficiency of their respective sector-size group. In Albania and Montenegro, for example, such energy efficiency improvements would reduce the electricity and gas price shock impact on total corporate costs from 9 percent to only 1.5 percent.

Figure 2.7. Energy-efficiency improvements have a large impact on reducing energy consumption, while the impact on corporate profits is relatively small.



Source: Staff calculations based on World Bank Enterprise Surveys.
Note: Energy costs are the sum of annual electricity and fuel costs. Total costs are defined as the sum of labor, energy, raw materials, and costs of goods sold. Value added results of subtracting raw materials costs from sales, while profits are calculated as total sales net of total costs. Baseline values are profits and costs before efficiency improvements.

Figure 2.8. Simulated impact of a large energy price shock on average corporate costs varies substantially depending on firms' improvements in energy efficiency.



Source: World Bank staff calculations based on World Bank Enterprise Surveys and Eurostat.
Note: No efficiency improvements consider the impact of the energy price shock on average firm-level total costs assuming the price increase is the average EU27 electricity and gas price changes. Improvement to the 50th percentile—p(50)—efficiency means that efficiency of firms below the median of the industry-by-size efficiency threshold is improved to the threshold value. The equivalent exercise if performed for the 75th percentile—p(75). Baseline costs are those under no efficiency improvements.

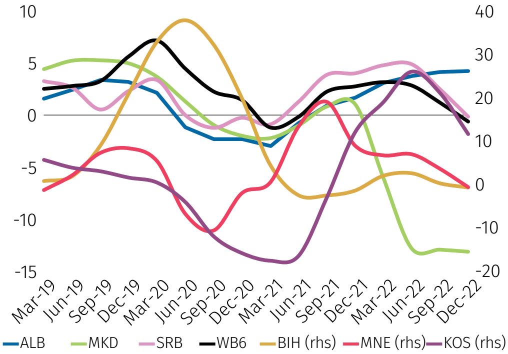
3. Job creation decelerated in late 2022 amidst a growth slowdown[1]

Despite employment growth, job creation lost strength across all the Western Balkan countries in the second half of 2022 (Figure 3.1). While employment in early 2022 increased in all countries (except North Macedonia, due to the adjustment to the new census-informed sample) by year-end the situation had reversed. By December 2022, employment dropped in all countries except Albania and Montenegro compared to end-2021. At year-end, overall annual employment in the Western Balkans had contracted by over 1 percent, equivalent to a net loss of 72,000 jobs. The largest annual drop was observed in North Macedonia, followed by Serbia and Kosovo. However, employment levels across all countries except North Macedonia are still above pre-crisis levels (Figure 3.2).

Employment contracted the most in agriculture and public administration, while industry and services also observed a slowdown. In December 2022, the strongest employment growth was in services (3.2 percent[2]) and construction (2.8 percent), while industry observed a mild 0.5 percent rate of employment growth (Figure 3.3). In Albania, Bosnia and Herzegovina, and Kosovo, employment increased in agriculture as well, while in other countries, a decline continued despite increased subsidies to the agriculture sector to contain the impact of food inflation and to increase import substitution. Albania, Bosnia and Herzegovina, and Serbia also observed a rise in public sector employment. Employment in construction, retail trade, information and communications technology (ICT), and tourism in Montenegro increased by double digits compared to 2021. Service sector employment in Serbia also gained

Figure 3.1. Employment growth has slowed since mid-2022.

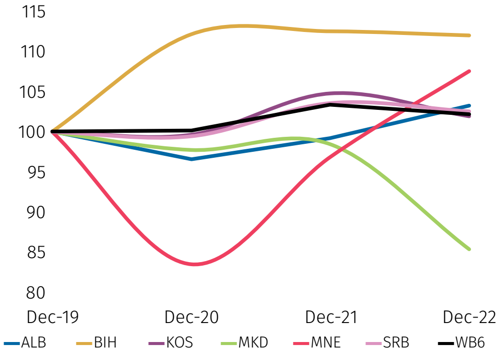
Two-quarter averages 2019 to 2022, y/y employment growth, percent



Source: National statistics offices and World Bank staff estimates.

Figure 3.2. In all countries except North Macedonia, employment is above the pre-crisis level.

December 2019=100



Source: National statistics offices and World Bank staff estimates.

1 This analysis was affected by (1) delayed publishing of Labor Force Survey (LFS) data in Kosovo; and by (2) a sampling revision in Bosnia and Herzegovina, Montenegro, and North Macedonia that reduced comparability with previous LFS data. Using administrative unemployment, and tax administration data for Kosovo, helped provide an approximate picture of the labor market from Q2 2022.

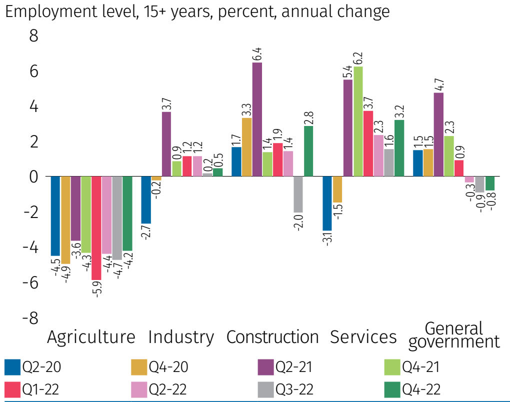
2 All comparisons are year on year unless otherwise indicated.

strength in late 2022, partially helped by migrant labor in ICT and professional services, as in Montenegro.

The Western Balkans employment rate (those aged 15 and over) reached a historic high of 47 percent in September 2022, after which it began to decline. The largest annual increases were registered in Albania and Montenegro at 2.7 and 7.9 percent, respectively. Albania is still the front-runner in the Western Balkans, with the highest employment rate of 56.3 percent, although Montenegro gained speed throughout 2022, reaching 51.3 percent in December 2022 (Figure 3.4). At 50.9 percent, Serbia registered a historically high employment rate in June 2022, and declined slightly by year-end, reflecting the growth slowdown. Although the employment rate in Kosovo increased, it is still a low 32 percent.

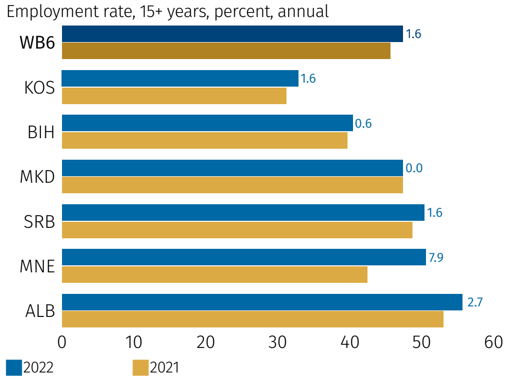
Unemployment declined across all countries and reached 13.2 percent at end-2022 (Figure 3.5). As of December 2022, there were 878,000 people unemployed in the region—10.5 percent or 103,000 people fewer than a year ago. Bosnia and Herzegovina, Kosovo, and North Macedonia recorded the

Figure 3.3. Public sector and agricultural employment declined in late 2022.



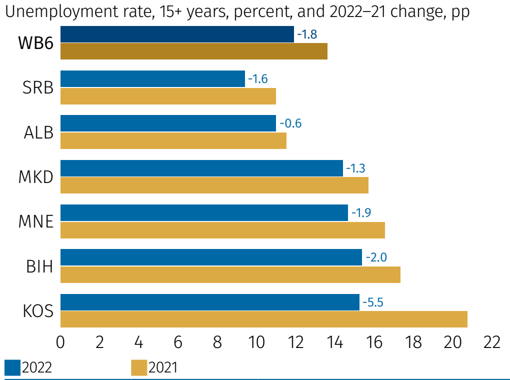
Sources: National statistics offices and World Bank staff estimates.
Note: Employment growth is weighted average.

Figure 3.4. Yet, the employment rate increased compared to 2021.



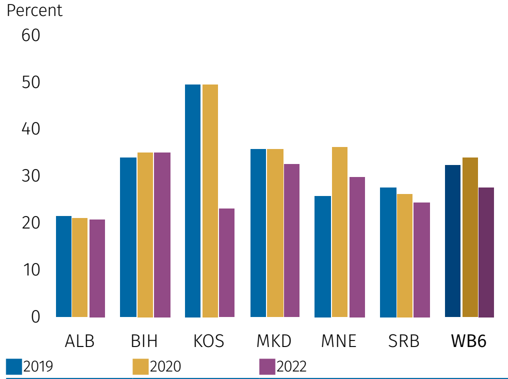
Sources: National statistics offices and World Bank staff estimates.

Figure 3.5. Unemployment declined in all Western Balkans countries in 2022.



Source: National statistics offices and World Bank staff estimates.

Figure 3.6. The youth unemployment is still high and double the overall unemployment rate.



Source: National statistics offices and World Bank staff estimates.

largest declines in the number of unemployed, by 13, 18, and 21 percent, respectively. In all three countries, this is explained by a declining labor force and an increase of inactivity, while in Montenegro, people moved to jobs. Montenegro is the only country that experienced a rise in both employment and unemployment, and where the regional differences are largest (Box 3.1). Bosnia and Herzegovina, and North Macedonia reached historically low unemployment rates—14.3 percent and 14 percent, respectively, but largely as people moved to inactivity or migrated. Serbia has the lowest unemployment rate in the region at 9.2 percent in December 2022, while the highest unemployment rate is in Kosovo, at slightly under 17 percent.

The youth unemployment rate in the Western Balkans is double the overall rate, although it declined to 27 percent—4.8 percentage points below the December 2021 rate (Figure 3.6). There are 202,000 young people unemployed in Western Balkans—a contingent in its highly productive age, some 36,000 less than in 2021. The lowest youth unemployment rate was in Albania, at 21.5 percent, followed by Kosovo and Serbia, each under 25 percent. Robust economic growth and diverse occupational and training programs for the young helped reduce youth unemployment to 31 percent in Montenegro, compared to 37 percent a year before. Despite improvements, the labor market situation for young people in the Western Balkan countries is characterized by high inactivity, persistent high levels of unemployment, a high share of informality, significant skills mismatches, and continued emigration. Since 2012, when half the young people were unemployed, the rate fell to 26 percent in 2022, but was still around 10 pp higher than the EU average. More than 50 percent of young people were long-term unemployed, which runs an increased risk of skill losses, reduced motivation to search for employment, and has the potential that youth will exit the local labor market altogether.

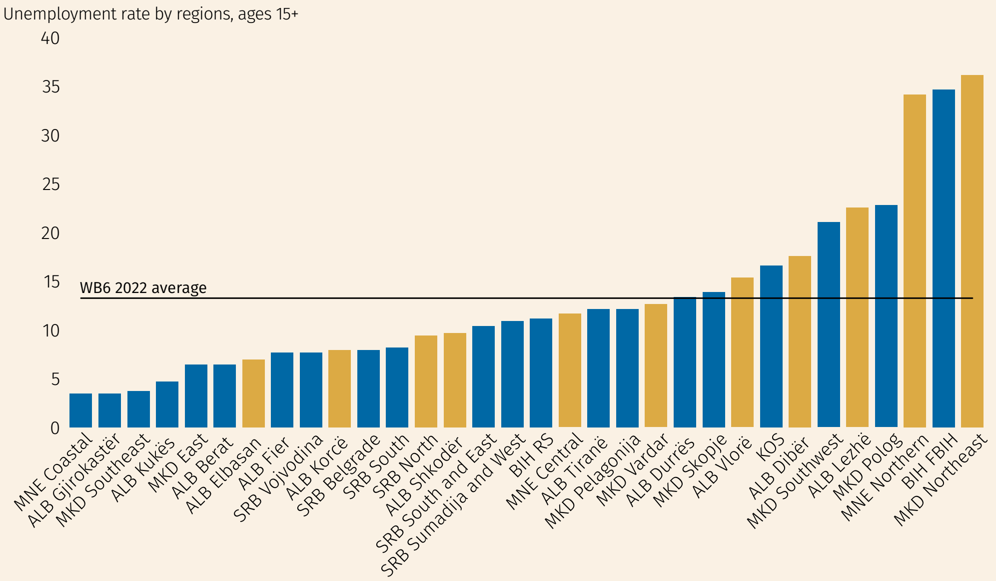
Box 3.1. Regional unemployment disparities in the Western Balkans persist.

Regional unemployment in the Western Balkans was disproportionately affected by the pandemic, with most of the impact absorbed by service-intensive regions. Nearly 70,000 jobs were lost across Western Balkan countries in 2020,[a] largely in tourism-oriented economies such as Albania and Montenegro, where coastal regions were hit hardest as a result of movement restrictions. At the same time, unemployment rates in capital cities (Tirana, Belgrade, Skopje) evidenced a modest reduction in unemployment. Post-pandemic, the regional recovery proved uneven and altered regional unemployment patterns across countries in the Western Balkans. In 2019, the bottom of the regional unemployment rate distribution was held by Elbasan, Albania (5.4 percent in 2019), but by 2022, Montenegro's coastal region took the lead (3.6 percent). Regions with high structural unemployment, such as the Northern region in Montenegro, the Federation of Bosnia and Herzegovina, and the Northeast region in North Macedonia, continued to struggle with unemployment rates of over 34 percent, largely unchanged compared to 2019.

(Box 3.1 continued)

Unemployment inequality within countries intensified, but the structure remained largely the same. In many Western Balkan countries, regions with the historically highest unemployment rates evidenced the largest hikes in unemployment relative to the pre-pandemic period, such as Lezhe and Diber in Albania (up by 5 pp and 7.6 pp to 22.7 percent and 17.7 percent in 2022) and the Northeast region in North Macedonia (up by 3.3 pp to 36 percent in 2021). Regional disparities also deepened as the gap among regions with the lowest and highest unemployment rates widened in most of the countries, particularly in North Macedonia, where the difference between the Northeast and the Southeast region increased by over 5 pp compared to 2019, and the unemployment rate gap between the two regions reached 32.5 pp in 2021.[b] The lack of mobility in Montenegro from the north to the coastal region is also pronounced; the unemployment rate gap between the two regions remained unchanged in 2022 compared to the pre-crisis 2019, at 30.6 pp. The coastal area's unemployment rate is below the natural rate of unemployment and is relying on foreign workers from neighboring Kosovo, Albania, and Serbia, but also Asian markets.

Figure 3.7. Despite chronic skills shortages, regional unemployment differences remain high.



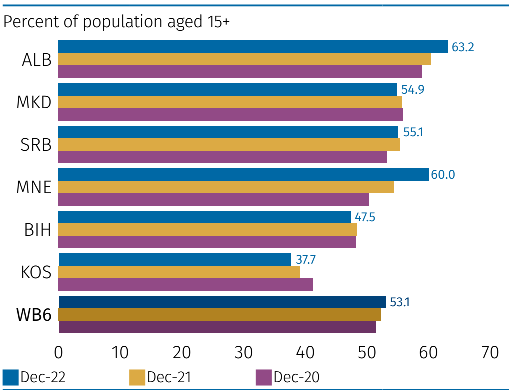
Sources. National statistical offices.
Note: North Macedonia (2021), and Kosovo (Q1 2022).

a. Western Balkans Regular Economic Report Spring 2021. The estimates exclude Bosnia and Herzegovina, which saw an increase in employment due to LFS sampling changes.
b. The 2021 census data have not yet been reflected on the historical population data adjustment from 2001 onwards. This may lead to overestimation of the unemployment rates in 2019 as labor outmigration has not been adequately captured.

The aggregate labor force participation rate improved slightly over the last year for the Western Balkans as a whole (Figure 3.8). The participation rate averaged 53.1 percent in December 2022—0.8 pp up since end-2021, with the gains coming only from Montenegro and Albania (of 5.6 pp and 2.8 pp, respectively). The labor force participation rate reached 63.2 percent in Albania—a record for the region, but after the revised methodology, Montenegro is following suit. In Bosnia and Herzegovina, Kosovo, North Macedonia, and Serbia the participation rate dropped in 2022 as employment growth slowed in late 2022, and people either moved to inactivity or to work abroad. The working age population over the past three years declined in Kosovo, North Macedonia, and Serbia, reflecting the high outmigration flows. The lowest ratio of the population participating in the labor market is in Kosovo (at 37.7 percent), where it has been declining since 2018. In Bosnia and Herzegovina and Kosovo, a rise in inactive population has been observed, which also reflects on pension outlay costs (Figure 5.3).

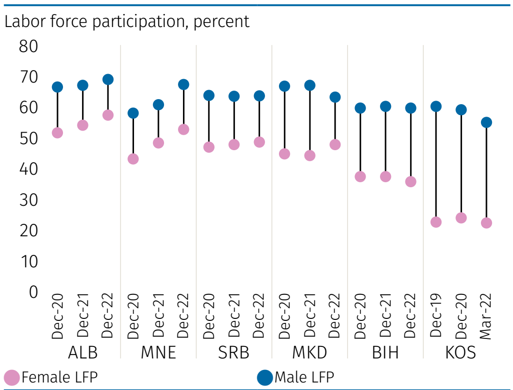
The improvement in the labor force participation rate is the result of women but also men entering the labor markets of Albania, Montenegro, and Serbia. The most pronounced increase of female participation was in Montenegro at 4.3 pp in 2022, Albania at 3.5 pp, and North Macedonia at 3 pp. With 57.4 percent of female participation rate, Albania sets the record for the region (Figure 3.9). Serbia and Montenegro have female participation rates also above the regional median of 48 percent, while in Albania, the gender gap is the narrowest, at 11.8 pp. The female-to-male participation gap for the region declined by 4 pp over the last year to 15.6 percent, with a stark difference of over 33 pp in Kosovo (Figure 3.9). Together with methodological improvements, the labor tax wedge reduction that came along with an increase in net wages as part of the Europe Now program in Montenegro, likely contributed to the increased labor force participation, as advances in male participation (at 67.4 percent) are also remarkable.

Figure 3.8. More people joined the Western Balkan labor force, but progress slowed in several countries.



Source: National statistics offices and World Bank staff estimates.

Figure 3.9. The female-to-male labor participation gap narrowed to 16 percentage points.



Source: National statistics offices and World Bank staff estimates.

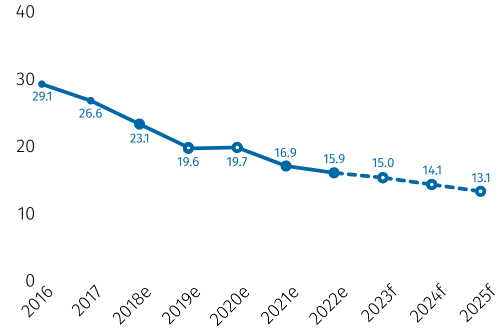
Wage pressures increased by end-2022 due to the inflation surge, and despite a slowdown in employment. In Montenegro, the average net monthly wage increased by 18.7 percent in real terms in 2022, due to the reduction in labor taxes and an increase in the minimum wage. In Albania, a nominal wage rise of 10.8 percent by December 2022 (or 3.4 percent in real terms) reflected the increased labor demand by the private sector. The average wage in Serbia increased by 13.8 percent in nominal terms or 1.7 percent in real terms, reflecting shortages of skills in the service sectors. The 2022 wage growth was more pronounced in the private sector, where the average net wage increased by 17 percent, whereas public sector wages increased by 7.3 percent. Led by a rise in the minimum wage, but also demand for workers in accommodation and recreation services, manufacturing, and the retail trade, nominal wages increased in North Macedonia by 11 percent in 2022. Yet, double-digit inflation meant that real net wages declined. In Bosnia and Herzegovina, nominal wage growth was 14.2 percent, and it was broad-based, with the highest increase in services, and the least in the public sector. But in real terms wages declined by 0.5 percent in December.

4. Protracted inflation poses a marked challenge to poverty reduction

Modest poverty reduction is expected in 2022, although many challenges remain.[3] Prior to the pandemic, the region had witnessed a significant reduction in poverty, with the poverty rate estimated to have decreased by around 10 percentage points (pp) between 2016 and 2019 (Figure 4.1), based on the upper middle-class poverty line of US$6.85 per day in 2017 purchasing power parity (PPP). This is equivalent to almost 1.4 million people moving out of poverty. The 2020 pandemic halted this positive trend. However, the economies of the region rebounded strongly in 2021, resulting in an estimated poverty reduction of about 2.8 pp, equivalent to lifting more than 400,000 people out of poverty. Several risks pose challenges for future poverty reduction. Poverty in 2022 is estimated to have decreased by only 1 pp in 2022 due to lower economic growth, equivalent to around 160,000 individuals. However, going forward, lower external demand could negatively affect exports and non-labor income by limiting remittances, while tighter fiscal space continues to constrain the support that can be provided to households.

Figure 4.1. Poverty is likely to have declined moderately in 2022, but many challenges lie ahead.

Poverty headcount, percent of population living on less than $6.85/day 2017 PPP



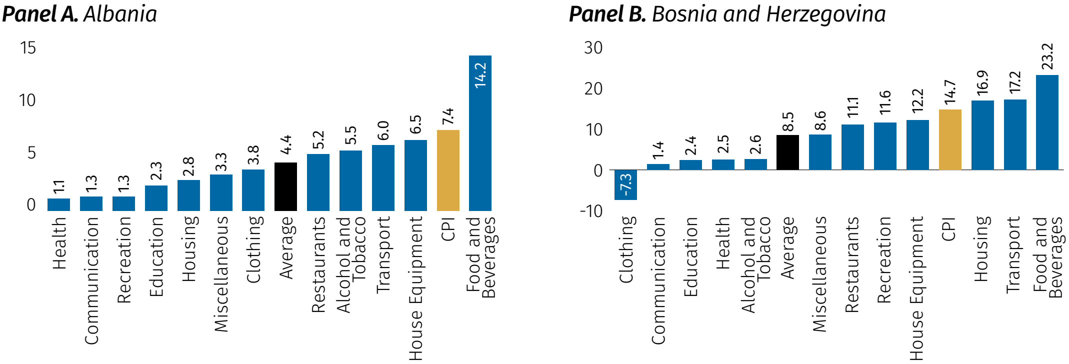
Sources: World Bank estimates and projections based on 2018 income data from the Survey of Income and Living Conditions (SILC) for Montenegro; 2019 for Albania and North Macedonia, 2020 Serbia, and 2017 Household Budget Survey (HBS) for Kosovo.
Note: Income measures in the SILC and consumption measures in the HBS are not strictly comparable. Welfare is estimated in U.S. dollars using 2017 PPPs. The regional estimate excludes Bosnia and Herzegovina (BiH) due to a lack of comparable data. Forecasts are based on GDP per capita in constant local currency units. e = estimate; f = forecast; PPP = purchasing power parity.

High inflation affected all countries in 2022, but its impact varied among household groups. Food and energy prices soared across the region, reducing the purchasing power of households, particularly the poor and vulnerable, as they spend a larger share of their income on these items. Estimates of the aggregate inflation impact on real incomes are based on each country's official Consumer Price Index (CPI), which typically measures the price changes for a fixed basket of goods and services. However, each household's consumption basket may differ from the CPI basket and from other households' consumption patterns. When prices do not vary much, this difference may not matter. However, when price variations are high or uneven (such as when the prices of some products increase more than the prices of others), the overall change in the CPI basket may differ significantly from changes in the price of households' actual consumption baskets. Among all six Western Balkan countries, Albania had the smallest between-group variation in inflation rate: a difference of about 13.1 percentage points

3 This section largely relies on Lokshin, Michael M.; Sajaia, Zurab; Torre, Ivan. Who Suffers the Most from the Cost-of-Living Crisis? (English). Policy Research working paper; no. WPS 10377 Washington, D.C.; World Bank Group.

Figure 4.2. Inflation varies significantly among product groups.

12-month price change across consumption groups, 2022



Source: World Bank staff calculations.
Note: This figure plots the 12-month price change by December 2022 of the 12 Classification of Individual Consumption According to Purpose (COICOP) broad consumption groups in Albania (panel A) and Bosnia and Herzegovina (panel B). The light blue bars indicate the simple average of the 12-month price across these groups. The red bars indicate the 12-month price change of the official Consumer Price Index (CPI) in each country during the same period.

(pp) between the largest-growing food and beverages and health divisions (Figure 4.2, panel A). In contrast, Bosnia and Herzegovina experienced a 23.2 percent growth in food prices compared to a deflation of 7.3 percent for clothing, resulting in a spread of 30.5 pp (Figure 4.2, panel B).

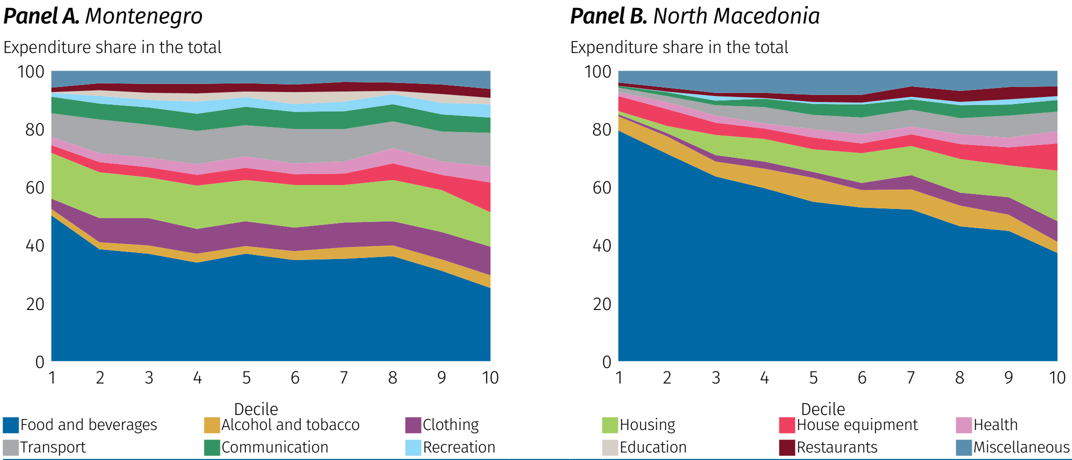
Household exposure to inflation depends not only on the different price changes between the goods and services they consume, but also on their consumption baskets. In countries where households spend approximately the same proportions of their budget on each consumption group, household-specific inflation rates will not vary significantly across households. If households have very dissimilar consumption baskets, then the opposite is true. In the Western Balkans, the poorest households have a significantly different expenditure composition from the richest ones, and these differences vary among countries. At one extreme, Montenegro shows the smallest diversity (Figure 4.3, panel A), while at the other extreme, North Macedonia presents the greatest dissimilarity of consumption shares among deciles when considering 12 consumption components (Figure 4.3, panel B).[4]

Given the significant price increases in 2022 and the evidence of the difference in the share of household spending, the cost-of-living (COL) inflation experienced among groups of households varies substantially. For all six Western Balkan countries, the less well-off systematically experience higher inflation rates compared to the better-off. On average, households in the lowest decile face inflation that is about 2.3 pp higher than the inflation rate faced by the households in the richest decile (Figure 4.4). In North Macedonia, the inflation rate experienced by the poorest group is 3.8 pp higher than the average, and 6.6 pp higher than households in the top decile. On the other extreme, the differences between the rates faced by the poorest and the richest is 1.6 pp for Albania.

4 These groups correspond to two-digit divisions in the Classification of Individual Consumption According to Purpose (COICOP).

Figure 4.3. Consumption shares vary significantly among income deciles.

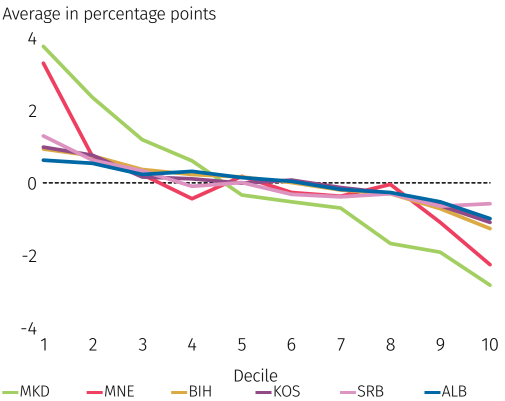
Composition of consumption expenditure across deciles, Montenegro and North Macedonia, 2021



Source: World Bank staff calculations.
Note: These figures plot the composition of consumption expenditure across deciles in Montenegro (panel A) and North Macedonia (panel B). Montenegro has the lowest value in consumption diversity among households among the Western Balkans countries with decile data in our sample, while North Macedonia has the highest value in consumption diversity among the same group. The values for both countries were calculated from their respective Household Budget Survey for 2021.

Figure 4.4. Cost-of-living inflation varies among households.

Cost-of-living annual inflation by decile across Western Balkan countries



Source: World Bank staff calculations.
Note: This figure plots the cost-of-living (COL) annual inflation by decile for December 2022. The inflation by decile is expressed as a difference with respect to the average COL inflation. The red line highlights the values for North Macedonia, the country with the largest difference between the COL annual inflation in decile 1 and decile 10, and the green line highlights the values for Albania, the country with the smallest difference between the COL annual inflation in decile 1 and decile 10.

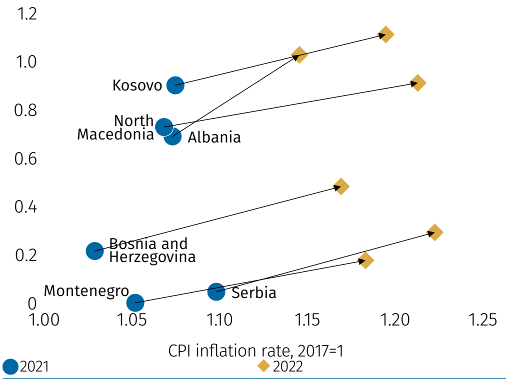
profiles of the poor derived from household-specific inflation rates differ systematically from those based on the standard CPI approach (Figure 4.5). Furthermore, the differences are even larger during periods of high inflation, such as 2022. Holding income constant and using COL inflation instead of official CPIs would result in a 0.7 pp higher poverty rate on average, while the simulated results for Albania and Kosovo show a difference of more than 1.0 pp. When comparing Gini coefficients of per capita consumption expenditures, the COL-based Gini coefficient is higher than the CPI-based one for all countries (Figure 4.6). Again, the difference is more pronounced for 2022, since price variations were high or uneven. North Macedonia's Gini coefficient changes the most (0.9 pp), while Serbia presents the lowest difference (0.3 pp).

The estimates for poverty and inequality would be higher if household-specific inflation were used instead of the standard CPI method. Poverty and inequality rates and

To design effective policies to protect the less well-off and promote economic growth, it is important to consider the variability of inflation rates across different household

Figure 4.5. Poverty measures are systematically affected by the inflation method used.

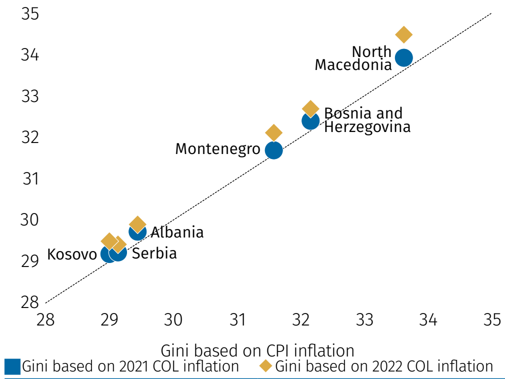
Difference between CPI- and COL-based poverty measures (percentage points)



Source: World Bank staff calculations.
Note: This figure plots the differences in poverty rates between the CPI-based and COL-based measures for Western Balkans countries. Each marker represents a value of corresponding poverty measure for a particular country and year. Square markers show differences between the poverty measures for 2021, and triangular markers show the differences calculated for 2022.

Figure 4.6. Inequality measures are also affected by the inflation method used.

Comparison of CPI- and COL-based Gini coefficients



Source: World Bank staff calculations.
Note: This figure plots the Gini coefficients of per capita consumption expenditures for the 6 Western Balkan countries. Each marker represents a value of Gini coefficient for a particular country and year. Square markers show the Gini estimated based on 2021 COL inflation, and triangular markers show the Gini estimated based on 2022 COL inflation. Markers on the dashed 45-degree line indicate no difference between the CPI- and COL-based Gini coefficients. The further the estimate is from the 45-degree line, the larger the difference.

types. The CPI may not be a reliable instrument for assessing to what extent household cost of living has increased in periods of high inflation, such as in 2022. As poorer households experience higher COL increases, using the CPI to measure inflation in such situations could also lead to policies with potentially unintended regressive consequences. As such, it is crucial that policies to protect vulnerable populations and promote economic growth consider the heterogeneity of inflation across households. For example, annual adjustments to benefit levels and eligibility criteria of government programs for poverty reduction are made based on inflation estimates. Thus, differences in inflation estimates could have significant implications for coverage, benefits, and budgets of such programs. Therefore, it would be important to employ inflation indicators that accurately capture the actual cost of living for different types of households to design efficient poverty alleviation policies.

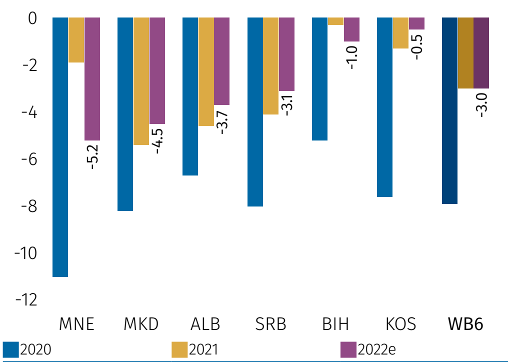
5. Rebuilding fiscal buffers as financing costs rise

Fiscal deficits narrowed in most Western Balkan countries despite persistent social spending pressures against record inflation. In four of the six Western Balkan countries, fiscal deficits narrowed by an average of 1 percentage point (pp) of GDP during 2022. Yet, in Montenegro and Bosnia and Herzegovina, fiscal balances deteriorated compared to 2021, although less than previously expected. While fiscal pressures heightened due to the needed social spending increases across the six countries to provide support during the energy crisis and rising prices, the tax policy change in Montenegro and election-driven spending in Bosnia and Herzegovina compounded this impact and exacerbated fiscal balances. As a result, the Western Balkan average[5] deficit remained broadly constant from a year before (Figure 5.1) and still higher than its pre-pandemic level.

Revenue growth remained strong but slowed compared to 2021, while expenditures moderated. In Albania, Kosovo, North Macedonia, and Serbia, nominal revenue increased by an average of 13 percent (Figure 5.2), boosted by record inflation.[6] In Montenegro, on the other hand, revenues increased by only 4.5 percent, while in Bosnia and Herzegovina they remained broadly constant. In Albania, Serbia, and Kosovo, intensified formalization efforts also bolstered revenue performance. Yet, compared to 2021, revenue growth slowed (Table 5.1). As a share of GDP, public revenues remained broadly unchanged for the region, averaging close to 36 percent of GDP, with Kosovo and Albania staying below 30 percent of GDP and Serbia and Bosnia and Herzegovina above 40 percent.

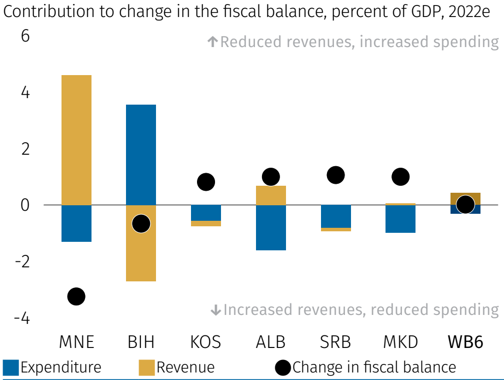
As a share of GDP, public expenditure remained at the previous year's level, mainly on account of lower real public wages and capital underspending. After consolidating by

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



Sources: National statistical offices; Ministries of Finance; World Bank estimates.
Note: e = estimated.

Figure 5.2. ...but widened in Montenegro and Bosnia and Herzegovina.



Sources: National statistical offices; Ministries of Finance; World Bank estimates.
Note: p = projected.

5 Unweighted average.
6 All comparisons are year over year unless otherwise indicated.

Table 5.1. Growth rates of key fiscal variables and inflation.

Country	Variable	2020	2021	2022	Cumulative 2020–22 nominal growth
		Percent y/y change			
Albania	CPI Inflation, average	2.2	2.6	6.7	11.9
	Revenues	-7.5	20.0	13.9	26.4
	Tax revenues	-6.5	19.3	14.7	27.9
	Expenditures	9.0	11.2	9.0	32.1
	Current expenditures	4.0	6.5	9.6	21.4
Bosnia and Herzegovina	CPI Inflation, average	-1.1	2.0	14.0	15.0
	Revenues	-4.8	13.3	-0.3	7.5
	Tax revenues	-5.1	24.4	-7.6	9.1
	Expenditures	12.5	1.2	1.2	15.2
	Current expenditures	10.0	10.3	-3.1	17.6
North Macedonia	CPI Inflation, average	1.2	3.2	14.2	19.3
	Revenues	-7.8	16.8	10.1	18.6
	Tax revenues	-3.4	14.5	11.2	23.0
	Expenditures	9.8	7.1	7.7	26.7
	Current expenditures	12.2	3.5	7.4	24.7
Montenegro	CPI Inflation, average	-0.3	2.4	13.0	15.4
	Revenues	-13.2	17.1	4.8	6.5
	Tax revenues	-12.3	16.5	4.5	6.8
	Expenditures	2	-2.1	13.7	13.5
	Current expenditures	3.7	4.2	11.6	20.6
Kosovo	CPI Inflation, average	0.2	3.4	11.6	15.6
	Revenues	-8.8	26.9	13.7	31.6
	Tax revenues	-9.5	30.0	14.0	34.1
	Expenditures	6.7	2.5	10.6	21.0
	Current expenditures	18.6	0.9	13.0	35.2
Serbia	CPI Inflation, average	1.6	4.0	11.9	18.2
	Revenues	-1.0	20.3	13.6	35.3
	Tax revenues	-0.2	23.2	13.4	39.4
	Expenditures	10.4	17.8	10.1	43.2
	Current expenditures	8.4	11.7	7.3	29.9

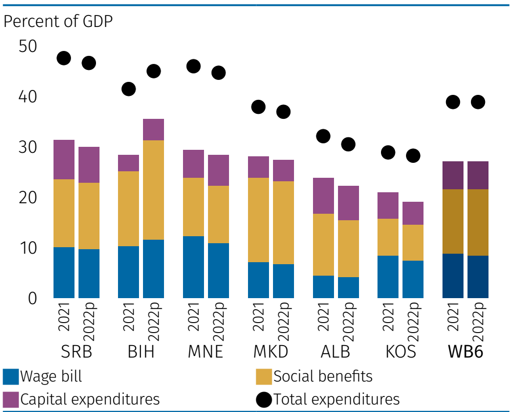
Sources: National statistics offices; Ministries of Finance; World Bank staff estimates.

almost 4 pp of GDP in 2021, average public expenditure remained broadly constant in 2022, at 38.6 percent of GDP (Figure 5.3). In fact, public expenditure contracted by around 1 pp of GDP in North Macedonia, Serbia, and Montenegro. In Kosovo and Albania, expenditures also declined, by 0.5 and 1.6 pp of GDP, respectively. In contrast, expenditures increased by 3.5 percentage points of GDP in Bosnia and Herzegovina, where the electoral cycle fueled increases in spending. All six countries adopted measures to mitigate the impact of rising inflation. At the same time, Albania, North Macedonia, Kosovo, and Serbia (through off-budget fiscal operations), provided significant energy subsidies. All countries except Bosnia and Herzegovina contained their public sector wage spending.

With fiscal policy in a crisis mode for yet another year, social protection spending continued to remain high and drive expenditure growth. Social protection spending increased by 0.6 pp of GDP, on average, in 2022; in Bosnia and Herzegovina, social benefits increased the most, by 5.2 pp, reaching the highest level among the Western Balkans at 19.8 percent of GDP (Figure 5.4). In Albania, Montenegro, and Kosovo, pension benefits also increased in response to inflation. Real public wages declined in Kosovo and Montenegro by more than 1 pp of GDP, and in Albania, Serbia and North Macedonia by around 0.5 pp. Wage spending increased by 1.1 pp of GDP in Bosnia and Herzegovina (Figure 5.4). Capital expenditure declined in Kosovo and Albania the most; in the latter due to slowing of the reconstruction process. Partly owing to high inflation, capital spending increased in Montenegro and Bosnia and Herzegovina, while it remained constant in North Macedonia. In both Kosovo and North Macedonia, under-execution of the planned capital budget remained significant. Inflationary pressures proved particularly challenging for the implementation of multiyear capital projects, with limited scope to adjust for changing input prices.

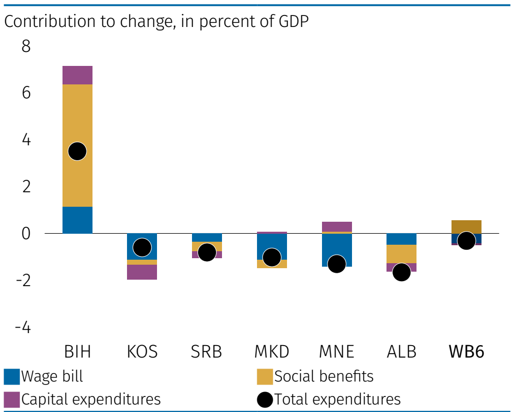
With persistent inflation, there are pent-up pressures for public wage increases, while looming external uncertainties might prevent a retraction of temporary measures. After the restraint demonstrated in 2022, most countries granted public wage increases in early 2023. Serbia, for example, increased wages by 12.5 percent in early 2023, while Montenegro increased civil servant and education sector net wages by almost 20 percent as health contributions got abolished and a minimum wage increase led to a rise in public sector salary base. A new public wage law entered into force in Kosovo in 2023 that will see total wage spending increasing by 15 percent.

Figure 5.3. The share of social benefit spending increased...



Sources: National statistical offices; Ministries of Finance; World Bank estimates.
Note: p = projected.

Figure 5.4. ...while real public wages declined across the Western Balkans, except for Bosnia and Herzegovina.



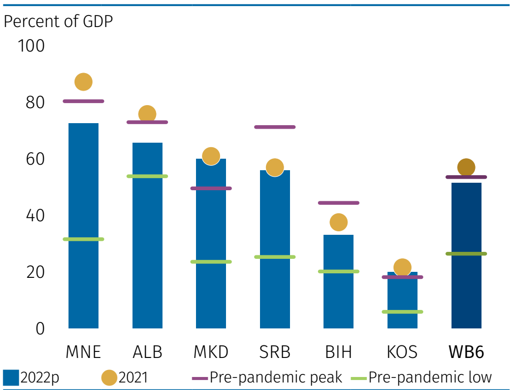
Sources: National statistical offices; Ministries of Finance; World Bank estimates.

North Macedonia is working on a new public wage law, after continuous demands from the Federation of Trade Unions. In parallel, the persistence of external uncertainties could slow plans for scaling down temporary inflation mitigation measures and energy subsidies.

In this context, a normalization path for fiscal policy might be challenging, but is necessary. Moreover, capital spending has served as a buffer to ensure fiscal agility, but this has come with important costs in addressing much-needed investments to close the infrastructure gaps and enhance competitiveness in Western Balkan economies. Elevated public debt amidst increasing financing costs and a slower growth environment call for the adjustment of government spending. To that extent, rigidity of indexation of pensions and wage bill with inflation need to be reviewed against the narrower fiscal space. Serbia has recently amended the fiscal rules to increase the upper bound for pension and public sector wage bill spending limits, but also increased the coverage of its general government. Kosovo is another country which has expenditure rule for some spending categories. Overall, there is a risk that capital spending will continue to bear the brunt of fiscal consolidation if indexation mechanisms and budget rigidity is not addressed.

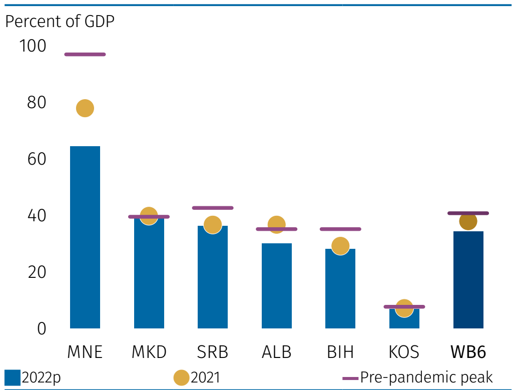
In all countries except Kosovo and North Macedonia, the public and publicly guaranteed (PPG) debt to GDP is below the pre-pandemic peak, but higher than the pre-pandemic low. Owing to the denominator effect, the PPG debt declined as a share of GDP. While growth was slower than initially projected in all the Western Balkan countries, high GDP deflators resulted in much-higher-than-expected nominal GDP. This has led to a reduction of PPG debt as a share of GDP in all countries (Figure 5.5). The average PPG debt to GDP declined to 51 percent of GDP from 56.6 percent in 2021. Given that Montenegro had the highest nominal growth of GDP, and since most of its financing needs in 2022 were serviced from deposits, the decline of PPG debt to GDP was the strongest—from 86.8 percent in 2021 to 72.5 percent in 2022. Albania's and Bosnia and Herzegovina's PPG debt declined by a strong 9.9 pp and 4.6 pp of GDP, while in the remaining countries, despite double-digit growth of nominal GDP, PPG debt to GDP declined by less than 2 pp. Going forward, slower growth and lower inflation will lead

Figure 5.5. Public and publicly guaranteed debt declined in all countries...



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

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



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

to a lower nominal GDP growth, which may lead to faster debt accumulation at the time of increased debt servicing costs.

In 2022, external PPG debt continued declining but remains above pre-pandemic levels as countries relied on borrowing from multilateral banks (Figure 5.6). The decline of the average external PPG debt from 38 percent to 34.5 percent was mostly driven by an increase in nominal GDP. Montenegro recorded the strongest decline of 14.3 pp of GDP, followed by Albania at -6.5 pp of GDP and Bosnia and Herzegovina at -1.7 pp. Montenegro's and Albania's net external borrowing was negative, considering both countries used Eurobond proceeds from previous years to cover a large share of financing needs in 2022. In November 2022, the International Monetary Fund (IMF) Executive Board approved a two-year arrangement of EUR 530 million for North Macedonia under the Precautionary and Liquidity Line, of which EUR 110 million has already been disbursed. A month later, the IMF approved a EUR 2.4 billion Stand-by Arrangement for Serbia, of which EUR 1 billion has been disbursed. Both countries will use this support to address the impact of the energy crisis. The World Bank provided additional support through the development policy loans approved for Kosovo (EUR 50.6 million), Albania (EUR 110 million), and Serbia (EUR 149.9 million), which aim to strengthen resilience of the countries' economies and their environmental sustainability. The EU has also allocated EUR 500 million of budget support to the Western Balkan countries to mitigate the impact of the energy crisis and support energy transition.

The higher cost of external financing requires fiscal prudence. Countries have become increasingly reliant on external financing in recent years and are vulnerable to the rising cost of financing resulting from monetary policy tightening. This is particularly so for countries with a high debt burden and limited fiscal space. After several successive years of Eurobond issuances, no Western Balkan country tapped the markets in 2022. However, in early 2023, Serbia and North Macedonia turned to international investors. In January, Serbia issued two Eurobonds—a five-year Eurobond of US$750 million at a coupon rate of 6.25 percent, and a 10-year Eurobond of US$1 billion at a coupon rate of 6.5 percent. In March 2023, North Macedonia issued a four-year Eurobond of EUR 500 million at a coupon rate of 6.95 percent to refinance a EUR 450 million Eurobond coming due in July. While no other countries tapped the Eurobond market, Montenegro signed a three-year loan agreement of EUR 100 million with Deutsche Bank, at an interest rate of a six-month Euro Interbank Offered Rate (Euribor) plus 5.9 percent. The interest rates increased by more than 500 bp since Eurobond placements in 2021. Considering the unfavorable market conditions, yields on the outstanding Eurobonds of the Western Balkans countries have increased substantially (Table 5.2). And while declining from their peaks in late 2022, still high yields and widening spreads are an indication of lasting unfavorable financing conditions.

Room for fiscal maneuver is expected to shrink further, unless governments focus on boosting their revenue base, improving tax collection, and strengthening spending efficiency, particularly social spending (Box 5.1). All Western Balkan governments have

Table 5.2. Yields on Western Balkan countries' outstanding Eurobonds.

Country	Coupon	Maturity	Yield in % (last price)	Spreads (basis points)
Albania	3.5	16/06/2027	6.5	421.6
	3.5	09/10/2025	6.1	358.6
Montenegro	2.785	16/12/2027	8.4	615.2
	3.375	21/04/2025	7.3	481.5
North Macedonia	3.675	03/06/2026	6.6	425.9
	2.75	18/01/2025	6.4	391.9
Serbia	3.125	15/05/2027	5.8	349.4
	1.5	26/06/2029	6.2	401.2
Bosnia and Herzegovina entity: Republic of Srpska	4.75	01/01/2023	9.0	650.6
	4.75	01/01/2026	7.0	463.5

Source: https://www.boerse-frankfurt.de/en.
Note: Spreads refer to spreads with yields on German bonds with the same residual maturity. Republic of Srpska is one of the two entities of Bosnia and Herzegovina, the other being the Federation of Bosnia and Herzegovina.

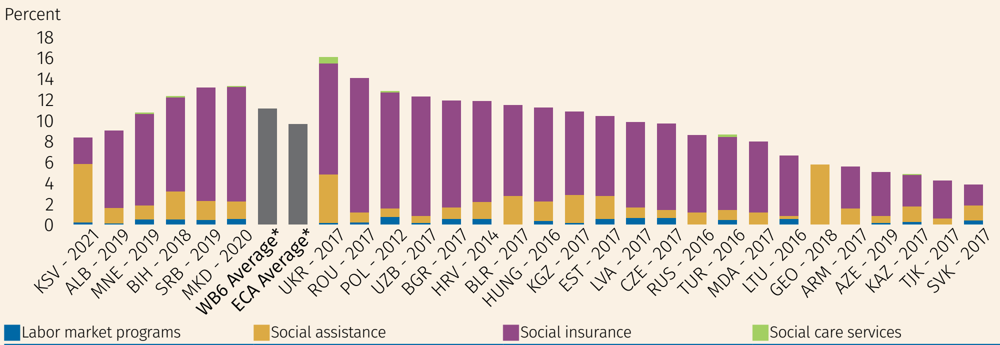
implemented support measures to combat the cost-of-living crisis, but compared to COVID-19 support, targeting of support measures worsened. All countries except Bosnia and Herzegovina and Montenegro have provided subsidies to the energy state-owned enterprises (SOEs), while government arrears increased in most countries, largely due to SOEs and the health sector. In North Macedonia, public sector arrears increased to 3.1 percent of GDP. Furthermore, contingent liabilities coming from SOEs and public-private partnerships are significant fiscal risks in Albania and Serbia. And while the impact of the energy crisis in 2022 proved to be milder than initially expected, it has highlighted the importance of shifting toward greener and more resilient drivers of economic growth and accelerating the green transition. This, however, would require unlocking energy efficiency and renewable private investments and incentivizing households and firm behavior through effective carbon pricing and removing fossil fuel subsidies (see *Spotlight*). Finally, all countries would benefit from strengthening fiscal transparency and establishing independent fiscal councils that would ensure longer-term fiscal sustainability. Serbia is the only country with an independent fiscal council, and Montenegro and North Macedonia are working toward their establishment.

Box 5.1. Boosting the efficiency, effectiveness, and equity of social protection in the Western Balkans.

Social protection systems played a critical role in response to first the pandemic and then the energy crisis, but reforms are needed to place the systems in the Western Balkans on a better footing.[a] The major shocks of recent years have highlighted the critical importance of social protection systems to protect vulnerable households from falling into poverty. Several countries in the Western Balkans are currently working on reforms to enhance the equity, sustainability, effectiveness, and adequacy of their social protection systems. However, while some progress has been made, pension funding sustainability, benefits adequacy, and contribution rates remain an issue. Reforms in other areas such as social assistance, social services, and employment programs are progressing, albeit slowly and unevenly in many countries. Isolated reforms focusing on a specific program or aspect of the delivery system are unlikely to lead to satisfactory outcomes, either in terms of reducing poverty or promoting growth.

Most of the Western Balkans' comparatively high public spending on social protection[b] goes toward pensions, suggesting that only a limited allocation reaches the poor and vulnerable households. Although the six countries spend between 8 and 13 percent of GDP on social protection (Figure 5.7), over 70 percent of this goes toward pensions, compared to the OECD countries, where median social protection spending on pensions is 40 percent. Pensions are based on contributions made by the formally employed, with social pensions tending to be very small in most countries. Wage employment is typically concentrated among people in the upper quintiles of the population, while those who are self-employed or unemployed are more likely to be at the bottom of income distribution, meaning that they are unlikely to qualify for pensions in the future.[c]

Figure 5.7. The Western Balkan countries spend considerable resources on social protection.



Source: World Bank Social Protection Expenditure and Evaluation Database (SPEED).
Note: Percent of GDP as arithmetic average of latest year available.

(Box 5.1 continued)

Despite absorbing most of the social protection funding, pension systems in the Western Balkans struggle with financial sustainability and adequacy. Each country faces different tradeoffs among sustainability, adequacy, and coverage. Albania has made efforts to improve the fiscal sustainability of its pension system but has a low support ratio (meaning that the share of employed who contribute to a pension plan is low compared to the share of the elderly population who receive a pension). Montenegro has improved pension adequacy but faces projected deficits. North Macedonia has slightly improved financial sustainability, but this has been offset with increased benefits. Serbia's low birth rates, outmigration, and informal employment threaten its pension system. Pandemic-related measures have widened pension deficits in Bosnia and Herzegovina. Finally, Kosovo's pensions, which cost 6 percent of GDP, are mostly government-funded, and the nascent contributory system requires adjustments to maintain sustainability, as it covers only a few years of pension outlays before individual pension accounts are depleted.

High inflation poses additional risks across the Western Balkans, and clear rules for indexation of pension benefits play an important role in protecting the purchasing power of retirees. The COVID-19 pandemic and the high inflation episodes induced interventions, largely through temporary supplements to pensions and one-off payments. The Western Balkan countries generally refrained from addressing short-run pension challenges through measures that could worsen long-run sustainability. With stabilization of inflationary trends, a growing contribution base, and diminished demographic pressure, the focus of pension policies is turning to long-term policies for improving pension adequacy through core pension measures aiming to prolong the length of service and raise more contributions.

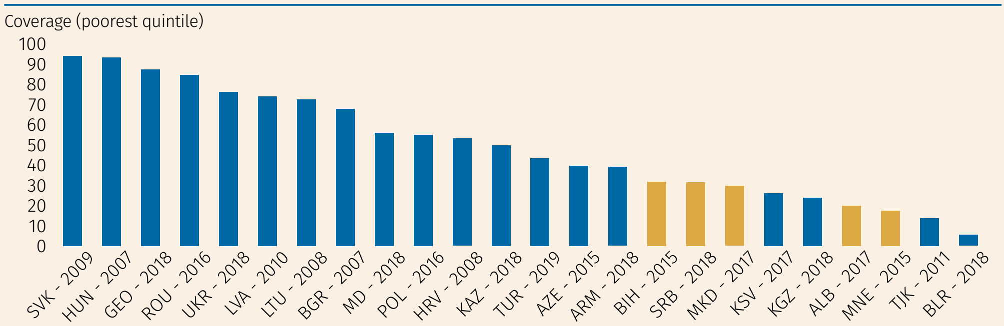
Low allocations for poverty-targeted policies, together with fragmented and poorly designed programs, lead to low coverage of the poorest families with social assistance. The six countries spend an average of only 0.3 percent of GDP on poverty-targeted income support for the poor. Throughout the Western Balkans, eligibility for social assistance is predominantly tied to categorical criteria, such as children being present in the household, dependency status (people with disabilities, orphans, caregivers, out-of-work), or military service (war veterans), but not to actual welfare status (such as income and assets). The outcome of this categorical targeting in combination with low overall funding for social assistance is that the coverage of the poorest families is much lower across the Western Balkans than in the rest of the emerging and developing countries of Europe and Central Asia (Figure 5.8), leaving poor people vulnerable to shocks. At the same time, cash benefits from poverty-targeted programs offer inadequate support and often create work disincentives.

Rebalancing social spending more toward poverty-targeted social assistance and social services strongly linked to employment policies is critical to effectively reduce poverty and improve living conditions. All countries in the Western Balkans face a dual challenge to

(Box 5.1 continued)

better protect the livelihoods of the poor, while encouraging greater labor force participation, especially among women. Better protecting the poor and reducing poverty would be achieved through increasing the budget and scope of poverty-targeted programs and better linking them with social and employment services. North Macedonia is an example of a country undergoing a comprehensive reform of its social protection system. As part of the reform, the untargeted and costly parental allowance was reformed into an income-tested program, meaning that more vulnerable families are eligible for the benefit. Also, a means-tested social pension for the elderly was introduced, and all other means-tested schemes were consolidated into one means-tested guaranteed minimum assistance scheme. This scheme was central to the government's response during the pandemic. By relaxing the eligibility criteria and simplifying the procedures, North Macedonia's authorities easily extended coverage of social assistance to newly poor families during the pandemic. These can be lessons for other countries.

Figure 5.8. Social assistance coverage of the poorest is low.



Source: World Bank Social Protection Expenditure and Evaluation Database (SPEED).

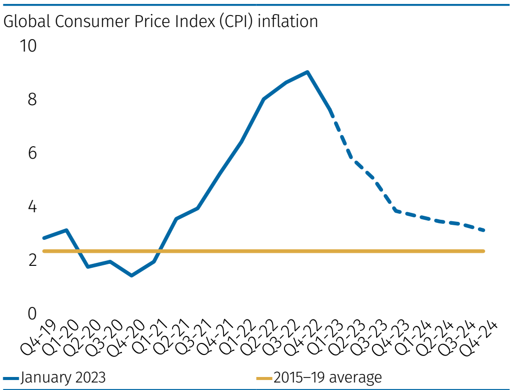
a. This summary of the key issues on social protection is based on detailed social protection situational analyses for Albania, Bosnia and Herzegovina, Kosovo, Montenegro, North Macedonia, and Serbia.
b. Includes social assistance, social services, social insurance, and employment and labor market programs.
c. See, for example, World Bank 2021, "Albania Country Economic Memorandum: Background Note on Supporting an Adaptive and Resilient Labor Force"; https://documents.worldbank.org/en/publication/documents-reports/documentdetail/099845001312217227/p1752090acdb7604a0918d0aa310774d0ea.

6. Inflation pressures soften, but prices remain elevated

Inflation continued to rise in 2022 in almost all economies, and price pressures remain high. Global median headline inflation exceeded 9 percent in the second half of 2022, its highest level since 1995 (Figure 6.1). In emerging markets and developing economies (EMDEs), inflation reached a record high of close to 10 percent, and in advanced economies over 9 percent. Although inflationary pressures started to abate toward the end of 2022, price pressures remain elevated and above central bank targets. Commodity prices have eased from their peaks in the aftermath of the Russian invasion of Ukraine, with fears about a growth slowdown intensifying. However, individual commodities have seen divergent trends, reflecting distinct demand and supply conditions (Figure 6.2). Energy prices declined 7.3 percent in February 2023 led by coal (-34.8 percent) and natural gas in the United States (-27.2 percent). Food price surges recorded in early 2022 subsided. However, domestic food price inflation[7] remains high, and many vulnerable countries still face heightened food insecurity (Box 6.1). New export restrictions could lead to additional price pressures.[8]

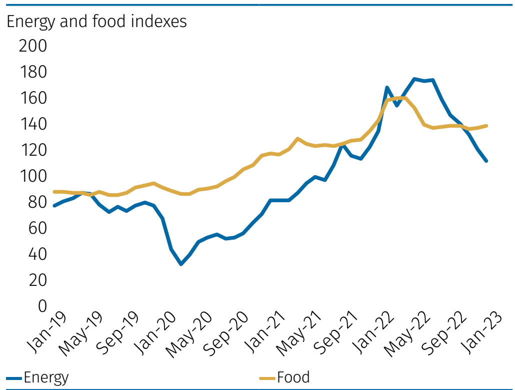
Price pressures during 2022 reflected a combination of both demand and supply factors. On the demand side, the persistence of price pressures was associated with accelerating growth and lagged effects of crisis support measures provided by governments in the first part of the year. At the same time, demand pressures encountered capacity and supply constraints, contributing to further price growth. On the supply side, high energy and food prices associated with Russia's invasion of Ukraine continued to contribute significantly to rising price pressures, along with wage pressures associated with tighter labor market conditions. Inflation remains high across a broad range of goods and services, with detrimental impact on

Figure 6.1. Inflation pressures are softening, but price pressures remain elevated globally.



Source: World Bank Global Economic Prospects, 2023.

Figure 6.2. Global energy and food prices remain above historical averages.



Source: World Bank Commodity Price Data, March 2023.

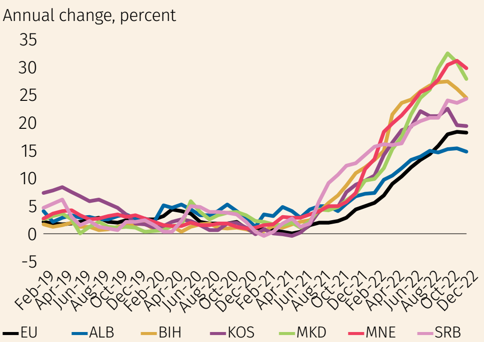
7 Measured as year-over-year change in the food component of a country's Consumer Price Index (CPI).

8 In February 2023, 101 export restrictions—including quotas, licenses, and outright bans—were still being enforced, contrary to World Trade Organization principles that the limits should be temporary.

Box 6.1. Food inflation in the Western Balkans.

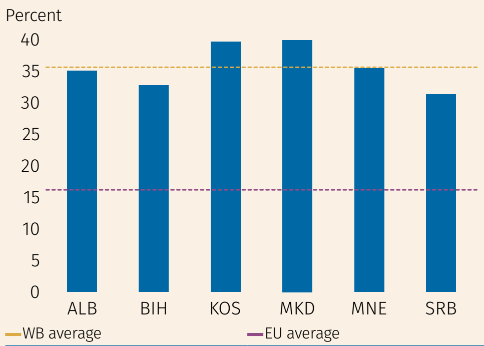
Global food prices, which reached a record high in 2022 caused by the COVID-19 outbreak and amplified by the Russian invasion of Ukraine, have increased food insecurity and added to the cost-of-living crisis. They have also strained household budgets struggling with rising food prices, which required government intervention to fund extra social protection measures for the most vulnerable after their budgets were strained due to the energy crisis. In 2022, annual food inflation ranged from 12 percent in Albania to 23 percent in Montenegro. For the six Western Balkan countries, it averaged 20 percent in 2022, a large increase from 2 percent in 2019–20 and 10 percent in 2021. Except in Albania, annual food inflation in the Western Balkans countries exceeded that in the EU27 (Figure 6.3).

Figure 6.3. Food inflation in WB6 and EU27.



Sources: Statistical offices; World Bank staff calculations.

Figure 6.4. Share of food and non-alcoholic beverages in total household consumption.



Sources: Statistical offices; World Bank staff calculations.

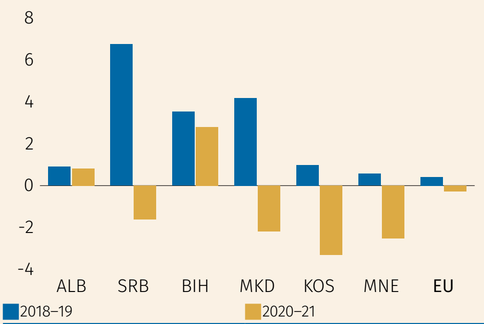
Food prices in the Western Balkans increased across all food subgroups, with the largest increases recorded for meat (17 percent), bread and cereals (26 percent), dairy products (29 percent), and oils and fats (32 percent). The prices for these food subgroups rose in all countries in the range of around the regional average. Together they accounted for more than 70 percent of food inflation. In comparison, the price increase of fruits, fish, and beverages was relatively moderate, from 8 to 13 percent. Given that food and beverages account for 36 percent of average household consumption in the Western Balkans, compared to 16 percent in the EU, for example (Figure 6.4), high food inflation stalled poverty reduction in 2022.

A rise in food inflation in the Western Balkans has been a result of not only a passthrough of high global prices to domestic prices, but also local factors. These local factors include the slowdown in agricultural growth in Albania and Bosnia-Herzegovina in 2020–21 compared to 2018–19, and the decline in agricultural growth in Kosovo, Montenegro, North Macedonia, and Serbia (Figure 6.5), driven by supply chain disruptions triggered by the COVID-19 outbreak and climate events such as drought. For comparison, EU agriculture weathered

(Box 6.1 continued)

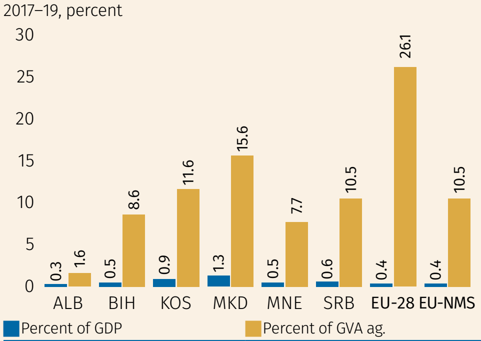
the recent multiple shocks much better, which helped contain its food inflation. Another reason for high food inflation in the Western Balkans was the exchange rate depreciation in some countries, which increased local prices of imported food, upon which the Western Balkan countries depend, being net food importers, especially of processed food products. The oligopoly of some food processors and retailers also added to inflation, although a lack of a consistent and accurate time series of farmgate, wholesale, and retail prices precludes a more conclusive analysis in this regard.

Figure 6.5. Growth in agricultural GDP in the WB6 and EU.



Sources: Statistical offices; World Bank staff calculations.

Figure 6.6. Budgetary support to agriculture in the WB6 and EU.



Sources: Statistical offices; World Bank staff calculations.

Policy responses in the Western Balkans focused on reducing food inflation for all consumers through food price caps (all countries, except Kosovo), tax reductions (Montenegro and North Macedonia), export bans (North Macedonia and Serbia), import tariff reductions (North Macedonia), and mitigation of its impact on the poor (through social protection). However, most measures were weakly targeted to the poor, while they worsened long-term incentives for farmers, thereby depressing agricultural growth potential and increasing long-term food price levels. Bosnia and Herzegovina and Kosovo provided significant extra funding to farmers, averaging 0.33 percent of GDP. The support to farmers in Albania and Montenegro was smaller, at about 0.05 percent of GDP. In North Macedonia and Serbia, farmers received no extra support, largely because they were already well supported through regular budget programs. The agricultural budget support as a share of GDP in the Western Balkans (0.3 to 1.3 percent) is generally higher than that in the EU (0.4 percent), while farmers in most countries, except Albania, receive comparable support as a share of gross value added to that in the EU New Member States (Figure 6.6). The existing agricultural support in the Western Balkans, however, favors direct and coupled farm measures over the support to delivery of general services (for example, research and extension services under the Agricultural Knowledge and Innovations System, soil nutrient management, sanitary and phytosanitary measures, and public infrastructure), the investments in which have globally proven to be of high impact for climate resilience, agricultural productivity, and agricultural diversification.

(Box 6.1 continued)

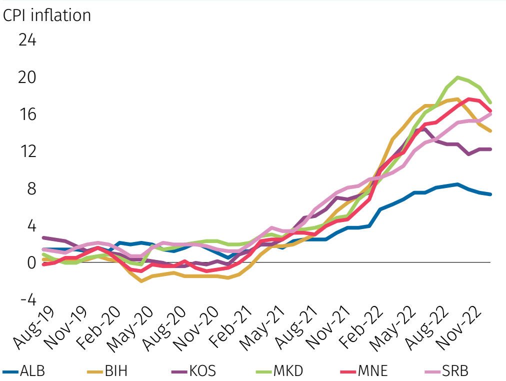
Global and local food prices are projected to stay elevated in 2023 and 2024. Although the World Bank's Food Price Index declined by 12 percent in the third quarter of 2022 after reaching an all-time high in April 2022, it remains almost 20 percent higher than a year ago, which is high by historical standards. War, climate change, and the cost of inputs could keep food prices elevated for longer. The continuation of the war in Ukraine could create an export gap of 35 million tons of grains and oilseeds in the 2022/23 marketing year. The weather phenomenon El Niño could cause droughts in south and southeast Asia and Australia, and floods in Latin America. The International Monetary Fund estimates that globally a 1 percent increase in fertilizer and oil prices, which have climbed recently and remain high, boosts food prices by 0.45 percent and 0.2 percent, respectively. All these risks put upward pressure on food inflation globally and in the Western Balkans in the foreseeable future.

the poor and most vulnerable. During 2022, global core inflation rose, reaching 6 percent on average for the Western Balkans. At the global level, the persistence of inflation has been higher than expected and several factors such as short-term inflation expectations and elevated core inflation suggest that inflation may remain above central bank targets for longer than initially expected.

Rising price pressures have triggered synchronized and rapid monetary policy tightening across advanced economies and most EMDEs. Although monetary policy tightening has been necessary to contain price increases, the consequent restrictive global financial conditions are exerting a drag on activity, including consumption and investment. In the Eurozone, inflation remains significantly above target but started decelerating to 8.5 percent in February 2023, reflecting a renewed sharp drop in energy prices. Underlying price pressures in the Eurozone economy remain high. Inflation, excluding energy and food, increased to 5.6 percent in February. Similarly, service inflation remains high (4.8 percent in February) reflecting pent-up demand and wage pressures. On the back of strong labor markets, wage pressures have also increased.

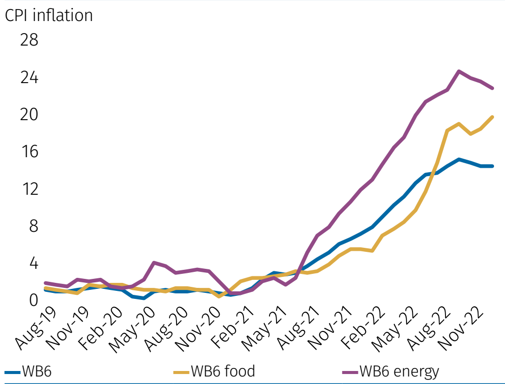
In the Western Balkan region, inflation remains elevated. In most countries, consumer price inflation peaked in 2022, and has shown signs of easing in the last months of the year (Figure 6.7). Between July and November 2022, Consumer Price Index (CPI) inflation reached 17.4 percent in Bosnia and Herzegovina (October 2022), 19.8 percent in North Macedonia (October 2022), 17.5 percent in Montenegro (November 2022), 14.2 percent in Kosovo (July 2022), and 8.3 percent in Albania (October 2022). Energy and food prices continue to fuel consumer inflation (Figure 6.8). At the regional level, food CPI inflation reached 24.6 percent in October 2022, 16.8 pp higher than the previous year. Similarly, energy CPI inflation has been on an increasing trend during 2022, reaching 19.7 percent in January 2023. Trends in core inflation suggest that price pressures remain broad-based. Since mid-2022, core inflation increased in almost all Western Balkan countries. Those with the highest increases were North Macedonia, Montenegro, and Albania, where core inflation reached 11 percent (December 2022), 10.3 percent

Figure 6.7. In the WB6 countries, inflation peaked at historic highs during 2022...



Sources: Statistical offices; World Bank staff calculations.

Figure 6.8. ...with elevated food and energy prices continuing to fuel consumer price inflation.



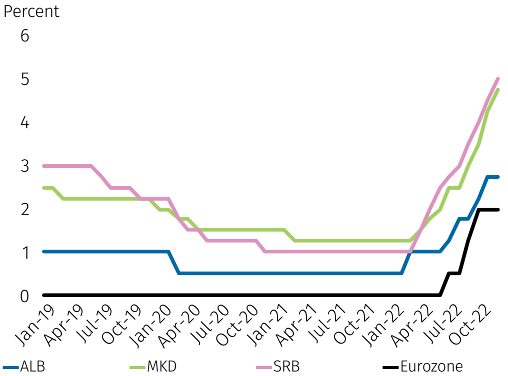
Sources: Statistical offices; World Bank staff calculations.

(November 2022), and 8.6 percent (October 2022), respectively.

In countries with an independent monetary policy, authorities have responded with a gradual tightening of monetary policy throughout 2022. The exchange rate management was different, however, reflecting the strength of the passthrough, direction of pressures during the year, and competitiveness concerns in a context of dampened demand. In Serbia, successive policy rate increases since April aimed to contain the larger-than-expected rise in inflation and dampen inflation expectations, which, due to moderate wage and pension increases, remained broadly consistent with the projected declining inflation path. In addition, efforts were made to stabilize the exchange rate in order to contain inflationary pressures emerging from high international energy and food prices. In Albania, the central bank raised its key policy rate again by 50 basis points to 2.75 percent in November, the fifth hike in 2022. The Albanian authorities did not try to manage the exchange rate, with the exception of a short-lived intervention at the start of the Russian invasion of Ukraine. With monetary policy normalization and further expectations of monetary policy tightening, domestic yields on Albanian government securities started to increase, and auctions, particularly in the longer-duration segment, were for a short time undersubscribed. Auctions started to normalize toward October 2022.

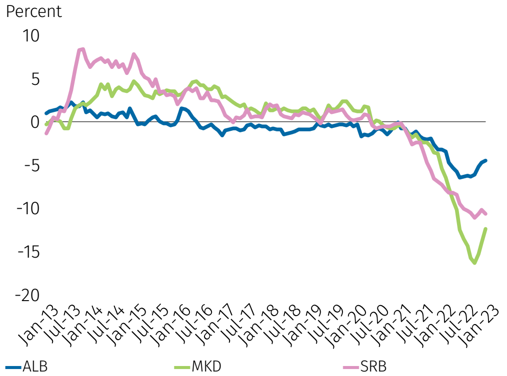
In North Macedonia, rising inflation expectations triggered a continuous monetary policy tightening during the year. By early February 2023, the central bank had raised the key policy rate by 3.5 pp to 5.25 percent in nine consecutive rounds and increased overnight loan and deposit rates. In all three countries the authorities were able to preserve and expand their international reserves: in Albania, reserves covered about 6.9 months of imports at year end. Similarly, in Serbia, reserves increased to a historic high of EUR 19.4 billion in December 2022, covering close to 5.5 months of imports of goods and services. In North Macedonia, reserves covered about 3.7 months of imports, recovering from earlier losses at the start of the Russian invasion of Ukraine.

Figure 6.9. Policy rates started to increase in line with monetary policy tightening in the EU…



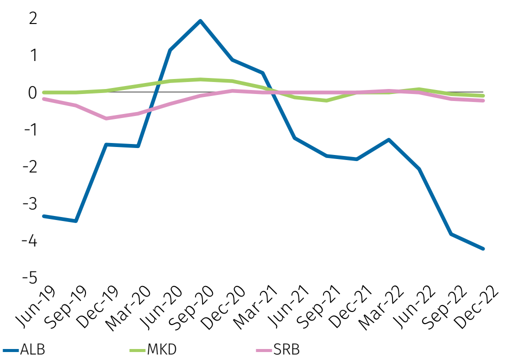
Source: World Bank staff calculations based on central bank data.

Figure 6.10. …but real policy rates are negative.



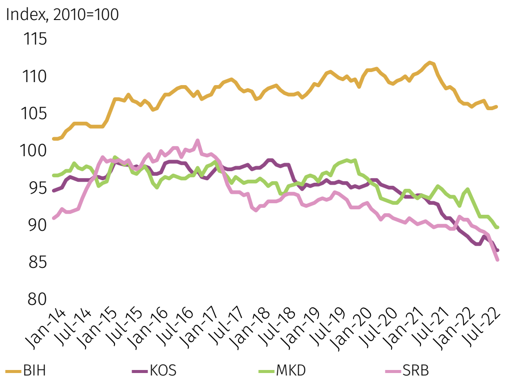
Source: World Bank staff calculations based on central bank data.

Figure 6.11. Exchange rate management was different among the three countries.



Source: World Bank staff calculations based on central bank data.

Figure 6.12. Real exchange rates appreciated.



Source: World Bank staff calculations based on central bank data.

Monetary conditions are still accommodative, as real policy rates remain negative, reflecting rising inflation and inflation expectations. Despite monetary tightening, real policy rates remained negative for all three countries in the Western Balkans that have own currencies. On one hand, the authorities have further room for maneuver in case global conditions and external energy prices prevent domestic inflation from returning to target and fuel inflation expectations. On the other hand, negative real rates may trigger further euroization of deposits and cause mismatches in bank balance sheets. In Serbia, deposit dinarization fell from an all-time high of 41.3 percent at end-2021, to 36.9 percent in August 2022, driven by higher risk aversion connected to Russia's war in Ukraine. Because of the stable exchange rate (in Serbia and North Macedonia) and appreciation of the Albanian lek, and given high inflation, the real exchange rate appreciated, raising competitiveness concerns. A prompt response to curbing inflation and allowing for some flexibility of the exchange rate should provide for less costly adjustments through the trade channel, and could help limit risks from the buildup of unhedged foreign exchange loans.

7. Financial stability risks increase as macro-financial conditions continue to weaken

The financial sector in the Western Balkans continued to be stable, but its resilience is tested by pressures on financial stability posed by the ongoing war in Ukraine, overall deterioration of economic sentiment and the growth outlook, and a surge in interest rates and inflation. Nonperforming loans continued to follow a downward trend, declining to a historical low (3.9 percent), while profitability recovered to pre-pandemic levels and capital buffers were preserved. The current financial sector outlook demonstrates the strong resilience of the financial sector on the one hand, while indicating the need for caution against elevated risks on the other. The strong resilience is mostly owed to the robust financial position banks achieved by decisive reforms and restructuring in the last decade (after the global financial crisis) and strong government support during the pandemic. In contrast, despite the demonstrated resilience, elevated risks remain and require continued focus and vigilance on any emergence of vulnerabilities.

Deteriorating macroeconomic conditions increase the pressure on risky asset classes and expose the weaknesses generated by pockets of vulnerabilities. The high interest rate environment, which is expected to last longer than anticipated, is triggering asset repricing, and changing investor sentiment and asset allocations. Therefore, risky assets and remaining vulnerabilities are coming under stress, evidenced by the recent Silicon Valley Bank (SVB) failure, together with a few other regional lenders in the United States and the Credit Suisse crisis in Europe.

While regulators and banks in the region maintain increased prudence, current market conditions require vigilance regarding the concentration of risky assets and remaining vulnerabilities. Credit risks from energy-intensive corporate sectors (Box 2.1), residential and commercial real estate, uncollateralized consumer finance, interest rate-sensitive portfolios, and sovereign exposures must be monitored closely. Pressure on both household and corporate borrowers will likely continue to intensify, as their income and earnings will be impacted by both inflation and lower growth expectations. As banks are expected to continue tightening financial conditions and credit standards, highly indebted households and corporates may come under stress. Bank exposure to residential and commercial real estate and sovereign debt instruments are particularly relevant to monitor in the Western Balkan region (Box 7.1).

Credit growth started to slow with the expectations of worsening economic outlook and tighter credit supply conditions. Average credit growth in the Western Balkans had flattened by June 2022 before starting to slow down in September 2022. Although still positive and strong, credit growth decelerated to 8.5 percent, almost 2 pp below its peak in June 2022 (10.4 percent) in the post-pandemic period. Corporate loan growth decelerated faster than the household loan growth since October 2022, indicating that banks tightened standards more for SMEs and corporate clients. The most pronounced slowdown of credit growth compared to June 2022 was in Serbia

Box 7.1. Western Balkans financial sector: Sovereign and real estate market exposure.

Macro-financial risks remain high in the Western Balkan countries. In 2021–22, the combined pressures of high global inflation and the continued impacts of the war in Ukraine resulted in a fragile economic growth outlook. In the Western Balkan countries, average inflation ranged from slightly above 6 percent in Albania to above 14 percent in Bosnia and Herzegovina and North Macedonia. The short-term outlook for economic growth has slowed to approximately 2 to 3 percent for the region, with convergence with the European Union stalling in 2022. This macroeconomic outlook comes on top of the fiscal impacts of the 2020 pandemic, which led to historically high public and private debt.

Due to tighter macro-financial conditions, many governments were left with lower access to affordable, external financing, including Eurobonds and bilateral financing; thus, they have become increasingly reliant upon the local financial sector. The Western Balkan countries are directly or indirectly impacted by the recent European Central Bank's and global interest rate increases, which have made external financing increasingly expensive for governments (Table 5.2). At the same time, sovereign budgets are tighter due to large post-pandemic or inflation support measures introduced between 2020 and 2023. As a result, governments increased their domestic bond issuances, while local insurance, pension, and banking sectors have increased their investment in this asset class.

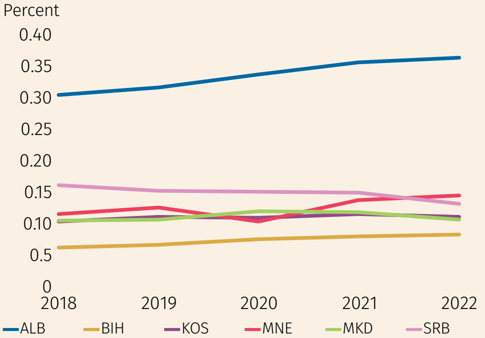
Elevated volatility, repricing risks, and liquidity planning may expose banks to potential disorderly adjustments in government bond markets. While pension funds and insurance companies are long term, buy and hold type, banks need a more liquid security portfolio. Banks in the region have low loan to deposit ratio around 75 percent on average while they place this liquidity largely in government bonds which exposes the banks to sovereign risks. Due to the relatively small size of the financial markets and shallow capital markets, the government bond markets are typically illiquid in the region. In the case of a liquidity stress scenario, banks could end up with the less liquid bond portfolio. While banks in the region keep on average around 15 percent of their assets in government bonds this ranges between as high as 36 percent in Albania to 8 percent in Bosnia and Herzegovina (Figure 7.1).

Another important market segment that needs to be monitored closely is the real estate market. Credit-fueled real estate booms can pose financial stability risks due to the important direct and indirect linkages among real estate markets, the economy, and the financial system. Real estate markets are systematically important as they influence economic activity (investment, consumption), financed primarily by banking sectors and they are an important form of wealth storage for households. As real estate is typically acquired by high leverage,

(Box 7.1 continued)

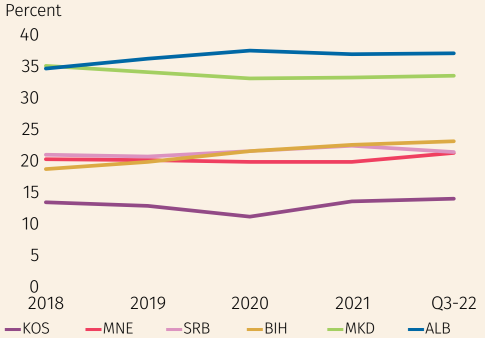
even small declines in real estate prices may lead to a significant decline in household wealth and in the net worth of firms who own a property with broader implications for demand, economic activity, and creditworthiness.

Figure 7.1. Share of government securities as a percentage of total banking sector assets.



Source: Central banks websites.

Figure 7.2. Residential real estate loans to total gross loans.



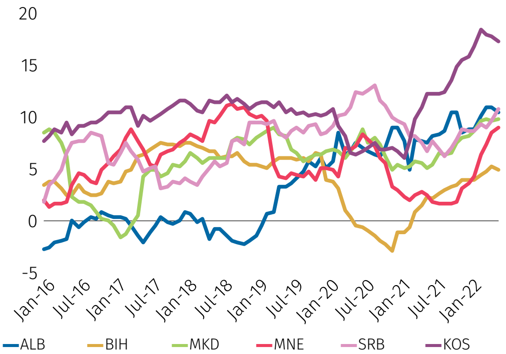
Source: IMF FSI and Central Banks.

Residential real estate price growth has accelerated sharply since 2020 reaching its highest growth rate in decades coupled with increased mortgage lending. This has led to concerns about overvaluation and household indebtedness. Exposure to real estate asset class is elevated in the region due to: (i) growing real estate and mortgage loan portfolio in recent years; (ii) mortgages forming most of the commercial bank's collateral portfolio; and (iii) acquired and unliquidated real estate assets remaining on balance sheet as a legacy since the global financial crisis. In the region average exposure to residential and commercial real estate loans is around 25 percent of the gross loans. However, this goes up to 37 percent in Albania and 33 percent in North Macedonia (Figure 7.2).

Due to the increasing exposure of the banking sector to both sovereign and real estate markets, policymakers should increase their vigilance against risks that can be transmitted from these channels. Regulators and central banks should intensify monitoring of exposure to real estate and sovereign and strengthen onsite and offsite supervision capacity to detect any buildup of risks or vulnerability. The main objective should be to identify early on any potential systemic risks that could endanger financial stability if they materialized. Macroprudential policy tools should be ready to contain any further build-up of the risks identified.

Figure 7.3. Credit growth has started to decelerate since September 2022.

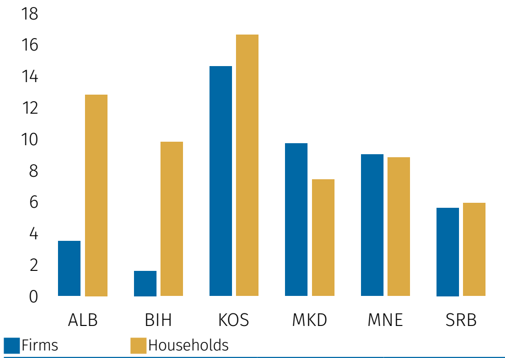
Change in nonfinancial private sector credit outstanding, December 2022, percent, y-o-y



Sources: IMF International Financial Statistics; central banks.

Figure 7.4. Household loans grew faster except in North Macedonia and Montenegro.

Change in credit outstanding, December 2022, percent, y-o-y



Source: Central banks.

and Albania (4.8 percent and 3.5 percent, respectively).

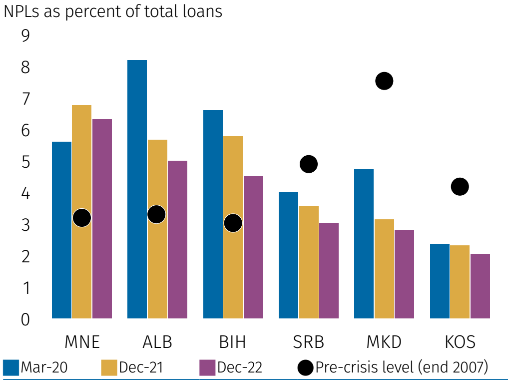
Continued strong loan demand from firms and households and tightened credit conditions are expected to widen the mismatch between credit demand and supply in the next six months. According to the results of the Central, Eastern and Southeastern Europe (CESEE) Bank Lending Survey[9], credit demand has remained strong and is expected to follow a similar pattern in H1 2023. Working capital loans reflecting firms' liquidity needs are expected to be the main driver of demand while fixed investments and retail segments are expected to contribute negatively. On the supply side, tightening of loan standards and costs are expected to continue in all segments as a result of increased uncertainty, worsened economic outlook, and increased costs of financing. While banks continue their selective approach in search for creditworthy customers, cross-border banking groups do not foresee a significant deleveraging or strategy change in the region. Positive funding conditions driven by corporate and retail deposits is expected to continue in the next six months.

The regional average NPL ratio continued to decline, recording its historical low value (Figure 7.5). The regional average NPL ratio decreased by 0.6 percentage points from December 2021 to 3.9 percent in December 2022. NPL ratios are higher than the region's average in Montenegro (6.3 percent), Albania (5.0 percent) and Bosnia and Herzegovina (4.5 percent). Kosovo's NPLs remained the lowest in the region (2.0 percent), while Albania registered the largest drop in NPLs in the post-COVID period (3.2 pp since March 2020).

While asset quality continues to improve in the region, concerns remain as sharply rising interest rates to curb the soaring inflation and the tightening of credit supply may accentuate borrowers' vulnerabilities. Deterioration in the macroeconomic outlook including high inflation and low growth may expose firm, household, and sovereign vulnerabilities, increase stress on their balance

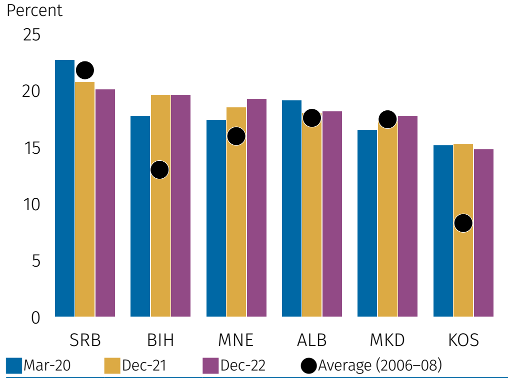
9 EIB Central, Eastern and Southeastern Europe Bank Lending Survey, Autumn 2022.

Figure 7.5. NPLs continued a downward trend in all countries.



Sources: IMF Financial Soundness Indicators; central banks.

Figure 7.6. Banks' capital buffers were preserved.



Sources: IMF Financial Soundness Indicators; central banks.

sheets, and ultimately negatively affect their debt servicing capacity. Signs of higher credit risk remain despite decreasing NPL ratios. Elevated stage 2 loans[10]—a good indicator of future NPLs—point to a higher share of loans with significant increase in credit risk. As of December 2021, Western Balkans' regional average stage 2 loans were at 10.5 percent, much higher than NPLs, at 4.6 percent. The CESEE Bank Lending Survey also indicates that given the unfavorable economic outlook, banks expect an increase in non-performing loans in the next six months[11].

Capital buffers in the Western Balkan countries remained broadly stable, while bank liquidity is slightly lower compared to December 2021. As of December 2022, bank capital adequacy averaged 18.3 percent, far above the regulatory minimum, and slightly higher compared to December 2021, at 18.2 percent (Figure 7.6). The ratio of liquid to total assets averaged 29.8 percent in December 2022, recovering from its lowest level in June 2022, potentially reflecting slowing loan growth in recent months. The loan-to-deposit ratios were well below 100 across the board (77 percent on average in September 2022) while declining slightly, indicating a slower loan growth compared to a deposit growth.

Regional average bank profitability has recovered to pre-pandemic levels as of September 2022—for the first time in the post-pandemic period. Profitability as measured by return on assets has recovered to 1.8 percent in December 2022 from 1.4 percent in December 2021, supported mainly by the rising interest rates. Kosovo had the highest profitability (2.5 percent), while Albania had the lowest (1.4 percent). The CESEE Bank Lending Survey also shows that all the international banks operating in Kosovo reported a higher return on assets compared to their group profitability, while in Albania a return on assets of the banking groups is not different than their group profitability. Going forward, it will be important to monitor profitability, considering the risks for the outlook. A weaker economy and increased

10 Stage 2 Assets, in the context of IFRS 9, are financial instruments that have deteriorated significantly in credit quality since initial recognition but that offer no objective evidence of a credit loss event. (The International Financial Reporting Standard [IFRS] is published by the International Accounting Standards Board. IFRS 9 specifies how an entity should classify and measure financial assets, financial liabilities, and some contracts to buy and sell nonfinancial items.)

11 Central, Eastern and Southeastern Europe (CESEE) Bank Lending Survey, Autumn 2022.

credit risk may weigh on bank profitability prospects in the medium term through increasing provisioning and impairment cost.

Authorities need to keep their focus on monitoring any remaining pockets of vulnerability in the banking sector, including the risk concentration and macro financial channels that can increase the pressure on banks. Higher funding costs and less fiscal space are putting pressure on sovereign fiscal balances. High inflation, energy prices, and interest rates put pressure on corporates and households balance sheets with growing recession risk. Increasingly volatile financial markets are more prone to disorderly adjustments especially in riskier and less liquid asset classes such as bonds, or real estate market. Regulators and banks need to take the necessary preemptive measures to prevent a new buildup of risks, and monitor exposure to sovereign and real estate market adjustment.

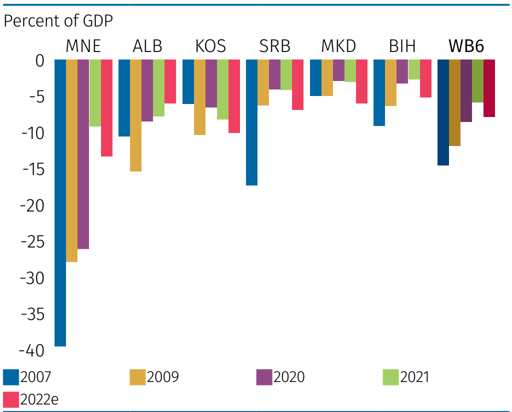
8. Current account balances deteriorate anew in the Western Balkans

The negative terms-of-trade shock and supply chain disruptions caused by Russia's invasion of Ukraine adversely affected the external sector in the Western Balkans in 2022. The food and energy crises continued to spread through the external sector to the Western Balkans. The effects were initially most evident in the disruption of commodity and energy trade; an increase in commodity prices, particularly food and oil; and sizable inflationary pressures not seen in decades. These market volatilities and geopolitical insecurities spilling over into the region are further intensifying uncertainties for consumers and investors alike, aggravated by tightening global financing conditions.

In 2022, the regional current account deficit exhibited the highest level in the last decade, with the exception of the pandemic year (Figure 8.1). The regional external deficit soared to 6.9 percent of GDP in 2022 from 4.8 percent the year before. The 2-percentage point (pp) widening of the external deficit is mainly driven by Montenegro (4.2 pp) and North Macedonia (2.9 pp), although deficits widened in other countries as well, with the exception of Albania, which reduced its deficit in 2022 to 6 percent of GDP. Montenegro and Kosovo exceeded the deficit level of 10 percent of GDP in 2022. While not unusual for Montenegro, which consistently recorded external deficits averaging 15.5 percent of GDP over the last decade,[12] it is the first time Kosovo exceeded 10 percent of GDP since 2011, despite strong growth in net service exports and remittances.

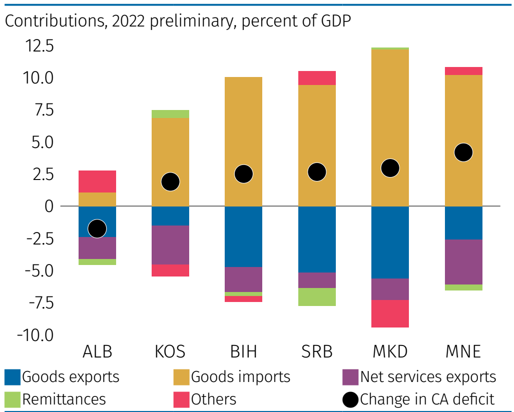
The deterioration in the regional current account deficit was driven by further worsening of the merchandise trade deficit (Figure 8.2). The merchandise trade deficit grew to around 15.3 percent of GDP in 2022 from 13 percent of GDP in 2021, or 2.3 percentage points. The continued increase in the merchandise trade deficit was caused by two broad factors: first, on the demand side,

Figure 8.1. Current account deficits widened in 2022...



Sources: Central banks; World Bank staff estimates.

Figure 8.2. ...in most countries in the region.



Sources: Central banks; World Bank staff estimates.

12 2011 to 2021.

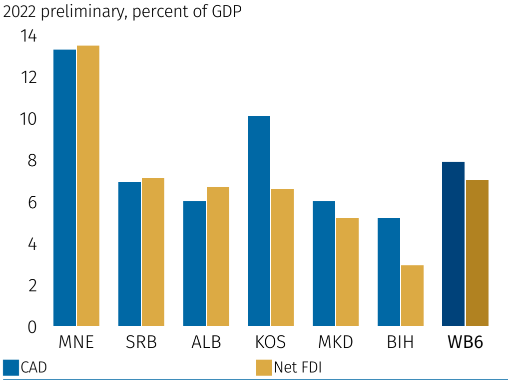
by the continued strong regional growth in investment and private consumption fed by the steady inflow of remittances; and second, by surging commodity prices such as oil, electricity, and food, as well as higher import volumes due to purchases to store reserves of food and other commodities. For some countries, such as Kosovo, the acceleration in electricity prices has added significantly to the widening of the trade deficit. The worsening of the merchandise trade balance was most substantial in Montenegro (7.5 pp), followed by and North Macedonia (6.5 pp), Bosnia and Herzegovina and Kosovo, where it totaled about 5 pp (for the former despite being an electricity exporter).

Net service exports picked up in 2022, softening the widening of the current account deficit (Figure 8.2). Net services in part offset the structurally high merchandise trade deficits in the region, by 2.2 percent of regional GDP. In 2022, net service inflows grew most in Bosnia and Herzegovina, to 9.3 percent of GDP from 7.4 percent, and in Montenegro to 22.7 percent of GDP, an increase of 3.4 percent of GDP, similar to Kosovo. In all countries, higher net services are accounted for by larger tourism inflows. The same applies to Albania, where, however, net service exports growth was limited, and recorded an increase of 1.7 percent of GDP, to 13.4 percent of GDP. In Kosovo and North Macedonia, visits by workers living abroad account for the majority of travel inflows.

Net remittance inflows remained steady in 2022 supported by, among others, a strong labor market in the European Union, with an all-time low unemployment rate of 6.1 percent. The regional inflow of remittances remained constant at 7.1 percent of GDP in 2022 compared to 2021, exhibiting a secular rise since 2016. Two countries stand out in this context: Kosovo and Bosnia and Herzegovina, both with flourishing outmigration flows. Kosovo's remittance inflows amounted to nearly 13 percent of GDP, while Bosnia and Herzegovina registered an inflow of 9 percent of GDP. Other countries, such as North Macedonia, Albania, and Serbia, show a more subdued outcome in remittances flows, totaling 2.7 percent, and 5.5 percent of GDP for both, respectively.

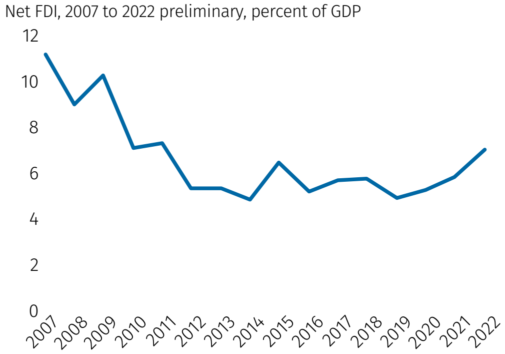
Regional external imbalances were largely funded by net inflows of foreign direct investment (FDI). Regionally, net FDI inflows rose by 1.2 pp of GDP in 2022 to 7.0 percent of GDP and helped finance over 80 percent of the regional external imbalance (Figure 8.3). However, the level of this mostly non-debt-creating financing inflow varies significantly across countries. Bosnia and Herzegovina at 2.9 percent of GDP exhibited the lowest net FDI inflows in 2022 which increased by only 0.3 percent of GDP compared to the year before. Continuous political frictions and a complex institutional setup are likely to have adversely affected foreign investor confidence. Kosovo, with FDI inflows at 6.6 percent of GDP, mostly for construction, and North Macedonia, with FDI inflows at 5.2 percent of GDP, are trailing the rest of Western Balkan countries in terms of FDI inflows. Montenegro had the strongest inflow of FDI in 2022, at 13.5 percent of GDP, mainly driven by tourism, followed by Serbia at 7.1 percent of GDP, largely in highly productive manufacturing subsectors. Overall, the sharper rebound in net FDI inflows since 2019 may give some credence to the argument of nearshoring benefiting the Western Balkans, but also relocation of businesses from Ukraine and Russia (Figure 8.4).

Figure 8.3. External deficits were mostly met with robust FDI...



Sources: Central banks; World Bank staff estimates.

Figure 8.4. ...among else due to the nearshoring to some parts of the Western Balkans.



Sources: Central banks; World Bank staff estimates.

Even with a small drop in external debt in 2022, the Western Balkan countries continue to depend on external financing. In 2022, the average external debt was estimated at 78 percent of GDP, a reduction of around 5 pp compared to 2021. Most of the countries reduced external indebtedness, except for Kosovo and North Macedonia, which increased total external debt by 0.6 and 5.6 percent of GDP, respectively, driven by private external borrowing. In fact, overall private external borrowing rose since end-2020. In other countries, the decline in total external debt is the result of the reduction in external public debt more than offsetting higher private external borrowing. Albania is an exception, where both private and public external debt declined in 2022 compared to 2021, together totaling 8.4 percent. A sudden halt to FDI inflows in the Western Balkan countries, or a persistent reliance on higher imports, particularly consumption goods, could amplify dependence on external financing and endanger foreign currency reserves. At end-2022, Western Balkan countries maintained stable reserves exceeding five months of imports, yet uncertainties are running high, and stronger regional cooperation could go a long way toward strengthening the gains in the external sector since the decline of the COVID-19 pandemic.

9. Domestic reforms would help offset a more challenging external outlook

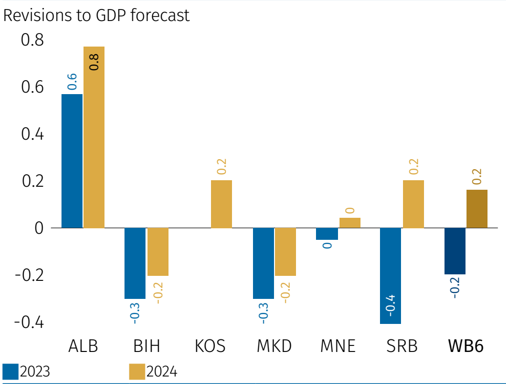
The outlook for the Western Balkans remains subdued and subject to high uncertainty. In the short term it is expected to be driven by the economic performance of the European Union (EU), the course of energy and food prices, and the fight against inflation. All these factors are affected by Russia's invasion of Ukraine and the persistent impacts of the pandemic, which prompted shifts in demand and revealed supply bottlenecks. The outlook for the EU remains challenging, although the latest forecasts suggest that the Eurozone will avoid a recession. Energy prices are driven by continued supply uncertainty, although price forecasts are lower than anticipated last year owing to the milder European winter and receding fears regarding gas storage stocks. However, natural gas prices are proving sticky, especially in Europe, given the critical role Russia has played in this market. Food prices are also expected to remain high and appear to be resulting in a pass-through to higher core inflation. Finally, monetary tightening, led by advanced economies, is compressing demand and raising financing costs for sovereigns, corporates, and households.

The Western Balkans economies had a good 2022, although growth decelerated sharply over the course of the year. Their average GDP growth rate was 3.2 percent, on the back of 7.8 percent GDP growth in 2021, which reflected a recovery from the previous year's contraction. However, growth slowed significantly in the second half of the year as sharply higher food and energy prices, along with elevated uncertainty, weighed on economic performance. Growth for the year in the Western Balkans matched world GDP growth and was just under the growth of the euro area. In short, the Western Balkans proved resilient in 2022 during a highly uncertain period.

Against this backdrop, growth in 2023 is expected to remain resilient, but that resilience will be tested further. GDP growth is expected to moderate to 2.6 percent in 2023, mainly driven by consumption, though public investment is expected to play an important role in Bosnia and Herzegovina, Montenegro, and North Macedonia. While several countries are expecting a continued recovery in tourism revenues as well as further growth in merchandise exports, external demand may weaken, and domestic demand is expected to remain an important growth factor. For the most part, GDP growth forecasts for 2023 have been revised downward since the last edition of the *Western Balkans Regular Economic Report* on account of the weaker external environment (Figure 9.1), which affects export growth, inflation, and financing costs. These factors, together with the preponderance of downside risks (discussed below), will test the resilience of the Western Balkans.

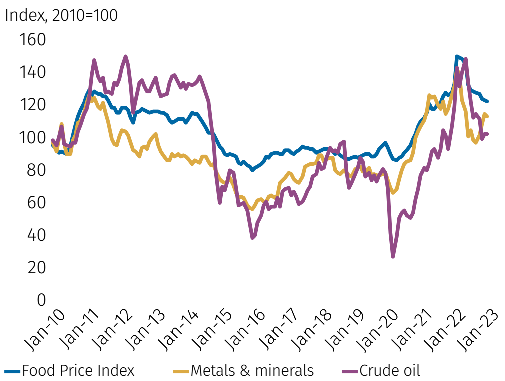
Inflation is projected to moderate in 2023, though monetary authorities are expected to maintain an aggressive stance, putting a dampener on growth. The average inflation rate for the Western Balkans is expected to drop to 7 percent, about 5 percentage points lower than the previous year. Nevertheless, monetary authorities are expected to remain vigilant as several authorities are committed to

Figure 9.1. Growth projections have been revised downward in 2023 for three economies.



Source: World Bank staff calculations.

Figure 9.2. Commodity prices have receded from past peaks, but remain elevated.



Sources: UN Food and Agriculture Organization; World Bank.

return inflation to about 2 percent by 2025. After surging in 2022, commodity prices have receded from their peaks, although prices remain significantly above their pre-crisis levels (Figure 9.2).

Management of fiscal balances is expected to remain challenging in 2023. Fiscal deficits are expected to narrow for Albania, Bosnia and Herzegovina, and Montenegro in 2023, but may widen in Kosovo and North Macedonia. For Albania, Bosnia and Herzegovina, and Serbia, the fiscal strategy is to phase out large crisis-response spending programs and intensify revenues, with a view toward reducing public debt, rebuilding fiscal buffers, and improving resilience. For Kosovo, Montenegro, and North Macedonia, recent increases in the public sector wage bill, other recurrent spending, and significant public investment commitments will drive larger fiscal balances in 2023. For countries with independent monetary policy, authorities need to carefully review the policy tradeoffs: while raising the policy rates will dampen the growth, it will at the same time strengthen currencies, reducing the cost of imported commodities and thus the need for mitigation measures for high energy and food prices. Authorities also need to carefully review the tradeoffs between measures to protect the purchasing power of households against high inflation and energy prices and the need for breaking inflation-wage spiral that feed into entrenched inflation. In this context the role of indexation, collective wage bargaining, and income policies would need to be synced with the monetary policy objectives.

Caution will be needed on debt management and the management of fiscal risks, including state-owned enterprises. While the Western Balkans have low to moderate debt, the external environment is precarious as borrowing costs have increased in light of the monetary tightening taking place on a global scale. Rollover risks are expected to be high, as will the cost of new borrowing in the domestic or Eurobond markets. Increased access to quick-disbursing resources from international financial institutions will help partially fill financing needs. However, in an environment still marred by uncertainty, countries will need to ensure that their social spending is well targeted and efficient and that they are getting value for money in their capital investments.

The Western Balkans' current accounts are expected to improve only modestly in 2023. Given the importance of the EU market, countries are expecting only a modest recovery in their exports of goods and services and in the flow of remittances. The current accounts of the countries with the most expansionary fiscal policies will also be affected as higher levels of investments will attract higher levels of imports.

The preponderance of risks to the outlook remains on the downside, although the aggregate level of risks appears to have receded somewhat. Energy prices remain elevated, but prices have fallen significantly since their peak in mid-2022. Similarly, concerns surrounding the security of energy supplies have partially receded. However, the region remains vulnerable to an extended energy and food price shock. A weaker-than-expected performance in the EU would naturally affect both the demand for exports from the Western Balkans and the flow of investments and remittances. The effects of monetary tightening in advanced economies could also spill over to impact the financial sector, as recent events in the United States and Switzerland have shown. Domestic investor sentiment remains vulnerable to all these factors, as do domestic political developments and the electoral cycle in several countries in the region. On the upside, should EU growth slowdown prove to be shallower than expected, or if a sustained decline in inflation leads to greater monetary accommodation, then the Western Balkans may see better-than-expected growth performance. Similarly, high-frequency indicators of FDI suggest that reshoring of global value chains continues to offer the region an opportunity to better integrate into Eurocentric supply chains. Further, normalization of relations between Serbia and Kosovo offers the opportunity to attract greater investments and accelerate the EU accession process.

The most appropriate response is to return to fundamentals and to emphasize growth-enhancing structural reforms. The Western Balkans now looks to be exiting a period of overlapping external shocks, but with sluggish growth and depleted fiscal space. In such an environment, with elevated uncertainty, the Western Balkans will need to pay attention to three kinds of policies: (i) domestic revenue mobilization, (ii) productivity-enhancing reforms, and (iii) debt management. Meanwhile, the region continues to face an impending green transition that will require structural reforms, including the need to put a price on carbon (see *Spotlight* section). Several countries are actively exploring revenue options including increasing progressivity in direct taxes, expanding direct tax coverage to previously excluded categories (such as dividends and interest) and increasing the use of excise taxes. Similarly, no-regret reforms that would boost productivity over the medium-term, such as to accelerate regional integration (Box 9.1), increase levels of market competition, attract higher quality investments, and to address barriers that limit labor-force participation (especially among women) should be a priority. Finally, there is a risk that the counter-cyclical fiscal response to the pandemic and subsequently the energy crisis will leave lasting scars on public debt. This necessitates a careful review of public debt policy and management with a view towards rebuilding buffers in readiness for the next shock.

The medium-term outlook for the Western Balkans continues to be positive but shaded with large uncertainty (Box 9.2); growth

acceleration is needed to close the gap with its EU peers. In the medium term, the countries of the Western Balkans will likely see growth reverting toward pre-crisis levels of annual potential growth of 2.5 to 3.5 percent. However, at that rate it will take many decades before living standards converge with today's EU averages. Reforms to boost potential growth would bring this convergence forward.

Box 9.1. Trade facilitation reforms could help to accelerate growth in the Western Balkans, especially if countries take coordinated action.

Trade facilitation and regional integration are crucial for the economic growth and competitiveness of the Western Balkan countries, which currently face challenges due to fragmentation and their being small economies. The Common Regional Market initiative, which covers the four freedoms (digital, investment, innovation, and industry policy) is an essential step towards integrating these economies with each other and with the EU economy. Recent efforts have focused on improving trade facilitation, upgrading transport and connectivity infrastructure, and leveraging deep trade agreements within the region and with the EU.

New World Bank research quantifies the economic and social benefits of regional economic integration in the Western Balkans using a general equilibrium model, and assesses the impacts of trade facilitation reforms, accession to the EU, and new infrastructure (Gomez, Taglioni and Zarate 2023). The region's economic integration is essential for fully integrating with the EU, which is already the largest trading partner, with over 70 percent of exports from the region going to EU member states. The EU is also the biggest source of foreign direct investment (FDI) in the region, similarly, accounting for around 70 percent of total FDI, and it offers access to a market of more than 500 million high-income consumers.

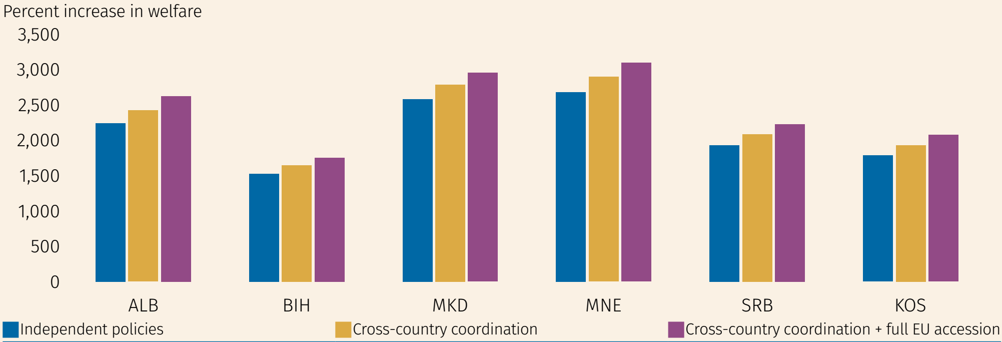
The study suggests that coordinated policies and investments for regional integration can generate significant economy-wide benefits. For example, reducing waiting times at the border has the same impact on exports as lowering tariffs in the EU market.

- A simple reduction of the waiting time at the border by three hours would be similar to lowering ad valorem tariffs by around 2 percent across all countries in the Western Balkans.
- The study also found that implementation of trade facilitation reforms can generate up to 8 percent additional gains with coordination among economies, equivalent to as much as 3 percent of per capita GDP in some cases.
- Meanwhile accession to the EU can amplify gains by an additional 6 percent. Furthermore, neighboring countries such as Romania, Hungary, and Bulgaria can experience gains of around 0.2 percent due to trade with the Western Balkans.
- Continued investment in transport infrastructure remains a regional priority as well. Past improvements in infrastructure, particularly roads, have increased real income by around

(Box 9.1 continued)

5 percent, with the potential to further boost real income by 7 percent in the case of EU accession. Hence coordination of infrastructure and trade policies can lead to additional synergies and economic growth.

Figure 9.3. Aggregate welfare gains: reducing waiting times at the border by three hours.



Source: Gomez M., Taglioni D., Zarate R., "The Economic Effect of Market Integration Policies in the Western Balkans", World Bank, (forthcoming) 2023.
Note: This figure plots the aggregate welfare gains after implementing trade facilitation reforms which consist of reducing border times by three hours. The blue bar corresponds to the counterfactual in which each economy implements the policy independently, the red bar when countries coordinate with each other, and the orange bar when countries coordinate with each other and are also part of the European Union.

Box 9.2. Global economy under large uncertainty.

Global growth is projected to slow sharply in 2023, the third weakest pace of expansion in nearly three decades after the global recession caused by the COVID-19 pandemic and the global financial crisis (Figure 9.4A).[13] The slowdown reflects ongoing monetary policy tightening to contain very high inflation, fiscal adjustments, worsening financial conditions, and continued disruptions from the Russian Federation's invasion of Ukraine. The world's three largest economies—the United States, the euro area, and China—are expected to face continued weakness in economic activity, with the resulting spillovers exacerbating other headwinds faced by emerging markets and developing economies.

Global activity, especially on the services side, appears to have stabilized in early 2023, reducing the likelihood of a global recession (Figure 9.4B and 9.4C).[14] After contracting for six months, the global composite Purchasing Managers' Index (PMI) returned to expansion in February 2023, reflecting a strong pickup in services activity. Services trade is likely to continue to benefit from the recovery in international tourist arrivals, which remained about 25 percent below pre-pandemic trends in December 2022. In contrast, global manufacturing

13 Based on the World Bank's January 2023 edition of *Global Economic Prospects*, the February 2023 "Global Monthly," and Consensus estimates from Consensus Economics. Data are as of March 13, 2023.
14 Defined as a contraction in annual global per capita income.

(Box 9.2 continued)

activity has continued to be subdued after global goods trade volumes and industrial production experienced renewed weakness in late 2022. The recovery in the global manufacturing PMI in early 2023 has lagged that of services, with manufacturing activity dampened by an ongoing contraction in new export orders. China's economic reopening is likely to boost headline global growth, but the positive spillovers to other economies and global trade could be modest given that the rebound has been less manufacturing- and trade-intensive relative to previous recoveries. More broadly, global demand for manufactured goods is likely to remain muted amid the ongoing and accumulating effects of tighter monetary policy. Nevertheless, weak goods demand and continued normalization of shipping conditions have helped ease global supply chain pressures, with suppliers' delivery times falling to pre-pandemic levels in February 2023.

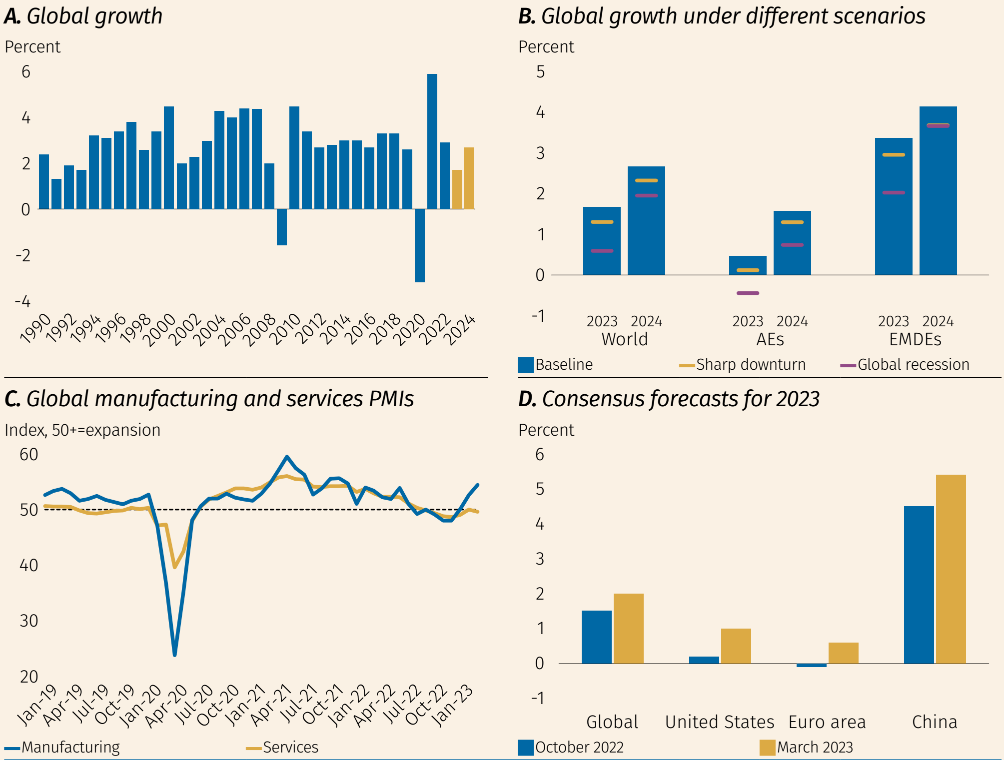
The outlook for the global economy appears to have improved in early 2023, with Consensus forecasts for global growth in 2023 rising from 1.5 percent in late December to 1.9 percent in mid-March (Figure 9.3D).[15] Various economic indicators suggest that particularly in large economies, activity was more resilient in late 2022 than earlier expected, implying that the drag from a weak fourth quarter in 2022 will weigh less on activity going forward. In the United States, continued strength in the labor market has supported services activity and underpinned a pickup in consumption in early 2023, with Consensus forecasts edging up from 0.2 percent in late December 2022 to a still modest 0.8 percent in March 2023. Nevertheless, the Consensus forecast for US growth in 2024, which is about 1 percent, points to sluggish activity as tighter monetary policy weighs on domestic demand.

For the euro area, Europe and Central Asia's largest economic partner, Consensus forecasts for 2023 growth remain subdued at about 0.5 percent, an improvement from the contraction envisioned in December 2022. The upward revision for euro area growth in 2023 is largely due to better-than-expected growth outturns in Q4 2022, with activity benefiting from a warmer winter and the decrease in energy prices. Incoming survey data point to an ongoing recovery in sentiment, particularly in the service sector, with the services PMI rising to its highest level in February 2023 since June 2022, amid a pickup in new business and improving expectations. In contrast, the manufacturing PMI in February 2023 contracted for the eighth consecutive month, with the decline in new export orders mirroring the weakness in global goods trade. Inflationary pressures also continue to weigh on euro area activity—although Harmonised Index of Consumer Prices inflation has decelerated in early 2023, core inflation continues to reach new record highs. This points to the possibility of more European Central Bank (ECB) policy rate hikes than currently envisioned by the market. The Consensus forecast for 2024 growth in the euro area remains subdued at 1.1 percent, as continued tightening of monetary policy to rein in inflation is expected to hold down domestic demand.

15 Consensus Economics, https://www.consensuseconomics.com.

(Box 9.2 continued)

Figure 9.4. Global Developments and Growth Scenarios.



Sources: Consensus Economics; Haver Analytics; World Bank 2023; World Bank.
Note: AEs = advanced economies; EMDEs = emerging markets and developing economies; GDP = gross domestic product; PMI = Purchasing Managers' Index.
a. Aggregate growth rates are calculated using real US dollar GDP weights at average 2010–19 prices and market exchange rates, as published in World Bank (2023). The shaded area indicates forecasts. The sample includes up to 37 advanced economies and 144 EMDEs.
b. Growth aggregates computed by Oxford Economics using 2015 market exchange rates and prices.
c. PMI readings above (below) 50 indicate expansion (contraction). The last observation is February 2023.
d. The figure shows growth projections from the last Continuous Consensus Forecast survey of the month indicated. Data are through March 15, 2023.

Risks to the global outlook remain tilted to the downside, including from sustained high inflation, financial stress, Russia's continued war in Ukraine, and rising geopolitical tensions. Inflation remains high in many economies. In the euro area, core inflation continues to rise amid strong momentum in the goods and services categories and second-round effects from earlier energy price increases. As a result, market participants expect the ECB to raise policy rates to higher levels compared to late 2022. Moreover, there is substantial uncertainty about the impact of central bank policy in terms of both magnitude and timing. To bring inflation under control, central banks, including those in Europe and Central Asia and the ECB, may need to hike policy rates more than is currently expected. Financial stress among sovereigns, banks, and nonbank financial institutions may result from the combination of additional monetary tightening, softer growth, and falling confidence in an environment of elevated debt. Given the already weak global growth, a combination of sharper monetary policy tightening and financial stress could result in a more pronounced slowdown this year.

10. *Spotlight:* Towards carbon pricing in the Western Balkans

Slow decarbonization progress is increasingly hurting Western Balkan economies

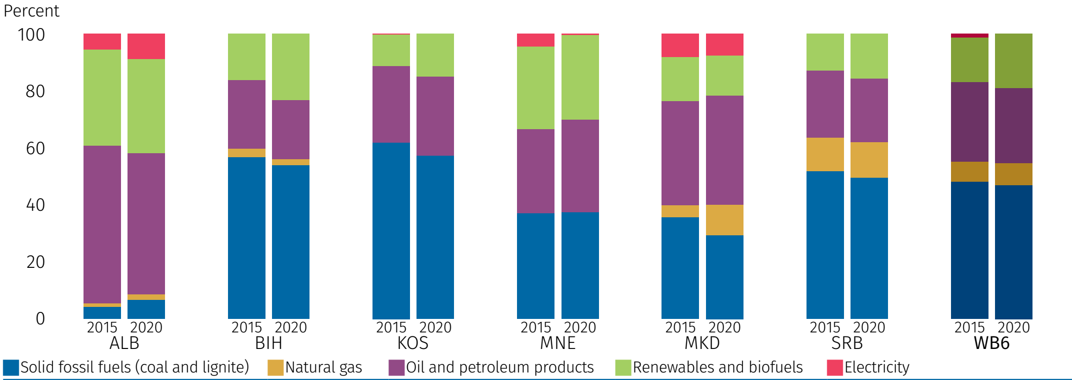
The transition toward a low-carbon, environmentally sustainable economy has begun in the Western Balkan countries (WB6), but progress has been slow and not without setbacks. Despite recent progress on wind and solar capacity additions, as well as the increased availability of renewable energy finance, the primary source of energy in the WB6—with the exception of Albania—is domestic lignite and coal (64 percent of electricity in the WB6 was produced from lignite and coal in 2020 and 47 percent of gross available energy in 2020, down from 49 percent in 2015) (Figure 10.1).[16] Material- and energy-intensive modes of production in industry are driving up production costs and emissions. Though declining, large fossil fuel subsidies[17] and electricity tariffs below generation cost reduce incentives to achieve energy savings, improve energy efficiency, and switch to greener fuels.

A quadruple energy crisis has hit WB6 countries hard in the past year, stalling progress and investment in key strategic areas but also highlighting the need for more diversified energy sources and strengthened cross-border interconnections. With average annual net energy imports equaling up to 52 percent of energy consumption by country, the WB6 countries have been hit hard by the rising cost of imported energy. Across the region, energy prices increased by an average of 13.1 percent annually by July 2022, ranging from 4.5 percent in Albania to 18.2 percent in Bosnia and Herzegovina.[18] In addition to high prices of electricity imports, quadruple energy crisis refers also to the parallel occurrence of a series of technical problems at coal power plants and mines (primarily in Kosovo, North Macedonia, and Serbia), unfavorable conditions for hydropower production (impacting all WB6 countries but mostly Albania), and an increase in biomass prices in all countries. Overdue investments into modernizing the power sector, including scheduled decommissioning of several coal power plants[19] and planned energy sector policy reforms, were further delayed, and the backlog continues to aggravate the impact of the energy crisis. The destabilizing impact of Russia's invasion of Ukraine has added the pressures of high food prices and inflation in the last year. With significant differences in primary energy mixes and import dependencies, the WB6 were hit by the same challenges, but to varying degrees (Figure 10.1).

The negative consequences of high fossil fuel dependency, high energy intensity and outdated technology use on the WB6 are clearly visible beyond the direct economic impacts. On the supply slide, ageing coal power plants and the use of biomass cause significant air pollution. Equally on the demand

16 IEA Electricity Information 2022 and Eurostat.
17 With the exception of Bosnia and Herzegovina, subsidies for coal and coal production have been continuously declining since 2016. Direct subsidies to coal mines and power plants amounted to EUR 73 million in the region in 2019 (Energy Community 2022).
18 World Bank 2022a; 2022b.
19 See Enervis (2021) for an overview of lignite plants in the Western Balkans as of 2021 and the schedule of phaseouts.

Figure 10.1. Western Balkans' energy mix: Gross available energy by product, 2015 and 2020



Source: Eurostat.
Note: Gross available energy is defined as the overall supply of energy for all activities on the territory of the country. Note that for derived products (electricity), the chart shows only stock changes and international trade, as the original primary form of supply is accounted for in the form of the respective primary product. Resulting small negative balances for electricity, where applicable, are excluded from the chart for better overview.

side, poor energy efficiency in buildings and heating also contribute to poor air quality. All WB6 countries have failed to comply with air pollution limits set in their National Emission Reduction Plans (NERPs) where applicable, also due to a lack of enforcement of pollution limits outlined in those plans. A majority of the WB6 power fleet is over 40 years old, with few plants scheduled for decommissioning and new plants in the pipeline.[20] Specifically, legal limit values for sulfur dioxide (SO_2) from coal power plants are frequently breached.[21] Coal combustion is the second largest source of PM 2.5 emissions in the region[22]. In 2019, annual mortality rates due to PM2.5[23] air pollution in the Western Balkans were more than double the EU-27 average, with mortality rates in Bosnia and Herzegovina 140 percent above those in the EU-27 average.[24]

The EU is incentivizing trading partners to act on the climate

This mode of power generation and fossil-fuel intensive economic production leaves the region vulnerable as the European Union (EU) decisively shifts to a cleaner and more resilient economic model. The European Green Deal (EGD)[25] outlines a 2030 target of reducing emissions at least 55 percent and a 2050 net zero emissions target.[26] Under the EGD, carbon pricing plays a central role, alongside phasing out of environmentally harmful subsidies: The European Union Emissions Trading System (EU ETS) will be strengthened and expanded, the Energy Tax Directive will be reformed to improve incentives for switching fuel, and a Carbon Border Adjustment Mechanism (CBAM) will impose a fee on the carbon content (direct and embedded CO_2, N_2O and PFC emissions) of

20 OECD (2022).
21 For quantitative country-level analyses on the apportionment of sources for Bosnia and Herzegovina, Kosovo, and North Macedonia, see https://www.worldbank.org/en/region/eca/publication/air-quality-management-in-western-balkans.
22 OECD (2022), Multi-dimensional Review of the Western Balkans: From Analysis to Action, OECD Development Pathways, OECD Publishing, Paris, https://doi.org/10.1787/8824c5db-en.
23 PM2.5 refers to particulate matter 2.5 micrometers and smaller. It is particularly harmful to health because it can travel deeply into the lungs.
24 Belis et al. 2021, Figure 4.
25 The EGD, a provisional agreement reached by the Council of the European Union and the European Parliament, is pending formal adoption by both institutions.
26 EU Climate Law; https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32021R1119.

covered emissions-intensive imports (iron and steel, cement, fertilizers, aluminum, electricity, and hydrogen, as well as selected articles of iron or steel).[27] The Green Deal Industrial Plan[28] has since been added to the EU policy framework on green transition, covering measures to support the deployment of clean technologies in the EU, also in response to the U.S. scheme of subsidies for green investment under the Inflation Reduction Act. This sends a strong signal to its trading partners about the potential financial risks of a fossil fuel-centric economic model.

The CBAM is a key tool for the EU to help level the playing field for domestic industries covered by increasingly ambitious carbon pricing. By expanding the carbon pricing signal to imported carbon-intensive products, the risk of carbon leakage—that is, relocation of carbon-intensive production to countries outside of the carbon pricing coverage—will be reduced. Should the regulation come into effect as planned, starting from 2023, importers of materials covered by the CBAM will have to start reporting embedded emissions of their products. From 2026, the CBAM fee will gradually be phased in (reaching average EU ETS allowance price levels by 2034) while the free allocation of allowances to EU ETS entities[29] will be phased out over the same time period. This gradual implementation provides time and opportunity for WB6 economies to adapt and prepare for the CBAM.

The CBAM aims to incentivize coordinated climate action in trading partner countries, including the Western Balkan economies. The CBAM proposal as of December 2022 encourages third countries to introduce carbon pricing, as the amount of CBAM certificates to be surrendered for a given product would be corrected for any carbon price paid in the country of origin (Article 9). Full CBAM exemptions would apply to countries linking to the EU ETS, partial CBAM exemptions could apply to third countries that integrate with the EU through electricity market coupling—a process WB6 countries are going through with the support of the Energy Community (Box 10.1). Clarifications on how the EU will determine these exemptions are needed in the form of bylaws and additional guidance documents.[30]

Emissions intensive sectors in WB6 would be negatively affected by CBAM but have time to adapt

The CBAM's impact on third countries that do not qualify for exemption or join the EU by the time CBAM becomes effective depends on their exposure and ability to adapt. Exposure can be measured as share of GDP from trade in CBAM goods with the EU and carbon intensity. Ability to adapt depends on characteristics such as export diversity, pace of decarbonization, and capacities for Measurement, Reporting and Verification, among other aspects.[31]

27 CBAM scope as of December 13, 2022 (Council of the European Union and European Parliament provisional agreement).

28 The Commission is expected to outline a draft proposal in March 2023.

29 "The free allocation of allowances deals with the risk of carbon leakage by reducing the costs of compliance faced by the operators covered by the EU ETS. These allowances thus help them to remain competitive against producers based in third countries"(https://op.europa.eu/webpub/eca/special-reports/emissions-trading-system-18-2020/en/#:~:text=The%20free%20allocation%20of%20allowances%20deals%20with%20the%20risk%20of,producers%20based%20in%20third%20countries.).

30 A list of questions and considerations these exemptions raise for the WB6 is included in Karova (2022).

31 For more details, see the total relative risk indicator based on vulnerability and exposure to the CBAM developed by Eicke et al. (2021).

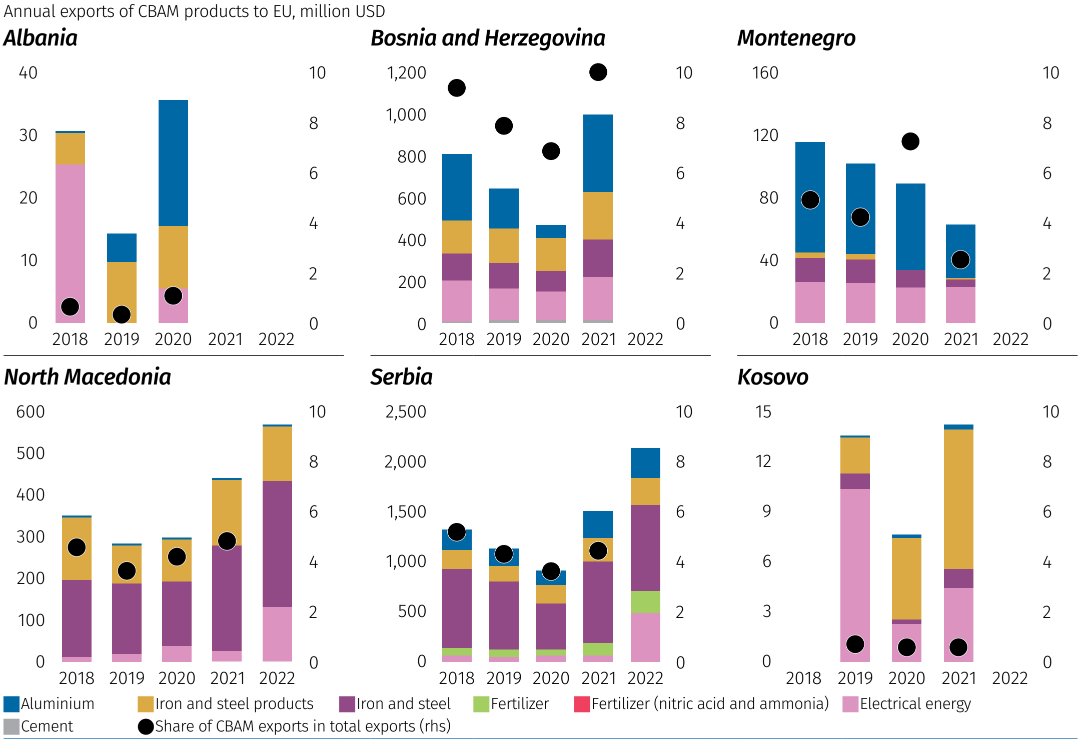
Box 10.1. EU CBAM Exemptions.[a]

Proposed Article 2(5) exempts third countries and territories from CBAM under the conditions that the EU ETS applies in the country or territory (or alternatively full linking of a domestic trading scheme to the EU ETS applies) and that the carbon price is effectively charged without rebates beyond those applicable in the EU ETS.

Article 2(7) applies to third countries integrating with the EU electricity internal market through market coupling. If technical solutions cannot be found in time to impose CBAM on electricity exported into the EU, then a limited CBAM exemption will be granted until 2030 at the latest for the export of electricity if certain criteria are satisfied. These relate to commitments and implementation of policies relating to climate neutrality and development of renewables, among others.[b]

a. This is based on the draft text from the December 2022 proposal. The final CBAM regulation still needs to be finalized and adopted, as such, it may change.
b. For an outline of WB6 progress in achieving these conditions, see Energy Community. 2022. Energy Transition Tracker.

Figure 10.2. Share of exports exposed to CBAM by sector and country, 2018–2022.



Source: COMTRADE, WDI and Kosovo Agency of Statistics.
Note: Kosovo data only includes EX1 exports. Total exposure is therefore underestimated in the chart.

Given that the EU is the main trading partner of the WB6, and the carbon-intensive modes of production in the region, the CBAM is a tangible transition risk for the WB6. Exposure to CBAM depends on the amount of the specified product exported and the relatively emissions intensity of that product. Looking at regional trade, 1 to 10 percent of total exports by country would be covered by the CBAM based on 2018–22 data, with an average of 4 percent covered across countries and assessed years (Figure 10.2). Bosnia and Herzegovina and Montenegro show the largest exposure, partly driven by large power exports. The carbon intensity of production processes in the WB6 is also much higher than in the EU. According to the Energy Community Energy Tracker, GHG in manufacturing in the WB6 is 10 times higher than the EU-27 average.[32] Carbon intensity of power is three times higher in the WB6 than in the EU-27, leading to relatively higher embedded emissions in electricity-intensive products produced in the WB6 (Table 10.1).[33] Looking at trends for renewables' shares in power generation, the risk of further carbon lock-in[34] in the power sector is high in all WB6 countries except Albania and North Macedonia.

Macroeconomic impacts are not large in aggregate but emissions-intensive sectors will be impacted significantly unless domestic policy adjustments or changes in the production process are made. Modeling done for Serbia shows CBAM leading to in a decline in exports, output and employment for electricity, ferrous metals, chemicals, and non-ferrous metals in the absence of supporting policy measures (Table 10.2). However, this does not translate into a significant macroeconomic impact as cleaner sectors, like consumer goods and electronics, increase their output due to labor and capital shifts away from CBAM-targeted sectors.

Despite the WB6's high vulnerability and exposure to the CBAM compared to other countries,[35] the expected aggregate macroeconomic impact for WB6 countries is small as economies are expected to adjust

Table 10.1. WB6 and EU27 energy mixes, GHG emissions, and renewables trends.

	RE in power generation 2020 (percent)	Carbon intensity of power (grams CO_2e / kwh)	Trend for RE in power mix
Albania	100	24 (2020)	→
Bosnia and Herzegovina	28.5	489 (2021)	↘
Kosovo	5.2	778 (2020)	→
Montenegro	52.2	336 (2021)	↘
North Macedonia	24.4	487 (2021)	↗
Serbia	21.9	549 (2021)	→
EU27	38.0	265 (2020)	→

Source: IEA; BP Statistical Review of World Energy; Ember; Eurostat.
Note: The third column indicates how the share of RE in power generation has changed in the last 10 years. Changes within +/-3pp are marked as ->.

32 Kantor, E3M 2021.
33 Based on the December 2022 CBAM draft, indirect emissions would be included but the final scope and timeline is yet to be determined.
34 "Carbon lock-in refers to the concern that investments in carbon-intensive infrastructure today will delay or foreclose a clean energy future by making it too difficult or too expensive to transition to alternative energies, thereby 'locking' a country into a fossil fuel-dependent development pathway" (https://www.energyforgrowth.org/memo/untangling-stranded-assets-and-carbon-lock-in/#:~:text=Carbon%20lock%2Din%20refers%20to,fossil%20fuel%2Ddependent%20development%20pathway.).
35 A global assessment put five of the WB6 countries in the top two quintiles in terms of relative CBAM risk (Eicke et al. 2021).

Table 10.2. CBAM selected sector effects by 2035 compared to BAU for Serbia.

Annual percent change

	Exports	Output	Employment
Electricity	-27.01	-3.96	-3.97
Ferrous Metals	-30.55	-28.95	-28.92
Chemicals	-6.53	-5.63	-5.35
Non-ferrous metals	-3.47	-3.44	-3.53

Note: Results stated are for a scenario assuming scope 2 emissions are priced in CBAM from 2030, and price level is EUR110/tCO2e in 2035.

Table 10.3. Overview of selected modeling results of CBAM impacts in WB6.

	CBAM IMPACT on GDP	Estimated total annual CBAM revenues	Change in GHG emissions
Albania	Up to -1.3% [2]	<USD 10 M [2]	
Bosnia and Herzegovina	Up to -3.7% [2]	USD 100 M [2] EUR 220 M [3]	
Kosovo	-0.25% [4]		
Montenegro	Up to -1.8% [2]	EUR 10 M [3]	
North Macedonia	Up to -2.6% [2]	USD 60 M [2] EUR 125 M [3]	
Serbia	-0.2% [1] Up to -4% [2]	EUR 230 M [1] USD 150 M [2] EUR 180 M [3]	-2.8% [1]

Sources: (1) WB 2022 Supporting Serbia's Transition to Greener and More Resilient Growth. GEM-E3-SRB CGE results for 2035, at EUR110/tCO2. (2) AFD 2022 Impacts of CBAM on EU trade partners. RMRIO results. Does not account for emissions intensities and economic transformation. Carbon revenue estimation assumes price of USD60/tCO2e, no forward projection. (3) Bankwatch 2022 The Western Balkan Power Sector: Between crisis and transition. No modelling, revenue calculation based on current trade flows and emissions intensity. No forward projection, price set at EUR50/tCO2. (4) World Bank. 2021. Environmental Tax Reform in Kosovo: Policy Note. Unpublished. MFMOD results. EUR35/tCO2e in 2035.
Note: Note that studies on CBAM impacts have only limited comparability due to a number of factors that impact results, including model choice, time horizon of the analysis, assumptions on price level and CBAM coverage developments. Results are compared to BAU unless otherwise stated. M=million.

quickly by reallocating production capacities to other products. For example, recent modeling for Serbia conducted by the World Bank[36] shows only a minor negative impact on GDP (a -0.23 percent change compared to business as usual[37] by 2035 in the Serbia case) and employment, while different modeling work done in Kosovo shows the CBAM having only a minor impact on GDP by 2035 (less than -0.3 percent compared to business as usual).[38] Table 10.3 provides an overview of recent studies by the World Bank and others.

While the CBAM may drive some emissions reductions in exposed countries, domestic policies are needed to drive transformative decarbonization and keep up with the EU acquis. Results for Serbia show marginal emissions reductions in response to the CBAM in the medium term (-2.8 percent). As the CBAM only targets the share of products exported to the EU, a decline in domestic production is expected to lead to proportional domestic GHG emissions reductions. More comprehensive domestic mitigation policies are needed to stimulate broader investment

36 World Bank 2022c. A decrease in total exports to the EU, and domestic production of selected products in response to the CBAM would be widely offset by decreases in imports of intermediate and final goods, as well as reallocation of labor and capital to increase production of other sectors including downstream products.

37 BAU assumes CBAM is not applied and Serbia is not a part of the EU.

38 World Bank 2021.

in efficiency improvements, fuel choices, and technological innovations.

The Western Balkan countries have committed to carbon pricing and need to act fast to keep pace with the EU

By signing the Sofia Declaration on the Green Agenda, and with subsequent treaties under the Energy Community,[39] all Western Balkan countries demonstrated their commitment to adopting EU legislation on energy and climate, including carbon pricing. In 2018, the Western Balkans leaders endorsed the Sofia Declaration, which aligns with the European Green Deal by committing to climate neutrality by 2050. This includes phasing out coal subsidies, market-based renewables support and Just Transition work for coal regions in the WB6. The Declaration also specifically calls for "continued alignment with the EU Emissions Trading Scheme," as well as working toward "introducing other carbon pricing instruments to promote decarbonization in the region."[40] Through the Energy Community, WB6 have furthermore committed to reforming electricity and gas markets, providing common rules for an internal power market, as well as cross-border cooperation. They also committed to diversifying their energy sources with renewables and energy efficiency targets, as well as to working on more open and fairer retail markets.[41] The adoption of a Decarbonization Roadmap under the Energy Community in 2021 further demonstrated the countries' commitment to work toward introducing carbon pricing, as well as a roadmap for implementation (the Green Agenda Action Plan).

Significant progress has been made in setting up the Monitoring, Reporting and Verification (MRV) frameworks for carbon pricing systems through national legislation and Energy Community proposals. Albania, Bosnia and Herzegovina, Montenegro, and Serbia have passed MRV legislation for GHG emissions (Table 10.4), and all WB6 countries report electricity production emissions and CO_2 intensity through the Energy Community. In December 2022, the Ministerial Council of the Energy Community adopted the MRV regulation, and members will have until the end of 2023 to transpose the regulation (including the required institutional framework), with full implementation anticipated by 2026.

To date, half the WB6 countries are actively considering carbon pricing systems and Montenegro has introduced an ETS (Table 10.4). Montenegro is the most advanced, with an ETS in place since 2020 covering the power and industrial sectors. Auctioned allowances are subject to a EUR 24 minimum price,[42] and revenues from the ETS are directed to the "Eco Fund," which supports environmental protection. Bosnia and Herzegovina is exploring potential design options for a national carbon pricing system,[43] while Serbia and North Macedonia conducted first impact assessments.

39 In addition to the WB6, the Energy Community also includes Georgia, Moldova, and Ukraine.

40 Contracting parties have furthermore committed to formulating 2030 National Energy and Climate Plans (NECPs), laying out their planned actions on decarbonization and other areas of energy transition including energy efficiency; energy security; the internal energy market; and research, innovation, and competitiveness. However, only Macedonia and Albania have submitted NECPs to date, and existing submissions lack specificity of actions.

41 OECD. (2022).

42 Though two thirds of emissions from regulated entities are allocated allowances for free.

43 Currently, the Ministry of Foreign Trade and Economic Relations is working with the United Nations Development Programme on carbon pricing infrastructure, and on assessing the scope and cap options for a national emissions trading system with the World Bank.

Table 10.4. WB6 Carbon pricing and MRV developments.[45]

	Direct Carbon Pricing	MRV*
Albania	Under consideration: ETS mentioned in Albania's draft NECP (2022).	In Law
Bosnia and Herzegovina	Under consideration: Roadmap for ETS implementation prepared with Energy Community (2022).[c]	In law
Kosovo	No update. Climate change law under preparation.	No update
Montenegro	ETS operational: Montenegro has been operating an ETS for the power and industry sectors since 2020 with a minimum price of EUR24 for auctioned permits.	In Law
North Macedonia	Under consideration: In 2022, adopted its NECP and has been developing its Law on Climate, including Article 40, which would establish the basis for a carbon fee. The revenues would be earmarked to support further decarbonization and green transition, and vulnerable consumers.[c]	No update
Serbia	Under consideration	In Law

Note: While MRV (Measurement, Reporting and Verification) regulation may be formulated in the law, bylaws are usually required for operationalization. a. For more information, see the Carbon Pricing Dashboard. b. MRV in this table refers to regulations that transpose the key provisions of Regulation (EU) No. 525/2013 (Monitoring Mechanism Regulation) and Regulation (EU) 2018/1999. c. In addition to developments toward direct carbon pricing at the national level, some developments occur at the entity level. For instance, Bosnia and Herzegovina's state-owned utility Elektroprivreda Bosne i Hercegovine is looking into including carbon costs in their financial reporting. Elektrani na Severna Makedonija, North Macedonia's electricity producer, is looking to incorporate an internal carbon price (based on the EU ETS price) into their investment decisions. ETS = Emissions Trading System; MRV = Monitoring, Reporting and Verifying Regulation; NECP = National Energy and Climate Plan.

Indirect carbon prices, which include policies that send either a positive or negative pricing signal like fossil fuel subsidies (negative pricing) and excises (positive pricing) exist in all WB6.

Recent carbon pricing roadmap proposals by the Energy Community Secretariat indicate the benefits of a coordinated approach. The Energy Community Secretariat prepared an options study in 2021 considering options for decarbonization of power and district heating sectors by 2040. Considering the market size, the level of competition, the maturity of institutions, and the state of the economy overall in the Energy Community contracting parties, the study finds the most economically efficient scenario to be a fully integrated and interconnected power market coupled with a gradually introduced regional carbon market. This would address carbon leakage in the power sector, which would be an issue if countries moved forward alone or in an uncoordinated manner. It would also allow countries (even those with a high share of fossil fuel-based power) to import low-cost and carbon-free resources, invest in renewables, and leverage natural gas as a transition fuel.[45]

Further steps have been put on hold by the ongoing energy crisis. In the current global environment of high energy prices[46] and a cost-of-living crisis,[47] many countries responded

44 For more information, see the Carbon Pricing Dashboard.
45 Kantor, E3M 2021.
46 World Bank, "Global Economic Prospects, January 2023," License: Creative Commons Attribution CC BY 3.0 IGO (World Bank, Washington, DC, 2023) and IMF. 2023. *World Economic Outlook Update*.
47 George Gray Molina, María Montoya-Aguirre, and Eduardo Ortiz-Juarez, "Addressing the Cost of Living Crisis in Vulnerable Countries: Poverty and Vulnerability Projections and Policy Responses".

by putting in energy price relief measures, including pausing or lowering fuel excise taxes. The high visibility of the price impact of carbon pricing means that getting the policy design right (including progressive revenue packages) and managing the political economy challenges will be critical to carbon pricing progress in the Western Balkans. The establishment of an Energy Community working group on carbon pricing in December 2022 may help reinvigorate work on common carbon pricing capacity building and infrastructure issues in the interim.

There is broad consensus that carbon pricing will deliver multiple benefits to the WB6 as they are transitioning to greener and more resilient growth. Carbon pricing plays a key role in supporting a green transition and can help manage energy security risks. It unlocks rapid low-cost emissions reductions and generates government revenue that can be deployed for productivity enhancing policy measures or to reduce distortionary taxes. Finally, it reduces their exposure to CBAM and promotes readiness for EU accession.

Box 10.2. Modeling results for impacts of domestic carbon pricing in Serbia.

Sector-level modeling results for Serbia show more targeted impacts on emissions-intensive sectors, and separate policies will be needed to manage these effects. In Serbia, EU-aligned carbon pricing[a] would trigger a structural shift away from emissions-intensive sectors in terms of GDP and employment. This would be particularly focused on the ferrous metals (-0.69 percent in GDP and -0.12 percent in employment), chemicals (-0.71 percent in GDP and -0.07 percent in employment), power supply (-0.33 percent in GDP and -0.11 percent in employment), and coal (-0.20 percent in GDP and -0.25 percent in employment) sectors, which would see declines by 2035 compared to business as usual. The decline in the emissions-intensive sectors projected in Serbia is counterbalanced by the increase in output and employment in greener sectors, such as market services (+0.79 percent and +0.46 percent), and consumer goods (+0.27 percent and +0.15 percent). A carbon price might nevertheless create significant distributional and political economy issues, and separate strategies are needed to manage the structural adjustment of the economy.[b]

Importantly, modeling results for Serbia also show positive macroeconomic effects in the long-run for an "EU accession"[c] scenario comprising of EU ETS aligned carbon pricing and excise duties, coal subsidy phase out and revenue invested into productivity-enhancing R&D. After an initial decline in GDP of 0.4 percent in the years after implementation, Serbia's economy could benefit from this fully EU-aligned carbon pricing package increasing GDP by 0.1 percent compared to BAU. More work would be needed to assess the optimal revenue use package.

a. It is unlikely that Serbia or other WB6 countries would immediately adopt a carbon price as high as EU levels. As such, carbon pricing's sectoral and macroeconomic impacts would not be as targeted as these initial results. Energy Community's modeling results, for instance, assume a price of between 4-26 EUR for the WB6 countries in 2025, gradually rising to EUR80 in 2040.
b. World Bank 2022c.
c. Results do not include other benefits of EU accession beyond carbon price alignment.

Modeling work in Kosovo, North Macedonia, and Serbia shows that a carbon price can drive significant emissions reductions with positive or only minor negative impact on growth, depending on revenue use. Table 10.5 outlines results of recent studies on carbon pricing done in the WB6, showing significant potential for GHG emissions reductions.

Revising fuel excises to better reflect carbon content of fuels in line with the Revised EU Energy Tax Directive can be a first step toward a stronger carbon pricing signal. All WB6 countries impose excise taxes, a form of indirect carbon pricing, on oil products and natural gas, among other fuels. These rates differ by jurisdiction, fuel, and partly also by end-use sector, and do not necessarily reflect the relative environmental damage of these. Excise taxes have also seen temporary downwards adjustments in WB6 countries in the last year in attempts to curb rising fuel prices. While considerations of short-term inflation and affordability of energy need to be accounted for, better reflecting the environmental cost of fuels by, for example, aligning rates with the

Table 10.5. Overview of carbon pricing modeling results in WB6.

Country	Carbon pricing impact on GDP	Estimated total annual CP revenues	GHG emissions
Albania	0.06% to 0.09% [3]	EUR 0M to EUR 6.5M [3]	
Bosnia and Herzegovina	0.04% to 0.05% [3]	EUR 150M to EUR 260M [3]	
Kosovo	-0.14% to 0.05% [3] -0.55% to -1.7% [4]	EUR 100M to EUR 210M [3]	-25% [4]
Montenegro	0.40% to 0.55% [3]	EUR 0M to EUR 55M [3]	
North Macedonia	0.13% to 0.15% [3]	EUR 115M [2] EUR 20M to EUR 95M [3]	-13% [2]
Serbia	-0.28 to 0.12% [1] 0.3% to 0.42% [3]	EUR 916M/ 0.9% of GDP [1] EUR 270M to EUR 1,080M [3]	-40% [1]

Sources: [1] World Bank (2022c) *Supporting Serbia's Transition to Greener and More Resilient Growth*. GEM-E3-SRB CGE results for 2035, at EUR 110/tCO2. [2] World Bank (2020) *Environmental Tax Reform in North Macedonia*. CPAT modeling of carbon price on fuels, EUR 20/tCO2 in 2030. [3] Kantor E3M (2021) *A carbon pricing design for the Energy Community*. PRIMES-IEM results, EUR 53/tCO2e in 2035. Power market coverage only. [4] World Bank (2021a) "Environmental Tax Reform in Kosovo: Policy Note." MFMod results, EUR 53/tCO2e in 2035.

Note that studies on carbon pricing impacts have only limited comparability due to a number of factors that impact results, including model choice, time horizon of the analysis, assumptions on price level and revenue use, and productivity growth. CP = carbon price; CPAT = *Climate Policy Assessment Tool*; MFMod = World Bank's macroeconomic and fiscal model; PRIMES-IEM = price-induced market equilibrium system-internal energy market; M=million.

Table 10.6. Fuel excise rates in WB6 and EU guidance.

	EU Energy Tax Directive (ETD) 2003	EU proposal for revised ETD[a]	Albania	Bosnia and Herzegovina	Kosovo	Montenegro	North Macedonia	Serbia
Gasoline	10.50	10.75	15.03	11.14	10.53	13.45	11.70	10.79
Diesel	8.68	10.75	13.53	9.34	9.47	9.21	6.53	6.63
LPG	2.55	7.17	1.31	4.14	3.06	2.53	1.59	2.57
Kerosene	7.33	10.75	3.56	3.38	3.33	3.47	3.91	2.80
Natural Gas	3.95	7.17	0.00	0.00	0.00	0.00	0.00	0.00

Source: Energy Community (Kantor, E3M), A carbon pricing design for the Energy Community Final Report (2021) and Revised EU ETD Proposal of 2021.
Note: For comparison, all values are stated in EUR/gigajoule (GJ). Excises in all countries are levied by liter, kilogram, or cubic meter (m3) of fuel. Conversion factors used: gasoline – 0.34GJ/liter, diesel – 0.38GJ/liter, LPG – 0.49GJ/kg, kerosene – 0.45GJ/liter, natural gas – 0.38GJ/m3. Red indicates excise level below revised EU ETD level. Data as of 2021, therefore does not reflect temporary excise rate reductions implemented by Serbia and others in 2022 and 2023.
a. Values presented for proposed revised EU ETD are suggested starting values for 2023, ahead of a 10-year transition period. The proposal also outlines different minimum tax rates for different uses of fuels. Minimum rates for non-motor fuels are at a lower rate, for instance.

proposal for a revised EU Energy Tax Directive (ETD), would improve incentives to reduce fuel consumption, complementing carbon and other environmental pricing. It would also move the WB6 toward further EU alignment. Table 10.6 shows the largest gaps between current excise rates and proposed excise rates in the Revised EU ETD exist for natural gas, kerosene, and liquified petroleum gas.

Region-specific challenges to carbon pricing implementation include the characteristics of domestic energy and power markets, as well as the implications of regional trade

Carbon pricing can increase the cost of emissions intensive generation, encouraging a transition away from coal, but additional policies are needed to incentivize the adoption of renewables in the region. While a carbon price can send a financial signal, it is only effective if those low-carbon substitutes are available and affordable. Furthermore, without the necessary conditions for cost pass through and economic dispatch, a carbon price is likely to have more limited effects without additional policies to encourage lower emission power options. In the region, artificially low electricity prices (below production costs) deter private investment in electricity generation capacity and maintenance.[48] The largely monopolistic markets in the region (with the largest supplier ranging from 37 percent of market share in Albania to 100 percent in Kosovo) also makes it hard to create a level playing field for renewables by deterring new entrants and limiting competition across suppliers.[49] Especially the wind and solar technologies could benefit from improved market conditions, with these technologies accounting for three percent of total energy supply in the region.[50] While a full discussion of the barriers and solutions to boosting renewables in the region is beyond the scope of this paper, OECD (2022) offers a more comprehensive analysis.[51]

With high energy poverty levels in the WB6 countries,[52] it is important to assess how the carbon price would affect vulnerable people on a country-by-country basis. Energy Community modeling shows a significant increase in retail electricity prices following the adoption of a carbon price, though a gradual implementation and electricity market integration can help manage the upward pressure on prices.[53] However, distributional impact assessments, including different revenue spending choices, are needed to gain insight into how each WB6 country will be affected. Similarly, coal-phase out may be accelerated by carbon pricing, impacting vulnerable communities. Some work has begun, for instance through the Initiative for Coal Regions in Transition in the Western Balkans and Ukraine, to support employment and social challenges from transitioning away from coal—a sector that has been the long been the main employment option in the region.[54] WB6 countries can leverage international funding,

48 OECD. 2022.
49 Ibid.
50 OECD (2022).
51 See section 14.3 and the conclusion, which calls for a holistic vision for sustainable development of the energy sector, including reforming subsidies, addressing energy poverty and clarity on coal phaseout dates.
52 Energy Community 2022.
53 Energy Community 2022.
54 EE Bankwatch Network (2020). Four principles for a participatory just transition in the Western Balkans and Ukraine, CEE Bankwatch Network, Prague, https://bankwatch.org/wp-content/uploads/2020/12/position-JT-WB-UA.pdf.

like the EU Economic and Investment Plan for the Western Balkans and Western Balkans Guarantee Facility to help support such initiatives.

For carbon pricing to be an effective tool to help manage the transition to a greener and more resilient growth, phaseout of counteracting pricing instruments, including a refocusing of fossil fuel subsidies and electricity tariffs, is needed. As part of this, different types of carbon revenue use need to be assessed, and additional policies to support consumers need to be designed. Given the tendency for some industries to cluster in certain regions, like the coal and ferrous metals industries in Serbia, this also becomes an issue of community—and not just sectoral—transition. Support policies for a Just Transition, such as the "Initiative for coal regions in transition in the Western Balkans and Ukraine,"[55] alongside other national and local policies, will be needed to prepare for a greener shift.

Significant progress has been made toward improving connectivity among Western Balkans partners (including through the Trans-Balkan Corridor), however a regional energy market is yet to be accomplished and could have implications for carbon pricing effectiveness. Beyond the benefit of the CBAM exemption when also linking to the EU power market, modeling done by the Energy Community,[56] mentioned earlier, shows that the effectiveness of a regional carbon pricing system is heavily contingent on how power and gas markets are set up. With a fully integrated energy market in the WB6, countries can better access cheaper and greener energy alternatives, balance resources, and better diversify their power mix. Integration would also allow for a gas supply across the region (and building up a currently nonexistent gas infrastructure), letting it serve as a bridge fuel as renewable energy capacity is built up.[57] A larger market would also partly mitigate the market dominance of fossil fuel-based entities in the respective domestic markets, encouraging a diversity of supply and the phaseout of old, inefficient, polluting power plants. However, a more integrated market would also exacerbate leakage if a few countries adopted carbon pricing on their own. A more coordinated carbon pricing approach across the region can help address carbon leakage concerns.

While the EU is the most important export market for the WB6 in the CBAM sectors, there is also significant trade within the WB6, leading to potential mismatches of preferences with respect to timing and scope of carbon price introduction. If a regional carbon pricing scheme for the power sector was implemented, Bosnia and Herzegovina would be most disadvantaged as it is the largest regional exporter of electricity and would be at risk of losing export demand to a lower-carbon-producing neighbor if it were to introduce domestic carbon pricing or join a regional scheme. On iron and steel, while Serbia is a larger global exporter of iron and steel than its neighbors, Serbia's exports within the WB6 are not significantly larger than those of Albania, Bosnia and Herzegovina, or North Macedonia. Fertilizers show the lowest regional trade levels among sectors analyzed, so neither domestic

55 https://energy.ec.europa.eu/topics/oil-gas-and-coal/coal-regions-western-balkans-and-ukraine/initiative-coal-regions-transition-western-balkans-and-ukraine_en.
56 https://www.energy-community.org/dam/jcr:82a4fc8b-c0b7-44e8-b699-0fd06ca9c74d/Kantor_carbon_012021.pdf.
57 Kantor, E3M 2021.

nor regional pricing approaches are expected to shift the WB6 trade balances. In relative terms, Albania has the largest relative intra-WB6 trade exposure of the EU CBAM-covered product groups, with nearly 4 percent of its exports being CBAM-covered product groups sent to other WB6s. It therefore has the strongest incentive not to move ahead with pricing these products unless the destination countries are also placing a price on competing products.

Lastly, introducing carbon pricing in a high-inflation environment intensifies some of the above-mentioned challenges. There is strong consensus that carbon pricing needs to be implemented along side tailored policy packages, including policies providing positive incentives—even more so in the current context.

Policy options for accelerated progress on carbon pricing

The WB6 countries are moving forward with carbon pricing as part of their EU accession strategies and broader energy reforms. As part of the WB6's work in aligning their energy markets regulation and structures with the EU, including a refocusing of fossil fuel subsidies and market integration, carbon pricing can play a supportive role by sending a market signal favoring low-carbon technologies and choices. Progress on carbon pricing supports greener and more resilient growth while also improving alignment with the EU. Continuing to build carbon pricing capacity, assessing phase-in options, and developing actionable roadmaps all lay the foundation for a robust domestic carbon pricing policy.

Similar carbon prices and coordinated timelines across the region can help address carbon leakage most effectively. Comparable and coordinated carbon prices or a linked regional market would reflect the interconnected nature of the electricity grid, improve ease of access for regionally active firms, and address leakage concerns. This reflects Energy Community analysis that shows carbon pricing would result in greater emissions reductions and impose lower costs in an integrated WB6 electricity market compared to a fragmented market.[58] A linked market could also help address liquidity challenges if countries were to adopt an ETS, as it would open the system to more market actors. Generally, an ETS offers very restricted benefits for smaller economies like the WB6 countries in absence of regional linking. Montenegro, for instance, is already operating an ETS but has struggled with price discovery and liquidity, as the market covers only three entities (and currently only one entity, given lower production levels for the other two entities).

Regional collaboration on carbon pricing through the Energy Community can help the WB6 move more quickly toward carbon pricing and deliver efficiency gains. Given their existing role in coordinating broader energy and climate reforms undertaken by the region, the Energy Community can support carbon pricing work in a manner that complements these reforms. Equally, strengthening institutional capacity jointly can help build knowledge and may encourage more effective enforcement of these policies once implemented.

58 Kantor, E3M 2021.

Regional collaboration can take many forms. Countries might share selected building blocks of pricing mechanisms including on institutional infrastructure and MRV as well as on market operation and flexibility mechanisms in the case of emissions trading schemes. Countries also may opt for looser collaboration, in the form of pooling resources; exchanging lessons on common challenges and issues or sending an aligned political signal on carbon pricing. Several examples of carbon pricing collaboration exist that the WB6 countries can draw from. The Regional Greenhouse Gas Initiative, for instance, developed common program standards, templates, and regional tools that participating states could leverage, while the Carbon Pricing in the Americas group promotes carbon pricing in the region and collaborates on MRV issues.

Immediate priorities in all countries could focus on improving MRV, assessing potential coverage, and building capacity. In the short term, work could focus on improving MRV, in accordance with the timelines set out by the Energy Community to transpose the EU ETS legislation and build capacity to operate and improve these systems. Similarly, an assessment of carbon pricing readiness could be undertaken to determine gaps and target international assistance accordingly. Several publicly available reports[59] and tools[60] can help countries make this assessment.

Similarly, aligning excise rates with the revised EU Energy Tax Directive (ETD) while refocusing fossil fuel subsidies can support a green transition in line with the EU. Excises are well below EU levels on most fuels across the WB6, and adjusting excise levels to match the proposed revisions to the EU ETD would send strong signals to the economy without increasing capacity needs. Refocusing fossil fuel subsidies, specifically for lignite, would also free up government revenue while reducing asset lock-in. Targeting subsidies to support consumers, especially low-income households, will help vulnerable consumers manage any changes in basic commodity prices whilst phasing out producer subsidies will help encourage a transition away from a fossil-fuel based economy.

Engaging and supporting WB6 businesses in greening their processes and products will help them minimize CBAM impacts as it is gradually phased in. Policy makers can send clear and early signals on planned carbon pricing developments to businesses to take measures now to start reducing emissions and emissions intensity. Until now, few WB6 businesses have reported taking steps to reduce their environmental impact.[61] Proactive engagement with businesses about transition opportunities and leveraging EU funding, for instance, through the EU Just Transition Fund for the Western Balkans or the EUR9 billion Economic and Investment Plan for the Western Balkans, among others, may help get private sector buy in. WB6 firms should also seek EU funds for research, development, and innovation in green and digital technology, due to home country fiscal constraints and a limited ability to attract private investment.

The CBAM incentivizes regional efforts for completing electricity market integration and coupling with the European electricity

59 https://pmiclimate.org/publication/carbon-pricing-assessment-and-decision-making-guide-adopting-carbon-price.
60 https://olc1.worldbank.org/content/mitigation-action-assessment-protocol-maap-tool.
61 Also see World Bank (2022a).

market.[62] WB6 transmission networks are strongly interconnected and removing barriers to leverage these connections can be a next step. In addition, most WB6 countries are working on activities to fulfil the preconditions for market coupling.[63] Further work on market coupling would be in line with WB6 Energy Community obligations and allow the WB6 to leverage the CBAM exemption for electricity markets.[64] For instance, the CBAM electricity market exemption requirements outline the need for an agreement with the EU to apply relevant EU energy laws and transpose them into national legislation, mirroring Energy Community commitments. Requirements to commit to 2050 climate neutrality and to implement a long-term low GHG emissions development strategy are also akin to the work WB6 countries are pursuing with the EU and Energy Community. If and when WB6 countries implement domestic carbon pricing, electricity market integration would also allow them to better leverage renewable energy resources in the region and lower the cost of compliance.

62 Rozeta 2022.
63 Kantor, E3M 2021.
64 Article 2 paragraph 7 in draft the CBAM proposal, December 2022.

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Country Notes

Albania

- During 2022, Albania's economy continued to rebound strongly, despite rising food and energy prices.
- High food and energy inflation have prompted additional government support to households and firms. Rising inflation expectations have also triggered a faster monetary policy tightening.
- In the context of tighter global financial conditions, an ongoing economic slowdown in Europe, and the withdrawal of energy crisis policy support, growth prospects hinge on the global recovery, the pace of the reform agenda, and the fiscal consolidation plans.

Recent Economic Developments

During 2022, the economy continued to rebound strongly, despite rising food and energy prices. Albania's economy expanded by an average 4.84 percent in 2022 with growth being broadbased. Private consumption drove growth expanding by 7.2 percent in real terms, despite increasing energy and food prices. Gross fixed capital formation, also continued to grow strongly 6.53 percent after expanding by 19.2 percent a year earlier. In contrast the contribution of net external demand subtracted to growth as the trade deficit expanded by 29 percent in real terms.

On the supply side, trade and construction led growth in 2022. Russia's invasion of Ukraine, however, disrupted the pace of growth as supply shocks were reflected in higher cost pressures and increased uncertainty, in particular in sectors such as agriculture and manufacturing. Lower hydroelectric production, due to unfavorable weather conditions, increased the need for energy imports and contributed negatively to growth. Services, however, were less affected and continued to expand by 5.9 percent 2022, supported by strong consumer demand and an exceptional tourism season. Tourist arrivals increased by 27.5 percent and nights of stay by 20 percent in 2022.

Consequently, improvements in labor market conditions were broad-based in 2022. Annual employment growth accelerated to an average of 4.0 percent in 2022. Job creation was broad-based, while the number of vacancies increased, thus putting upward pressure on wages, in particular among more skilled employees. Unemployment fell to 11.0 percent in 2022, while labor force participation increased. However, employment growth started to slow from August 2022 for businesses operating in industry and services. Wages also reflected the improved labor demand and increased by 10.8 percent in Q4 2022, continuing the trend from earlier in the year.

Following Russia's invasion of Ukraine, inflationary pressures intensified. Average inflation for 2022 is estimated at 6.7 percent, driven by food and transport prices. Such increases are adversely impacting the poorest citizens, given the higher weights these items have in their consumption basket. Nonetheless, inflation in Albania remains lower than in its peers, for several reasons.

First, the availability of hydropower, though not able to meet up to 85 percent of the domestic energy demand, as it would in a year with average precipitation, has, nonetheless, provided some insulation

from the ongoing energy crisis. Second, the exchange rate against the euro continued to appreciate (by 4.9 percent in December), thus restraining the transmission of imported inflation into the domestic economy. Third, increases in energy prices were contained for the majority of businesses and households ("regulated" customers, that is, medium- and low-voltage consumers). Finally, temporarily controlled prices were imposed for transport fuels and key food items. Persistent supply-side shocks created second-round effects. Inflation has become more broad-based, while components, which tend to be more volatile, have been more stable. This is reflected by the fact that since August 2022, core inflation—that is, inflation subtracting food and energy components – has been slightly higher than the average CPI. In November 2022, core inflation stood at 8.3 percent against its long-term average of 0.8 percent during 2015–21. Inflation expectations also started to reflect these trends.

The increase in inflation expectations prompted faster monetary policy normalization. The central bank, the Bank of Albania (BoA), raised its key policy rate again by 50 basis points to 2.75 percent in November, the fifth hike in 2022. Despite the faster tightening, monetary conditions are still accommodative, as real policy rates remain negative, reflecting rising inflation and inflation expectations. With monetary policy normalization and further expectations of monetary policy tightening, domestic yields on government securities have started to increase, and auctions, particularly in the longer-duration segment, were for a short time, undersubscribed. Auctions started to normalize toward October 2022.

Credit to the private sector continued its strong positive trend from 2021 for both enterprises and households. Despite increasing interest rates, outstanding credit to the private sector increased by 7 percent in 2022. Higher production costs for businesses translated into stronger demand for working capital. Nonperforming loans stood at 5.0 percent in December 2022, reflecting sound asset quality but also the strong pickup in credit growth over the past three years. For the same period, total deposits grew by 4.6 percent. Growth of foreign currency deposits reflected higher tourism export inflows and sustained remittances inflows during year 2022. While the banking system's capital adequacy ratio is above regulatory requirements, the banking system remains susceptible to credit, exchange rate, and interest rate risks, reflecting large unhedged foreign exchange (FX) loans (one-quarter of total loans), prevalence of bank loans with variable interest rates, and large holdings of government bonds.

Albania's current account deficit declined to 6 percent of GDP, despite increasing import prices, mostly thanks to the exceptional growth in tourism exports. Merchandise exports (especially minerals, metals, construction materials, energy, and crude oil) also recorded high growth of 48.6 percent, largely explained by increased international prices. Imports grew by 23.1 percent, largely driven by the increase in imports of goods, minerals, energy, refined fuels, and food, also driven by the terms-of-trade shock. Despite sluggish growth in hosting countries, Albanian migrants' remittances increased by 9.8 percent. Direct investment inflows increased by 34.8 percent and experienced a double-digit increase in real estate, extractive industries, energy, the financial and insurance sectors, and manufacturing. The FX reserve stock remained robust at EUR 5 billion (or 6.9 months of imports) at end-November 2022.

Strong revenue performance in 2021 and 2022 helped mitigate the fiscal impact of the Government of Albania's response to shocks and reduce the fiscal deficits. In 2022, the fiscal position strengthened further on account of robust revenue and restrained spending in times of high uncertainty. To provide temporary and targeted support to the most vulnerable during the crisis, the government revised the budget four times in 2022, in March, July, and twice in December, compensating with lower capital spending. The support to households and firms amounted to 0.6 percent of GDP, while additional subsidies were provided for energy purchases to the electricity state-owned enterprises (SOEs) amounting to 1 percent of GDP. The additional spending was entirely financed through spending reallocation and the strong revenue performance on the back of tax administration efforts, higher prices, and continued economic growth.

Outlook and Risks

Growth is expected to remain subdued for 2023, in the context of tighter global financial conditions, an expected economic slowdown in Europe, and the withdrawal of policy support related to post-earthquake reconstruction. Real exports, consumption, and investment are expected to grow at rates below those in the pre-pandemic period. Real imports are expected to grow by 3.4 percent in 2023, given the outlook of lower import-intensive sectors such as manufacturing. On the supply side, services are expected to continue leading growth, aided by construction, as indicated by expanding building permits issued for new building toward the end of 2022. Industry and, to a lesser extent, agriculture, are likely to continue to be affected by increased production costs. Under a baseline of improving growth prospects in the EU and a gradual normalization of prices in the global market, from 2024 onward, growth is expected to be broad-based.

Inflation is expected to gradually start receding in 2023 and to return to the BoA's target of 3 percent by mid-2024. However, prolonged geopolitical tensions could further increase inflation, disrupt supply chains, and disturb financial markets. In response to increasing domestic inflationary pressures and rising inflation expectations, in the context of a normalization of monetary policy in advanced economies, the central bank is expected to further tighten its monetary policy. All of these could further dim Albania's growth prospects.

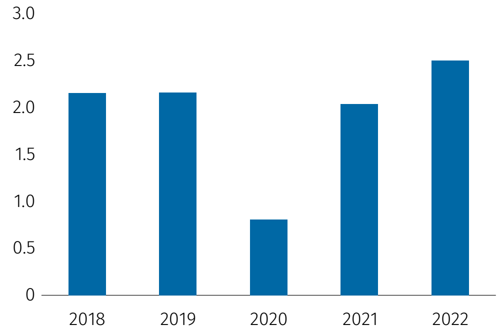
The fiscal consolidation plan targets a positive primary balance from 2023. Fiscal consolidation will be largely based on the spending side. The government projects continuing to limit the growth of public wages, goods and services spending, and current transfers to local governments and SOEs. This will also be enabled by ongoing reforms in key sectors, such as energy and public water utilities. On the revenue side, the government plans to introduce a number of tax policy measures to boost revenue, as envisioned in the draft Medium-Term Revenue Strategy (MTRS) including a new personal income tax regime for self-employed professionals, and a one-off solidarity tax on extra profits of independent power producers. Tax compliance is projected to gradually improve, through the reduction of the VAT compliance gap, cash economy, undeclared work, underreporting, artificial tax avoidance arrangements, and through improvement of customs administration by expanding information-sharing arrangements. The adoption of a sound MTRS could make a more ambitious, revenue-based consolidation possible.

Regarding the external account, services exports, including tourism and fast-expanding business-process operations, should remain strong. The trade deficit is projected to increase to 12.8 percent of GDP in 2023 from 10.4 percent in 2022, and remain in similar levels over the medium term. FDI inflows, including into tourism, energy, and manufacturing, are projected to finance most of the current account deficit over the projection period.

Unlocking further growth is conditional on the swift implementation of the government's program of reforms. Reforms, anchored in the prospect of EU accession, are expected to boost productivity growth, including through improving the business environment, streamlining government interactions with the private sector, and expanding Albania's integration into foreign markets.

The tourism sector saw an unprecedent number of arrivals and nights spent.

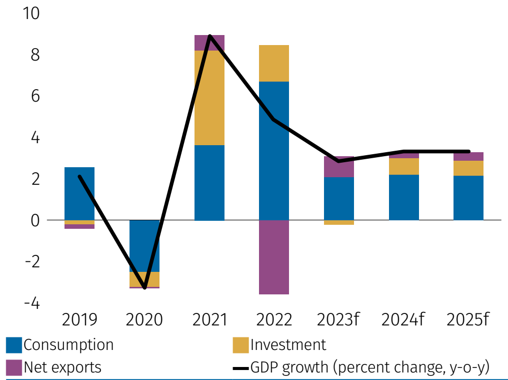
Number of nights spent by nonresident, per year (millions)



Source: INSTAT.

Despite rising energy and food prices, GDP growth is estimated at 4.8 percent in 2022.

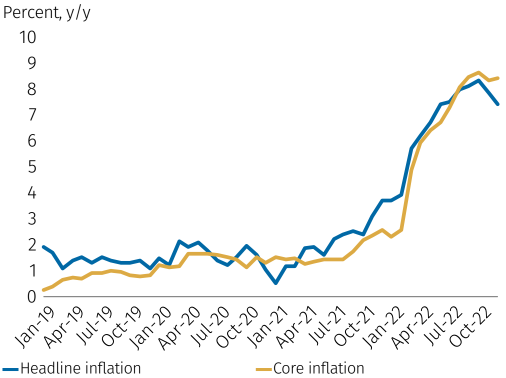
GDP growth and contributions, percent



Sources: INSTAT.

Headline and core inflation have increased significantly.

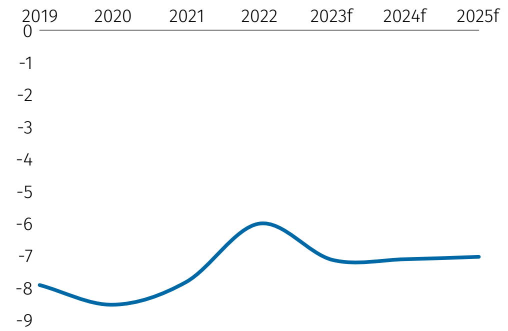
Percent, y/y



Source: INSTAT.

Despite increased imports, the current account balance has improved, supported by export growth.

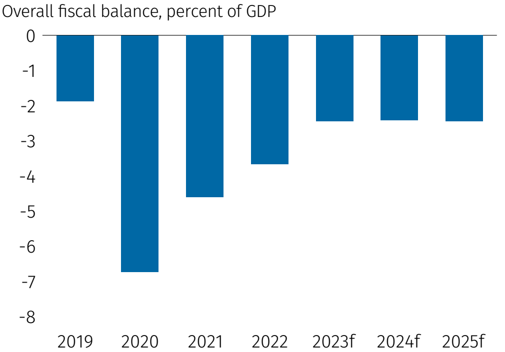
Percent of GDP



Source: Bank of Albania.

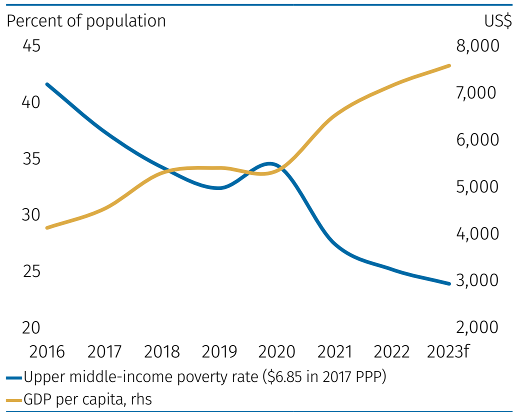
Strong revenue performance helped mitigate the fiscal impact of the Government of Albania's response to shocks.

Overall fiscal balance, percent of GDP



Source: Ministry of Finance.
Note: F = forecast.

Poverty is expected to continue its downward trend in 2022.



Source: Ministry of Finance, World Bank calculations.
Note: PPP = purchasing power parity.

ALBANIA Selected Economic Indicators	2020	2021	2022e	2023f	2024f	2025f
Real GDP growth (percent)	-3.3	8.9	4.8	2.8	3.3	3.3
Composition (percentage points):						
Consumption	-2.5	3.6	6.7	2.1	2.2	2.1
Investment	-0.8	4.6	1.7	-0.2	0.8	0.7
Net exports	0.0	0.7	-3.6	0.9	0.3	0.4
Exports	-9.4	13.0	2.6	1.0	2.0	2.2
Imports (-)	-9.3	12.3	6.2	0.1	1.7	1.8
Consumer price inflation (percent, period average)	2.2	2.6	6.7	4.0	3.5	3.0
Public revenues (percent of GDP)	25.9	27.5	26.8	28.2	27.8	27.8
Public expenditures (percent of GDP)	32.6	32.1	30.5	30.6	30.2	30.2
Of which:						
Wage bill (percent of GDP)	4.7	4.5	4.0	4.3	4.1	4.1
Social benefits (percent of GDP)	13.4	12.3	11.6	11.6	11.2	11.3
Capital expenditures (percent of GDP)	6.2	6.9	6.6	5.4	5.3	5.2
Fiscal balance (percent of GDP)	-6.7	-4.6	-3.7	-2.4	-2.4	-2.4
Primary fiscal balance (percent of GDP)	-4.6	-2.7	-1.8	0.2	0.6	0.4
Public debt (percent of GDP)	73.0	71.5	62.1	60.3	59.4	58.5
Public and publicly guaranteed debt (percent of GDP)	75.8	75.4	65.4	63.6	62.7	61.8
Of which: External (percent of GDP)	35.2	36.8	30.3	30.1	29.6	28.1
Goods exports (percent of GDP)	6.0	8.3	10.8	11.0	11.0	11.0
Goods imports (percent of GDP)	28.4	33.6	34.6	39.2	39.1	38.9
Net services exports (percent of GDP)	8.1	11.7	13.4	15.5	15.1	15.0
Trade balance (percent of GDP)	-14.3	-13.5	-10.4	-12.8	-13.0	-12.9
Net remittance inflows (percent of GDP)	5.1	5.0	5.5	5.5	5.5	5.4
Current account balance (percent of GDP)	-8.5	-7.8	-6.0	-7.1	-7.1	-7.0
Net foreign direct investment inflows (percent of GDP)	6.7	6.5	6.7	6.8	6.8	6.9
External debt (percent of GDP)	60.5	62.7	54.3	51.8	50.0	49.0
Real private credit growth (percent, period average)	4.6	5.5	2.9	–	–	–
Nonperforming loans (percent of gross loans, end of period)	8.1	5.7	5.0	–	–	–
Unemployment rate (percent, period average)	11.7	11.5	11.0	–	–	–
Youth unemployment rate (percent, period average)	20.9	20.9	20.7	–	–	–
Labor force participation rate (percent, period average)	59.5	59.8	62.4	–	–	–
GDP per capita, PPP (current international $)	14,888	16,302	16,782	17,151	17,734	18,515
Poverty rate (percent of population)	34.4	27.5	25.2	23.9	22.0	20.4

Sources: Country authorities, World Bank estimates and projections.
Note: Youth unemployment rate is for labor force aged 15–29. Statistical discrepancy contribution is divided at the ratio of 80 percent and 20 percent between Consumption and Investment respectively. Change in inventories is included in Investments. Poverty rate calculations based on ECAPOV harmonization using SILC-C data. Nowcasted/projected values start at 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

- Despite the external inflationary shock fanned by Russia's invasion of Ukraine, economic activity in Bosnia and Herzegovina grew at 4 percent in 2022 following a strong rebound in 2021.
- Labor market participation and the employment rate remained decreased in 2022, with unemployment at about 15.4 percent.
- The fiscal impact of stronger tax revenues supported by high inflation at 14 percent in 2022 was more than offset by pre-election spending and social measures softening the inflationary impact on households.
- Real output growth is expected to decelerate to 2.5 percent in 2023 due to a slowdown in private consumption and a further deterioration in negative net exports due to projected weak growth in the EU.
- By 2025, real GDP growth is projected to increase, driven largely by a recovery in private consumption supported by remittances, incomes following a tightening labor market, and investment in energy and infrastructure.
- EU candidacy status received in December 2022 could serve as a catalyst for much needed structural reforms, especially with governments formed following October 2022 elections.

Recent Economic Developments

Economic activity in 2022 in Bosnia and Herzegovina exceeded expectations buoyed by a surge in investment and higher private consumption. Real output growth decelerated to 4 percent in 2022, following the strong rebound in 2021 when it reached 7.4 percent. In 2022, growth was driven by two countervailing forces: (i) a robust increase in domestic demand of 6.8 percent owed to private consumption and a surge in public investment; and (ii) an adverse terms of trade shock compounded by investment-driven imports. A boost in investment totaling 18.4 percent (y/y) in real terms, contributed 4.9 percentage points to real output growth. Public investment was largely supported by infrastructure works boosted by elections held in October 2022, whereas foreign direct investment flows decelerated somewhat compared to the previous year. Private consumption added to the robust growth in domestic demand, increasing at a rate of 3.2 percent (y/y), even though real after-tax wages declined marginally by 1.4 percent in 2022, after growing 2.3 percent the year before. The softening in real net wages was offset by higher remittances, which rose 2.7 percent, in real terms, and drawdowns in household deposits, largely foreign currency long-term deposits. Meanwhile, negative net exports widened considerably, as real imports soared 25.5 percent in 2022 from 20.5 percent the year before. At the same time, exports continued to grow, but they did so at a slower pace than in 2021. As a result, the trade deficit in goods and services expanded by 0.3 percent of GDP, after improving only 0.1 percent of GDP in 2021. On the production side, industrial production slowed to 1.7 percent in 2022, compared to a strong rebound totaling 10 percent the year before.

Inflation in 2022 amounted to 14 percent, with a disproportionate impact on the less well-off. This compares to an inflation rate of 2 percent in 2021. The sharp rise was due to soaring food and transport prices that grew 22 percent and 26 percent, respectively, in comparison to the year before, negatively affecting welfare especially among the poor and vulnerable households and creating challenges for poverty reduction. This jump in prices reflected in part the adverse terms of trade shock of a sharp increase in import prices of processed food and oil derivatives, with the latter feeding into higher prices of other products.

The unemployment rate declined owing largely to a reduction in the participation rate. Labor market participation decreased by 0.4 percentage point to 47.6 percent in 2022, entirely reflecting a reduction in female participation to 35.7 percent, according to LFS Q4. While the employment rate remained almost unchanged at 40.2 percent, the unemployment rate declined to 15.4 percent from 17.4 percent in 2021, as more people moved to inactivity.[1] In Q4 unemployment rate reached 14.3 percent. This unemployment rate is a combination of the male unemployment rate totaling 7.2 percent and the female unemployment rate of 7.1 percent.

During 2022, the fiscal impact of stronger tax revenues supported by high inflation was more than offset by higher spending, which is expected to result in a fiscal deficit of 1.0 percent of GDP in 2022.[2] This compares to a deficit of 0.3 percent of GDP in 2021, and 5.2 percent of GDP in 2020. Expenditures in 2022 were driven by social measures softening the inflationary impact on households and pre-election spending, including wage and pension hikes, as well as higher capital expenditures which helped drive GDP growth. Nevertheless, public debt remains sustainable at around 35 percent of GDP.

The current account deficit reached 5.2 percent of GDP in 2022. The expansion of the external deficit was caused by investment-driven import volumes in combination with a deterioration in the terms of trade. Higher import volumes and a relatively larger increase in import than in export prices, exacerbated by Russia's invasion of Ukraine, resulted in an expansion of the merchandise trade deficit to 16.5 percent of GDP in 2022, from 13.2 percent of GDP the previous year. The broadened merchandise trade deficit was in part offset by a higher services trade surplus (9.3 percent of GDP), due to an increase in tourism inflows, and significant inflow of remittances (9.2 percent of GDP). Sizably smaller investment income outflows also helped keep the current account deficit from widening further. Adjusted for capital account inflows of 0.8 percent of GDP, the external financing requirement therefore amounted to 4.4 percent of GDP in 2022. Net FDI inflows totaled 2.9 percent of GDP and were stronger compared to inflows in 2021. They covered more than one-half of the external deficit in 2022. Foreign borrowing by the government and private sector, together with a drawdown on reserves, more than offset net portfolio outflows and helped finance the remainder of the external borrowing requirement.

The banking sector is well-capitalized, and its profitability has further improved in 2022. Asset quality has further improved compared to the previous years and pre-pandemic period, with non-performing loans to total loans declining to 4.9 percent at the end of the third quarter 2022 from 5.5 percent of the same period last year and 7.7 percent in 2019. Capital adequacy, meanwhile, remains

1 The methodology of the Labor Force Survey was changed in 2021, which makes direct comparisons between 2021 and 2020 data difficult.
2 BiH Global Fiscal Framework for 2022-2024 and WB staff estimates.

robust compared to 2021 as the Tier 1 capital ratio is steady at around 18.5 percent. The profitability of the banking sector has improved given the rise in the higher return on equity by 1.4 percentage points to 12.6 percent in Q3 of 2022 compared to the same period last year.

Outlook and Risks

In 2023, real GDP is expected to decelerate to 2.5 percent as private consumption growth continues slowing due to dampening real disposable income, and as negative net exports further deteriorate due to weak growth in the main export markets. Real output growth is set to reach 3.5 percent by 2025 driven largely by private consumption supported by remittances. Investments in energy and transport infrastructure (windmills, highway corridor, etc.) are expected to add to the growth stimulus, although not to the same extent as in 2021 and 2022.

With general elections completed (October 2022), and governments formed in the state and entities' levels, the attention of policy makers is expected to turn to the structural reform agenda needed for EU accession. To start the EU accession negotiations, the authorities need to address 14 largely political measures covering democracy, rule of law and fundamental rights, and public administration. In parallel, Bosnia and Herzegovina needs to meet economic criteria that require progress on internal market and state institutional integration, strengthening of state supervisory and regulatory institutions, and reduction of an oversized public sector. Priority economic reforms include enhancing oversight and management of SOEs, improving the business environment, concluding WTO accession, enhancing employment policies for youth, reducing the cost of labor, and transitioning to green energy from coal.

Inflationary pressures are expected to continue dissipating in 2023. Nevertheless, inflation is projected to remain elevated at around 5 percent in 2023, significantly above pre-pandemic levels. Barring further external shocks, inflation is expected to stabilize in 2024–25 at rates seen prior to the pandemic, at around 2 percent.

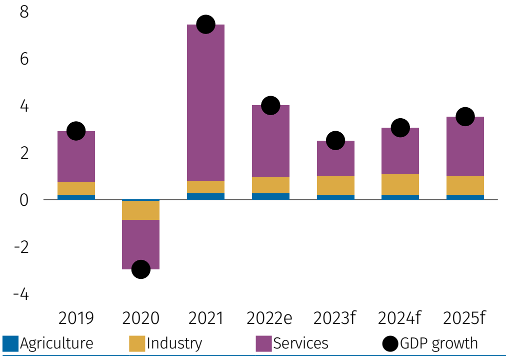
Under the assumption of markets stabilizing, the current account deficit is expected to narrow to 4 percent of GDP by 2025. The reduction in the external deficit is expected to come from gradual improvement of the terms of trade, after the shock in 2022, which will compress the merchandise trade deficit. Contractionary fiscal policy is also expected to improve the external account.

A return to fiscal surpluses is expected by 2025. In 2023, higher interest payments and the pension increase will in part offset phased out pre-election spending and one-off expenditures in response to the price shock. Barring any further shocks, the fiscal surplus is projected to exceed 1 percent of GDP in 2025, with the primary surplus expected to total 2.1 percent of GDP. This will help keep public and publicly guaranteed debt below 35 percent of GDP.

Downside risks dominate the outlook as an end of Russia's invasion of Ukraine is not in sight and global, and particularly European uncertainty, is expected to continue. Protracted effects of the war could have a negative impact on aggregate demand through depressed consumer and business confidence. In addition, war-related uncertainties can dampen the recovery prospects in the EU, negatively impacting foreign investments and demand for Bosnia and Herzegovina's exports, except for energy. Adverse labor market developments across the EU could limit remittances inflows, which support private consumption. Finally, geopolitical spillovers could further aggravate domestic political frictions with adverse consequences for the much-needed structural reform push.

GDP growth slowed in 2022.

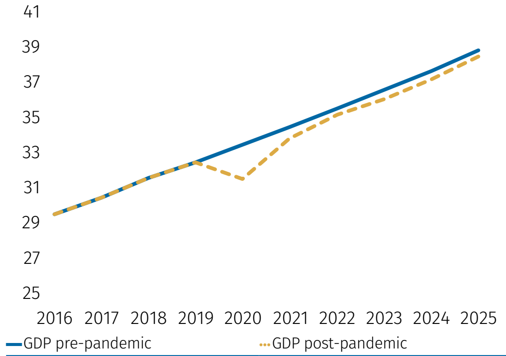
Contributions to growth, percentage points of GDP



Sources: BiH Agency for Statistics; World Bank.
Note: e = estimate; f = forecast.

Post-crisis growth trajectory unlikely to close the gap with pre-crisis growth path.

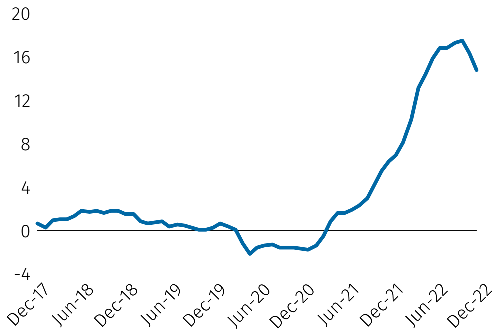
In 2015, thousand KM



Source: World Bank staff estimates.

Consumer price and food inflation surged to double digits in 2022...

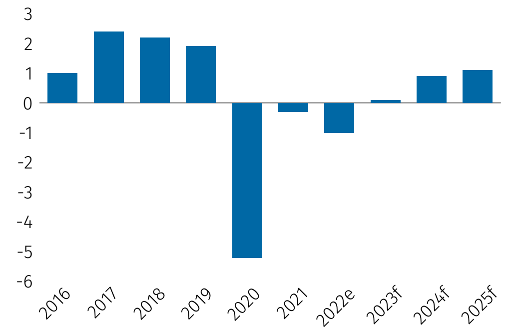
CPI, percent y-o-y



Sources: BiH Agency for Statistics; World Bank.

...while the fiscal deficit widened in 2022, reflecting election year spending.

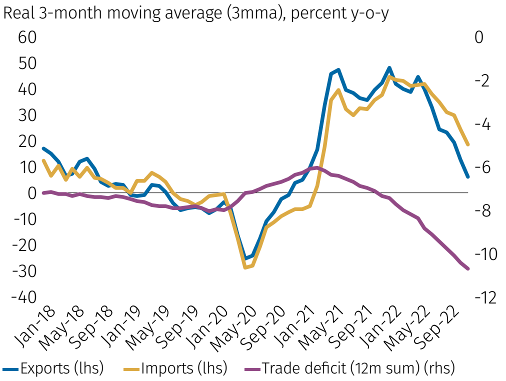
General government fiscal balance, percent of GDP



Sources: BiH fiscal authorities; World Bank staff estimates.

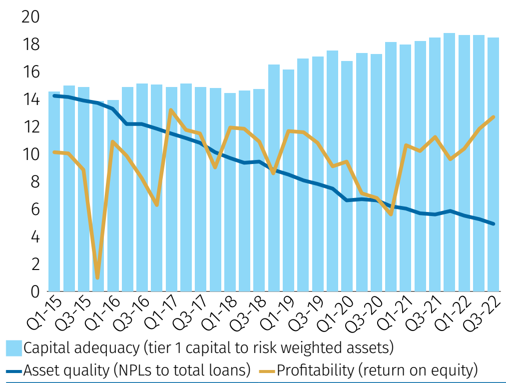
The merchandise trade deficit widened.

Real 3-month moving average (3mma), percent y-o-y



Sources: BiH Indirect Tax Office; World Bank.

Nonperforming loans in commercial bank portfolios decline steadily.



Sources: Central Bank of BiH; World Bank calculations.

BOSNIA AND HERZEGOVINA Selected Economic Indicators	2020	2021	2022e	2023f	2024f	2025f
Real GDP growth (percent)	-3.0	7.4	4.0	2.5	3.0	3.5
Composition (percentage points):						
Consumption	-	-	2.7	1.7	1.8	2.1
Investment	-	-	3.6	0.8	0.7	0.6
Net exports	-	-	-2.3	0.0	0.5	0.8
Exports	-	-	3.5	2.6	2.7	2.8
Imports (-)	-	-	5.8	2.6	2.1	2.0
Consumer price inflation (percent, period average)	-1.1	2.0	14.0	5.0	2.1	1.9
Public revenues (percent of GDP)	41.6	41.1	43.8	45.0	45.3	45.2
Public expenditures (percent of GDP)	46.8	41.3	44.8	44.9	44.4	44.1
Of which:						
Wage bill (percent of GDP)	11.3	10.3	11.4	11.9	11.6	11.3
Social benefits (percent of GDP)	15.9	14.6	19.8	19.9	20.1	20.2
Capital expenditures (percent of GDP)	5.1	3.5	4.3	3.7	3.3	3.3
Fiscal balance (percent of GDP)	-5.2	-0.3	-1.0	0.1	0.9	1.1
Primary fiscal balance (percent of GDP)	-4.5	0.3	-0.2	1.0	1.8	2.1
Public debt (percent of GDP)	36.1	34.0	32.5	32.3	32.3	31.8
Public and publicly guaranteed debt (percent of GDP)	38.8	37.6	33.0	34.0	35.5	33.8
Of which: External (percent of GDP)	30.4	29.5	27.8	27.5	27.3	26.7
Goods exports (percent of GDP)	26.3	36.6	41.3	42.8	43.7	44.8
Goods imports (percent of GDP)	43.8	57.2	67.1	68.4	69.3	70.4
Net services exports (percent of GDP)	4.2	7.4	9.3	10.4	10.3	10.2
Trade balance (percent of GDP)	-13.3	-13.2	-16.5	-15.2	-15.3	-15.4
Net remittance inflows (percent of GDP)	7.0	8.8	9.2	9.0	8.9	8.9
Current account balance (percent of GDP)	-3.3	-2.7	-5.2	-4.1	-3.9	-3.7
Net foreign direct investment inflows (percent of GDP)	1.8	2.6	2.9	2.9	2.9	2.9
External debt (percent of GDP)	69.7	62.4	60.5	60.0	59.1	57.4
Real private credit growth (percent, period average)	1.3	-0.3	-8.1	-	-	-
Nonperforming loans (percent of gross loans, end of period)	6.1	5.8	-	-	-	-
Unemployment rate (percent, period average)	15.9	17.4	15.4	-	-	-
Youth unemployment rate (percent, period average)	36.6	38.2	35.0	-	-	-
Labor force participation rate (percent, period average)	47.7	48.0	47.6	-	-	-
GDP per capita, PPP (current international $)	15,337	17,377	17,898	18,345	18,896	19,557

Sources: Country authorities, World Bank estimates and projections.
Note: e = estimate; f = forecast; — = not available.

Kosovo

- The negative terms-of-trade shock driven by Russia's invasion of Ukraine and the associated energy crisis impacted economic activity in Kosovo during 2022, but the economy showed signs of resilience.
- In 2022, growth moderated to 3.5 percent driven by exports and private consumption—which continues to show resilience despite the erosion of disposable incomes caused by inflation.
- The fiscal position continued to improve, led by sustained positive revenue performance driven by inflation effects and formalization gains, and capital investment underspending.
- Although the outlook remains positive, the balance of risks remains tilted to the downside. Pressures could rise in case of an inflation rebound and weaker-than-expected EU growth. In this context, preserving macroeconomic buffers to respond to the evolving economic environment is key.

Recent Economic Developments

In 2022, GDP growth moderated to 3.5 percent, after reaching a record of almost 11 percent in 2021. The negative terms-of-trade shock driven by Russia's invasion of Ukraine continued to impact economic recovery in 2022. Growth reached 3.5 percent, driven by exports and private consumption. Real GDP growth reached 4.5 percent in Q1, decelerating thereafter as elevated price pressures led to the erosion of disposable incomes and private demand. As a net importer of food and energy, Kosovo remains highly vulnerable to imported inflation. As such, the passthrough of price changes in external markets to domestic inflation is elevated.

During 2022, the rise in energy and food prices caused inflation to peak in July, weighing on private demand throughout the year. Private consumption, increasing by 4 percent in real terms, was the main contributor to growth, supported by positive credit growth, remittances, and crisis-related fiscal support. The investment's negative growth trend continued, amid a contraction in investment activity and low execution of the public investment program. Merchanndise exports grew by 23.6 percent (y/y), driven by electricity and plastic and manfucatured goods exports. Similarly, exports of services growth remained strong, driven by travel, telecommunications, and information services.

Between January and December, nominal imports surged by 22 percent, led primarily by the rise in commodity prices, which more than offset the posive performance of goods and service exports. On the supply side, the economy was marked by a contraction in construction and a slowdown of trade and transport, contributing to softer growth. Yet, sercives continued to remain the key contributor to growth. After contracting consecutively for two years, agriculture added to growth in 2022.

Inflation peaked in July 2022, and price pressures remain elevated. The Harmonized Index of Consumer Prices reached a historic high of 14.2 percent (y/y) in July 2022, and remained above 11 percent until December, bringing annual inflation to 11.6 percent. Key inflation drivers remained transport (16.9 percent) and food (16.3 percent), with a disproportionate impact on the poor and most vulnerable. Core inflation reached its yearly peak at 5.8 percent in June 2022, and has been on a decreasing trend since. In 2022, import prices remained elevated. The annual change of the import price index in 2022 reached 18.7. Data from the agricultural sector show that in 2022, prices of inputs remained elevated, although pressures eased in the second half of the year. The annual price index for goods and services consumed in agriculture in 2022 increased by 31.5 percent compared to 2021.

Labor market formalization continued, although information on labor markets remains limited. According to administrative data on pension contributions, formal employment increased by 4.9 percent compared to 2021. At the same time, in December 2022, registered job seekers decreased by 1.5 percent from December 2021. The latest available data from the Labor Force Survey (LFS) show that in 2021, only a third of the working-age population was employed (31.3 percent). In line with the recovery of 2021, the unemployment rate declined to 20.7 percent, from 25.9 in 2020. LFS data also show that the labor market continues to be characterized by significant gender imbalances in employment (a 45.9 percent employment rate for males and 16.5 percent for females in 2021) and inactivity (78 percent inactivity rate for females and 43.4 for males).

In 2022, the external current account deficit (CAD) deteriorated. The CAD reached 10.1 percent of GDP from 8.2 percent in 2021, driven by higher import prices, which more than offset the significant nominal export growth. The trade balance worsened further, reaching 32.1 percent of GDP. Annual export growth reached close to 30 percent, supported by resilient diaspora-driven travel services and merchandise export growth. In parallel, the value of wider-base imports grew by 22 percent on the back of higher prices for mineral products and food and beverages. Remittance growth eased in 2022 reaching 6 percent (y/y). FDI recorded a significant spike of more than 80 percent, driven primarily by diaspora dominated real estate investment, but also with notable increases in mining and quarrying, financial and insurance activities, and manufacturing. The increase in real estate FDI can be partly attributable to the increase in the prices of construction inputs and real estate prices. Two third of FDI came from non-debt creating flows.

The fiscal position improved in 2022. The combination of positive tax revenue growth and capital underspending compensated for the increases in current transfers associated to crisis-response measures. By end-2022, the fiscal deficit reached 0.5 percent of GDP, reflecting continued positive revenue growth (13.7 percent) supported by inflation effects and gains in value-added tax, corporate income tax, and personal income tax collection. On the expenditure front, the implementation of crisis-response measures led to an increase in expenditures for current transfers by 26.3 percent (y/y). Capital investments remained at 2021 levels, reaching 60 percent of the initial budgeted amount by end-December 2022 and contributing to lower-than-budgeted aggregate fiscal expenditures.

Total public and publicly guaranteed (PPG) debt remains low, and well below Kosovo's debt limit. Kosovo has no access to international capital markets and the average maturity of debt is 5.5 years. In 2022, PPG debt reached 20.7 percent of GDP, down from 21.5 percent of GDP at end-2021. The total stock of PPG debt comprises mostly domestic debt (63.4 percent of total PPG debt, or 12.9 percent of GDP), held predominantly by the Kosovo Pension Savings Trust, commercial banks, and the Central Bank of Kosovo. Diversifying Kosovo's financing sources and extending debt maturities remains a priority for the policy agenda.

Despite the challenging external environment, the financial sector remains robust. In December 2022, the annual increase in loans was 16.1 percent, supporting consumption smoothing and investment activity amid high inflationary pressures. During the same period, deposit growth reached 13.3 percent. The cost of funding as reflected in the interest rate on new loans increased since the start of the year from 5.7 percent to 6.3 percent. In terms of the banking sector, capital buffers and asset quality remain adequate, with the ratio of regulatory capital on risk-weighted assets standing at 14.8 percent and nonperforming loans remaining stable at 1.8 percent in December 2022.

Outlook and Risks

GDP growth is expected to pick up modestly, reaching 3.7 percent in 2023. The contribution of diaspora flows to private consumption and service exports is expected to weaken against the likely slowdown in EU economic growth. Similarly, the contribution of government transfers to private consumption is expected to slow. However, the implementation of the recently adopted Law on Public Wages, as well as continued financial deepening, could contribute to consumption resilience and growth. After experiencing a contraction in real terms in 2022, investments—both public and private—are expected to provide a positive contribution to growth in 2023, on the heels of the recent approval of the legislation on input price adjustments for public contracts and the easing of international price pressures.

Over the medium term, the outlook is positive but remains characterized by high uncertainty. Medium-term growth is expected to converge toward potential but is subject to significant risks. Continued uncertainties related to the war in Ukraine, including on international food and energy prices, entail significant downside risks. A rebound in energy prices could lead to significant fiscal and external sector pressures, negatively impacting growth. A further slowdown in EU growth could lead to an erosion of income of the diaspora, with detrimental impacts on remittances, investment, and diaspora inflows. Timely implementation of the new energy strategy, and an acceleration in public investment execution, also represent upside potential.

Inflation risks remain elevated given Kosovo's high import dependency. While decreasing in line with international trends, consumer price inflation is projected to average 6.0 percent in 2023, and converge toward 2 percent over the medium term. Kosovo's high dependency on imports exposes the country to international prices fluctuations. On the external sector front, despite an expected slowdown in service exports and remittances growth, easing import prices pressures are expected to lead to minor a CAD improvement in 2023.

Over the medium term, the fiscal deficit is set to gradually increase but remain within the fiscal rule limit. In 2023, public wages and capital investment, are expected to increase to lead to an increase of the fiscal deficit to

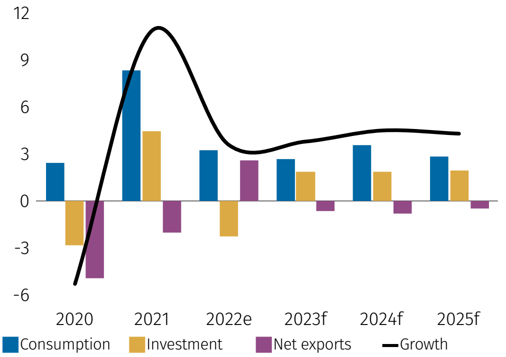
1.1 percent of GDP. Further spending needs for energy subsidies could increase the deficit beyond what is expected. Over the medium term, public debt is projected to remain below 25 percent of GDP given historic bottlenecks to implementing IFI-financed capital projects, remaining below the 40 percent legal debt ceiling.

Financial sector deepening is expected to continue, contributing positively to growth. Over the medium term, credit growth is expected to remain positive, although tighter financing conditions in Europe and international markets could lead to an increase in financing costs. This could increase the vulnerability of highly exposed sectors such as construction, and add pressure to bank balance sheets.

With the outlook characterized by high uncertainty, there is a pressing need to preserve fiscal buffers. This in turns requires that crisis mitigation measures (in particular transfers) remain targeted and time-bound. At the same time, the implementation of structural reforms in energy, education, social protection, and healthcare remains critical to enhance inclusive and sustainable growth.

Growth in 2022 moderated but remained resilient.

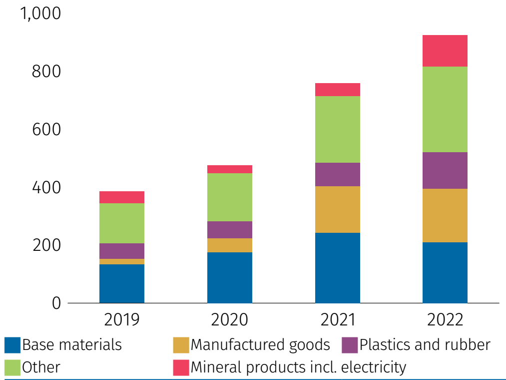
Contributions to growth, percentage points



Sources: Kosovo Statistics Agency; World Bank staff calculations.

Merchandise exports continued to increase.

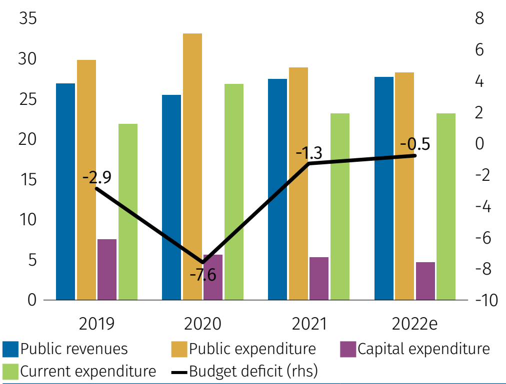
Exports by economic category, in mil. Euros



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

The fiscal deficit narrowed significantly in 2022.

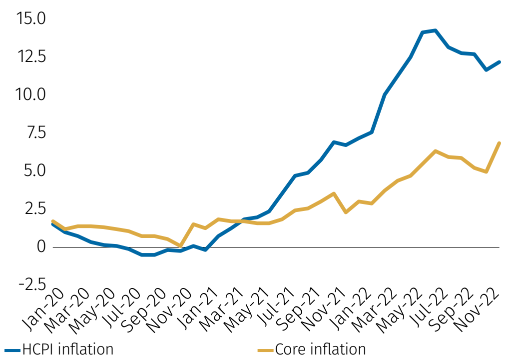
Percent of GDP



Sources: Ministry of Finance; World Bank staff calculations.

Inflationary pressures increased in 2022.

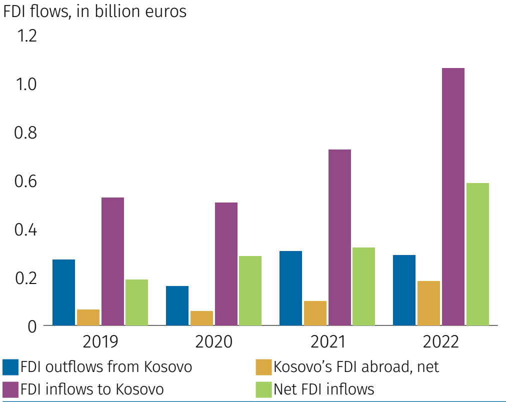
2015=100



Source: Kosovo Statistics Agency and Central Bank of Kosovo.

FDI inflows reached a record high in 2022.

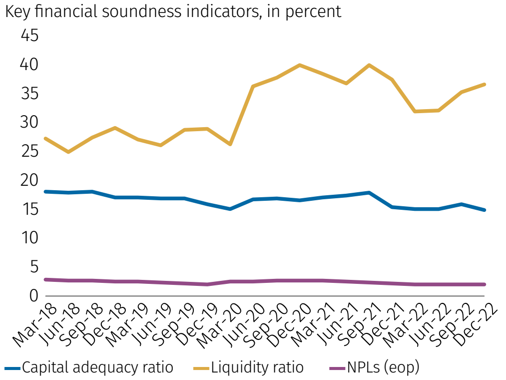
FDI flows, in billion euros



Source: Central Bank of Kosovo.

The financial sector remained stable.

Key financial soundness indicators, in percent



Source: Central Bank of Kosovo.
Note: eop = end-of-period; NPLs = nonperforming loans.

KOSOVO Selected Economic Indicators	2020	2021	2022e	2023f	2024f	2025f
Real GDP growth (percent)	-5.3	10.7	3.5	3.7	4.4	4.2
Composition (percentage points):						
Consumption	2.4	8.2	3.2	2.6	3.5	2.8
Investment	-2.8	4.4	-2.3	1.8	1.8	1.9
Net exports	-4.9	-1.9	2.6	-0.7	-0.8	-0.5
Exports	-8.5	16.7	5.7	1.2	1.3	1.4
Imports (-)	-3.6	18.7	3.2	1.9	2.1	1.9
Consumer price inflation (percent, period average)	0.2	3.4	11.6	6.0	3.3	2.5
Public revenues (percent of GDP)	25.4	27.4	27.6	27.9	26.7	26.9
Public expenditures (percent of GDP)	33.0	28.8	28.2	29.0	29.0	29.8
Of which:						
Wage bill (percent of GDP)	9.8	8.4	7.3	7.8	7.8	7.9
Social benefits (percent of GDP)	7.7	7.3	7.1	6.2	6.4	6.9
Capital expenditures (percent of GDP)	5.6	5.3	4.7	5.7	6.3	6.8
Fiscal balance (percent of GDP)	-7.6	-1.3	-0.5	-1.1	-2.3	-2.9
Primary fiscal balance (percent of GDP)	-7.2	-0.9	-0.1	-0.7	-1.9	-2.5
Public debt (percent of GDP)	22.0	21.2	19.5	19.7	20.5	22.0
Public and publicly guaranteed debt (percent of GDP)	22.4	21.6	19.8	20.7	20.8	22.3
Of which: External (percent of GDP)	7.8	7.3	7.1	7.2	7.9	9.1
Goods exports (percent of GDP)	6.6	8.9	10.4	11.1	11.9	12.9
Goods imports (percent of GDP)	51.0	51.2	58.0	62.6	66.3	70.3
Net services exports (percent of GDP)	5.5	12.3	15.5	16.9	17.8	19.4
Trade balance (percent of GDP)	-38.9	-30.0	-32.1	-34.6	-36.6	-38.1
Net remittance inflows (percent of GDP)	13.7	13.7	12.7	12.2	12.2	11.7
Current account balance (percent of GDP)	-6.6	-8.2	-10.1	-9.9	-9.7	-9.2
Net foreign direct investment inflows (percent of GDP)	4.0	3.8	6.6	5.7	5.5	5.5
External debt (percent of GDP)	37.2	37.4	37.3	36.7	37.0	37.6
Real private credit growth (percent, period average)	7.6	7.5	5.2	–	–	–
Nonperforming loans (percent of gross loans, end of period)	2.5	2.3	2.0	–	–	–
Unemployment rate (percent, period average)	25.9	20.7	–	–	–	–
Youth unemployment rate (percent, period average)	49.4	38.0	–	–	–	–
Labor force participation rate (percent, period average)	38.3	39.3	–	–	–	–
GDP per capita (US$)	4,314	5,267	5,760	6,327	6,854	7,327
Poverty rate (percent of population)	32.4	27.0	25.3	23.6	22.2	20.3

Sources: Country authorities; World Bank staff estimates and projections.
Note: Poverty rate calculations based on ECAPOV harmonization using Household Budget Survey (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$6.85/day per person in revised 2017 PPP. e= estimate; f = forecast; PPP = purchasing power parity. – = not available.

Montenegro

- While growth was strong in 2022, driven by private consumption, it decelerated in the second half of the year.
- The adverse impact of surging inflation was largely mitigated by an increase in real income.
- The fiscal deficit widened to 5.2 percent in 2022 due to foregone revenues and additional spending, but the public debt-to-GDP ratio declined given the rise in nominal GDP and a sharp drop in deposits to service the debt.
- Considering the rising costs of financing and large Eurobond repayments in 2025 and 2027, the fiscal consolidation reform program needs to be a government priority.

Recent Economic Developments

Private consumption led a strong recovery in 2022. After a strong performance in the first half of the year, growth decelerated in the second half, to an average 6.1 percent for 2022. Private consumption was the main driver of growth supported by increases in real disposable income, a good tourism season, solid employment gains, household lending, and a rise in remittances. Government consumption also added to growth, while the contribution of investment was negative following completion of the first section of the highway and a slowdown in private investment. Net inventories, in contrast, increased and made a significant contribution to growth. While export growth was strong, supported by further tourism recovery and exports of electricity and metals, a surge in imports due to strong domestic demand and high import inflation turned net exports negative.

On the production side, growth was led primarily by tourism, trade, and other service sectors. Total international tourism overnight stays recovered to 85 percent of their 2019 level from 68 percent in 2021. Further recovery in tourism, along with an increase in real disposable income, supported retail trade, which expanded by 13.4[3] percent in real terms. However, industrial production declined by 3.2 percent, due to unfavorable hydrometeorological conditions earlier in the year that affected electricity generation. Similarly, construction declined by 2.9 percent,[4] but an increase in the number of building permits issued points to a likely resumption of construction activity in the near term.

Sustained improvements in the labor market have led to a historically low unemployment rate. The Labor Force Survey shows average employment increased by 18 percent in 2022, which benefited more female than male employees. The employment rate thus rose to 50.3 percent in 2022 from 42.5 percent in 2021. The activity rate rose to a record high of 58.9 from 50.9 percent a year ago, while the unemployment rate declined to a historical low of 14.7 percent from 16.7 percent a year ago. The youth unemployment rate also declined significantly to 29.4 percent in 2022 from 38 percent a year ago.

3 All comparisons are year on year, unless otherwise indicated.
4 Measured as the number of effective hours worked on construction sites.

The administrative data suggest strong employment gains of 9.2 percent in the last quarter of 2022, which continued into January, when total registered employment increased by 8.5 percent. All sectors except public administration registered employment growth, with the ICT sector surging by 48 percent, also affected by the immigrant workers from Russia registering businesses in Montenegro. The registered unemployment rate in January 2023 further declined (to 16.3 percent, down by 5 pp compared to a year ago). In 2022, the real average net monthly wage increased by 18.7 percent in real terms, due to the reduction in labor taxes and an increase in the minimum wage.

Inflation peaked at a two-decade high in 2022. Global inflationary pressures and higher wages have been driving a surge in prices. In 2022, inflation averaged 13 percent, peaking in November at 17.5 percent. Most of the inflation is explained by increases in the prices of food and non-alcoholic beverages (22.6 percent) and fuel (35.3 percent). Inflation moderated in early 2023, averaging 15.1 percent in February 2023, driven by food prices. The cost-of-living crisis has been largely mitigated by an increase in real disposable income through the tax reform,[5] supported additionally by government measures to reduce the VAT on selected food staples and a reduction of the fuel excise tax.

The financial sector remains well capitalized and liquid. In January 2023, outstanding loans were up by 10 percent, driven by lending to households and nonresidents. At the same time, overall deposits were up by 23 percent, led by the corporate and household sectors. As a result, the lending-to-deposits ratio declined to 72 percent, its lowest level ever. In 2022, new loans surged by 31.5 percent, outpacing 2019 new lending by 18.7 percent. The average capital adequacy ratio was a healthy 19.3 percent in December 2022, well above the regulatory minimum, while nonperforming loans declined to 6.3 percent of total loans from 6.8 percent in December 2021. Liquidity is ample—liquid assets over total assets stood at 30.7 percent in December 2022. While the financial sector is stable, at a time of high economic uncertainty and vulnerabilities to global shocks, added vigilance on the side of bank supervision is warranted.

The current account deficit (CAD) widened to 13.3 percent of GDP. After an 18-year low in 2021, the CAD widened due to a surge in import prices. In 2022, exports of goods and services grew by 44 percent. Transport and tourism services led service export growth, while exports of electricity and metals, benefiting from higher global prices, supported merchandise exports. In 2022, Montenegro exported 233 percent more in value of electricity and metals than in 2021. Owing to higher demand and higher food and energy prices, import growth was also strong, expanding by 43 percent. Net primary and secondary income strengthened, primarily due to strong net remittances, which increased by 29 percent. The CAD was completely financed by net FDI, which increased by 73 percent to reach 13.5 percent of GDP. In January 2023, international reserves stood at EUR 1.9 billion, covering six months of merchandise imports.

5 The tax reform, implemented in 2022, introduced progressive income taxation, removed healthcare contributions, and increased the net minimum wage from EUR 250 to EUR 450.

Lower revenues as a share of GDP and higher spending widened the fiscal deficit to 5.2 percent of GDP in 2022. Total revenues as a share of GDP dropped from 44 percent in 2021 to 39.4 percent in 2022 despite a surge in VAT collection, which improved by 31 percent. Excise revenues remained flat despite a 50- and 40-percent reduction of the excise on fuel that has been implemented since May 2022. However, revenues from social security contributions and the personal income tax declined as part of the government's tax reform that removed healthcare contributions. At the same time, expenditures increased, led by higher capital and social spending, including higher ad-hoc pension spending. Transfers also increased, primarily due to a one-off clearance of health arrears of over 1 percent of GDP that had accumulated in recent years. While there are strong political pressures to increase spending, Montenegro's fiscal space is limited, and new spending commitments should be consistent with the need to reduce the deficit and debt. The adopted increase in the excise tax on tobacco and the expanded scope of excise taxation on sugary products are welcome not only in terms of generating stronger revenues, but also in achieving better health and social outcomes.

Though declining, Montenegro's public debt remains high in an environment of the rising cost of financing. Montenegro's public debt declined from 84 percent of GDP in 2021 to 70.8 percent of GDP in 2022, owing to a larger nominal GDP (that is, a denominator effect), negative net borrowing, and the fact that most of Montenegro's financing needs for 2022 were sourced from the deposits. As a result, the stock of outstanding central government deposits declined from 9.4 percent of GDP in 2021 to 1.9 percent of GDP in 2022.

The fragility of Montenegro's political setting adds to the overall uncertainty. Montenegro has been at a political and institutional standstill since August 2022, when the government received a vote of no confidence—making it the second government to collapse in 2022. A month later, the Constitutional Court lost a quorum and remained nonfunctional until end-February 2023, when the Parliament voted for three judges of the Court. The complexity and fragility of the political landscape exacerbates uncertainties, slows the reform process, and not only diverts the focus from imminent economic challenges, but amplifies them. Given Montenegro's high vulnerability to external shocks, and particularly in a very uncertain external environment, subject to many downside risks, Montenegro must fortify its internal stabilization mechanism. That is, it must fully resolve its political and institutional crisis, pursue prudent fiscal policy, and implement structural reforms for more resilient growth.

Outlook and Risks

The unfavorable global economic outlook and high domestic uncertainty are weighing on Montenegro's otherwise positive outlook. Over 2023–25, growth is projected to average 3.1 percent, as private consumption growth slows, whereas investment is expected to provide marginally positive contributions to growth. Tourism is likely to continue recovering in 2023 to reach its 2019 level, although deteriorating growth prospects in the EU and the region may have an adverse effect on both tourism and wider growth prospects.

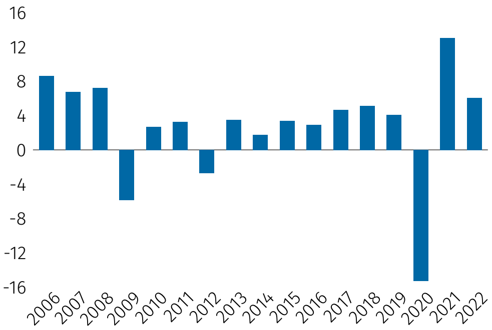
Inflation is projected to decelerate to 7.9 percent in 2023 and to 4 percent in 2024. While higher energy prices are disproportionally affecting the poor, they are also supporting Montenegro's electricity exports, helped by increasing generation capacities in the medium term. These factors, together with exports of tourism and transport services and solid remittances, are projected to support a modest reduction in the current account deficit to 11.1 percent of GDP by 2025.

While the fiscal deficit is expected to moderate over the medium term, it will remain elevated. Given a higher wage bill and social and capital spending, the fiscal deficit will remain high at 4.9 percent of GDP in 2023, before gradually declining to 4.2 percent in 2025, unless additional revenue and/or expenditure measures such as the recent increases in excise taxes are implemented. As a result, public debt is expected to stay high at around 70 percent of GDP over 2023–25. Given the tightening of global financial conditions, Montenegro's sizable financing needs of around 10 percent of GDP in 2023, and the need to repay three large Eurobonds due between 2025 and 2029, starting with a EUR 500 million Eurobond in 2025, the government must demonstrate its commitment to a debt reduction path. This requires carefully weighing the costs and benefits of any new spending commitments, and coordinating activities to increase tax compliance, broaden the tax base, and reduce the informal economy.

The outlook is clouded with multiple downside risks. High geopolitical uncertainties stemming from Russia's invasion of Ukraine and global inflation may weaken growth prospects in Montenegro's major trading partners. Risk premia are rising for most borrowers and the appetite for absorbing credit risk is shrinking. These conditions may lead to greater difficulty in mobilizing large amounts of capital at favorable terms, particularly if fiscal targets are not solidified through fiscal prudence. It is therefore critical that the government demonstrates its commitment to the debt reduction path. Political instability and complexity are major domestic risks. The severity of the challenges ahead, however, requires strong political commitment and actions to mitigate these risks.

GDP growth was solid at 6.1 percent...

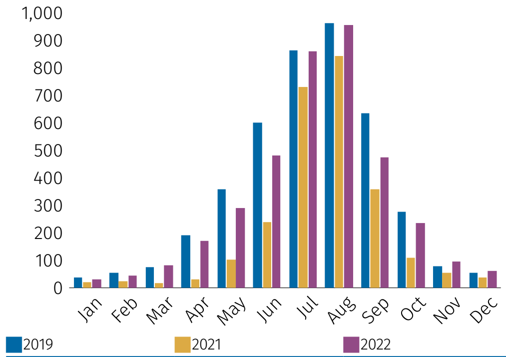
Real GDP growth, percent



Sources: MONSTAT data; World Bank staff calculations.

...supported by continuous tourism recovery.

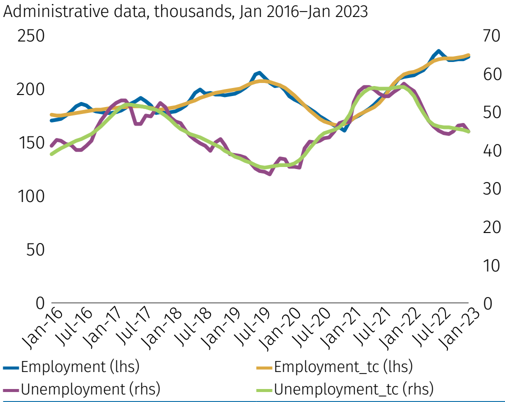
International tourist overnight stays, in thousands



Sources: MONSTAT; World Bank staff calculations.

The labor market continued improving...

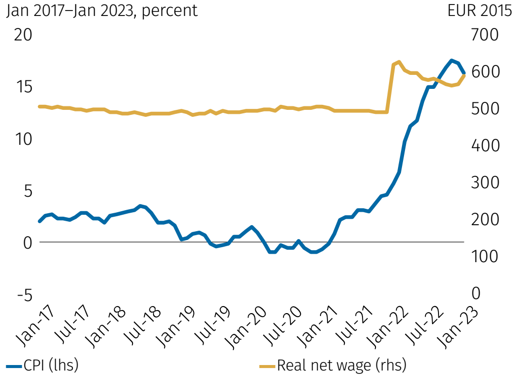
Administrative data, thousands, Jan 2016–Jan 2023



Source: MONSTAT data.
Note: tc=trend cycle.

...while inflation is still in double digits.

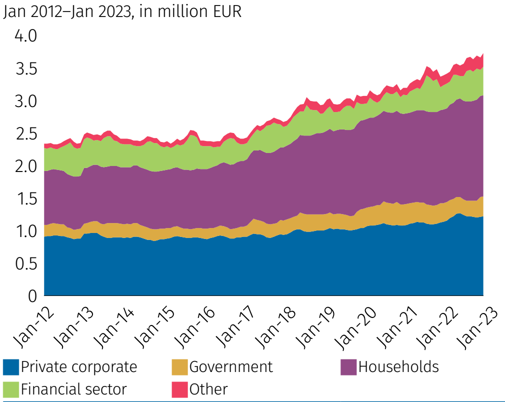
Jan 2017–Jan 2023, percent



Source: MONSTAT data; World Bank staff calculations.

Outstanding loans reached a record high.

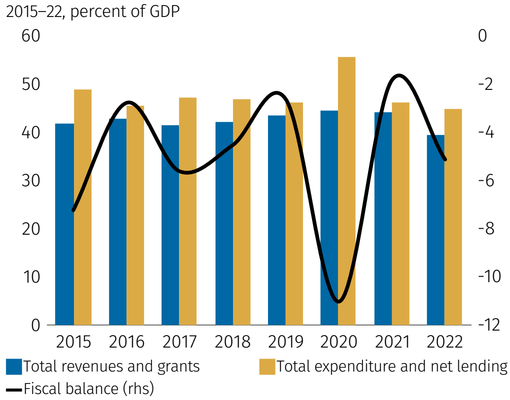
Jan 2012–Jan 2023, in million EUR



Sources: Central Bank; World Bank staff calculations.

The fiscal deficit is widening again.

2015–22, percent of GDP



Sources: Ministry of Finance; World Bank staff calculations.

MONTENEGRO Selected Economic Indicators	2020	2021	2022e	2023f	2024f	2025f
Real GDP growth (percent)	-15.3	13.0	6.1	3.4	3.1	2.9
Composition (percentage points):						
Consumption	-3.9	4.1	8.9	3.4	2.8	2.9
Investment	-5.9	-4.7	4.5	0.5	1.0	1.1
Net exports	-5.5	13.7	-7.3	-0.5	-0.7	-1.1
Exports	-24.2	25.7	11.5	2.9	2.6	2.5
Imports (-)	-18.7	12.0	18.8	3.4	3.3	3.6
Consumer price inflation (percent, period average)	-0.3	2.4	13.0	7.9	4.0	2.8
Public revenues (percent of GDP)	44.4	44.0	39.4	39.3	39.1	38.8
Public expenditures (percent of GDP)	55.5	45.9	44.6	44.1	43.6	43.0
Of which:						
Wage bill (percent of GDP)	13.5	12.2	10.7	11.2	10.8	10.4
Social benefits (percent of GDP)	13.4	11.5	11.6	12.4	12.4	12.5
Capital expenditures (percent of GDP)	7.5	5.7	6.1	5.5	5.5	5.5
Fiscal balance (percent of GDP)	-11.0	-1.9	-5.2	-4.9	-4.5	-4.2
Primary fiscal balance (percent of GDP)	-8.3	0.5	-3.5	-3.1	-2.2	-1.7
Public debt (percent of GDP)	105.3	84.0	70.8	69.0	70.3	69.6
Public and publicly guaranteed debt (percent of GDP)	108.7	86.8	72.5	70.6	71.8	71.1
Of which: External (percent of GDP)	97.3	78.3	64.0	62.7	65.0	64.4
Goods exports (percent of GDP)	9.8	10.6	13.2	12.6	12.5	12.5
Goods imports (percent of GDP)	49.0	49.3	59.3	58.8	57.8	57.1
Net services exports (percent of GDP)	4.2	19.3	22.7	24.1	24.3	24.6
Trade and services balance (percent of GDP)	-35.0	-19.4	-23.4	-22.1	-20.9	-20.0
Net remittance inflows (percent of GDP)	5.3	6.1	6.7	6.3	6.1	6.1
Current account balance (percent of GDP)	-26.1	-9.2	-13.3	-12.4	-11.9	-11.1
Net foreign direct investment inflows (percent of GDP)	11.2	11.7	13.5	8.8	7.7	7.5
External debt (percent of GDP)	221.6	190.0	162.5	151.4	145.9	141.2
Real private credit growth (percent, period average)	6.4	-0.2	-4.9	–	–	–
Nonperforming loans (percent of gross loans, end of period)	5.9	6.8	6.3	–	–	–
Unemployment rate (percent, period average)	17.9	16.7	14.7	–	–	–
Youth unemployment rate (percent, period average)	36.0	38.0	29.4	–	–	–
Labor force participation rate (percent, period average)	53.3	50.9	58.9	–	–	–
GDP per capita, PPP (current international $)	19,990	24,508	28,153	30,918	33,076	35,050
Poverty rate (percent of population)	20.0	18.0	17.0	16.6	16.2	15.8

Sources: Country authorities; World Bank estimates and projections.
Note: PPP = purchasing price parity. — = not available.

North Macedonia

- Despite a brisk post-pandemic recovery, the energy crisis has depressed growth and pushed inflation to a two-decade high, stretching public finances amidst a rise in borrowing costs.
- While on a decelerating pathway, inflation is projected to remain elevated. Economic growth is projected to moderately accelerate over the medium term.
- Given scarce fiscal space, government support to shield the economy from high energy prices needs to be better targeted to incentivize energy efficiency and the green transition.
- Downside risks to the outlook have subsided amidst a partial easing of financing conditions, but fiscal consolidation is still a priority. Structural reforms to boost medium-term sustainable and inclusive growth should be prioritized ahead of the 2024 general elections.

Recent Economic Developments

After a rebound in 2021, growth momentum waned in 2022 as the effects of the Russia's invasion on Ukraine interrupted the post-pandemic recovery. After growing by 3.9 percent in 2021, domestic output increased by 2.1 percent on an annual basis in 2022, as gross investments surged, largely due to import-intensive stockpiling. Despite double-digit growth, exports lagged imports. Growth in personal consumption decelerated during the same period. On the production side, expansion was driven by services, as industry struggled, and construction slipped further into negative territory.

High-frequency indicators point to a further slowdown of growth in the first quarter of 2023. Industrial production dropped by 2.3 percent in January 2023 as higher mining and energy production cushioned the manufacturing fallout. At the same time, real retail trade went up by 3.6 percent, but decreased 13.6 percent relative to the previous month. Tourism continued to see a steady recovery, but arrivals and nights spent have still not reached levels observed before the pandemic.

Owing to a deterioration in the merchandise trade balance, with surging import prices and stockpiling, the current account deficit worsened to 6 percent of GDP. The trade deficit widened more than 6 percentage points (pp) to 26.8 percent of GDP, mainly because of the negative energy balance along with intensified inventory imports that served as an inflation-hedging mechanism and provided security against supply shortages. The services surplus increased to 5.7 percent of GDP, largely due to stronger exports of ICT and other business-related services. At the same time, the primary income deficit eased, while the secondary income surplus grew due to higher remittances. Solid foreign direct investment inflows into the manufacturing and services sectors at 5.2 percent of GDP helped finance the current account deficit. Gross external debt increased to 85.9 percent of GDP by September 2022 with rising private debt.

Despite strong government support, the labor market remains scarred from the enduring effects of the pandemic. By Q4 2022,[6] the participation rate was still hovering around 55 percent, with a more than 21 pp difference between men and women. The employment rate has remained stagnant at

6 The 2022 data are not fully comparable to previous labor data due to the change in the Labor Force Survey (LFS) sample based on the 2021 census.

around 47 percent. The unemployment rate declined slightly to 14.4 percent, but the youth unemployment rate remained high at 31.8 percent, more than double the EU average. At the same time, rising labor shortages due to outmigration and population aging pushed the vacancy rate up to a decade high, particularly for services and construction workers.

Nominal net wages increased by 11 percent during the year to December 2022, but double-digit inflation meant that growth in real net wages was negative. Undeterred by low and declining labor productivity, a double-digit nominal wage growth spread almost uniformly across all economic sectors, spurred by a minimum wage hike and public sector pay rises. Wage growth was strongest in sectors most affected by overlapping crises such as accommodation and recreation services, manufacturing, and retail trade, where it increased by at least 14 percent in nominal terms on an annual basis.

The two-decade-high inflation rate started to decelerate after it peaked at close to 20 percent in October 2022. The inflation rate averaged 14.2 percent for 2022, with food and energy prices accounting for more than 75 percent of the total increase in prices. Core inflation also remained high at 7.1 percent in 2022. At end-2022, the government moved food manufacturing companies to the regulated electricity market in another effort to contain the surge in food prices by lowering their input costs. This helped lower domestic food prices somewhat, and with pressures from global commodity markets abating, it contributed to a deceleration of the monthly increase in inflation. Relative to the preceding month, inflation increased by only 0.1 percent in January 2023, while the annual change amounted to 17.1 percent.

Monetary policy tightening continued as rising consumer prices became further entrenched in inflationary expectations. By March 2023, the central bank had raised the key policy rate by 4.25 pp to 5.5 percent in ten consecutive rounds and increased overnight loan and deposit rates. Reserves recovered from earlier losses incurred largely at the start of the Russia's invasion on Ukraine, now covering 3.7 months of imports. Banking sector stability was preserved, with an increase in the capital adequacy ratio to 17.7 percent in Q3 2022, albeit with a 2.3 pp drop in the liquidity rate on an annual basis to 19.7 percent. Despite a 1.2 pp increase in the interest rate for new loans since end-2021, credit growth remained robust at 9.4 percent in December 2022, led by accelerated FX-denominated corporate lending. At the same time, nonperforming loans stood at 3.2 percent of total loans, 0.1 pp higher than in the previous quarter.

The general government deficit declined in 2022. By December 2022, the general government deficit reached 4.5 percent of GDP, down from 5.4 percent in 2021. This was below the budget plan, as revenues led by value-added tax and personal and corporate income taxes outpaced expenditures, and as capital expenditure execution fell short of the planned amount. Electricity company subsidies to cover operational losses amounted to 2.4 percent of GDP. The general government deficit for 2023 is set at 4.8 percent of GDP (higher than originally planned) largely due to increased spending needs related to the energy crisis and new highway construction.

Public and publicly guaranteed and non-guaranteed debt dropped to 59.6 percent of GDP by end-2022. Inflation helped reduce the debt-to-GDP ratio, but nominal public debt remained elevated relative to the pre-crisis period. Further, government arrears increased to 3.2 percent of GDP, largely due to state-owned enterprise, health, and local government nonpayment. In February 2023, the government attempted to issue a EUR 600 million Eurobond with a 6.25 percent coupon rate to help cover higher financing needs for 2023 (that include a EUR 450 million Eurobond repayment due in July), but the transaction was not confirmed due to a partial government reshuffle, so the government ended up issuing a EUR 500 million Eurobond with a 6.96 percent coupon rate in early March. The IMF's Precautionary and Liquidity Line (EUR 530 million, of which half is disbursing), as well as the first tranche of EU's EUR 80 million grant for energy crisis support, would cover the financing needs for Q1. The request for EUR 100 million in Macro-Financial Assistance from the EU would further reduce financing pressures for 2023.

Outlook and Risks

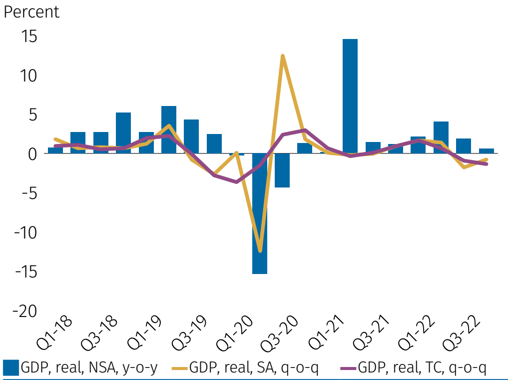
The medium-term growth outlook is positive, while downside risks have subsided. Growth in 2023 is expected to increase to 2.4 percent, although this is 0.3 pp below the World Bank's autumn round forecast, reflecting continued disruptions from the war on Ukraine, and a protracted energy crisis. Growth is projected to remain below potential, but to moderately accelerate as the large public investment starts and nearshoring of FDI continues.

With commodity prices expected to decline over the next two years, the inflation rate is projected to decelerate to 9.1 percent in 2023 and further to 3 percent in 2024. The central bank is expected to continue tightening monetary policy over the near term but to gradually ease policy as price pressures subside. The baseline scenario is built on the assumption that the impacts of multiple crises gradually lessen over the forecast horizon.

Underlying risks remain skewed to the downside and are closely tied to the outlook of the European Union. Moving ahead with North Macedonia's EU accession negotiations may provide a much-needed boost to the reform appetite and unlock higher growth prospects. At the same time, heightened political uncertainty and a parliamentary impasse prior to elections may delay the implementation of critical reforms. Further, higher-than-expected inflation may trigger more significant monetary policy tightening that would additionally restrict financing options and suppress economic activity going forward.

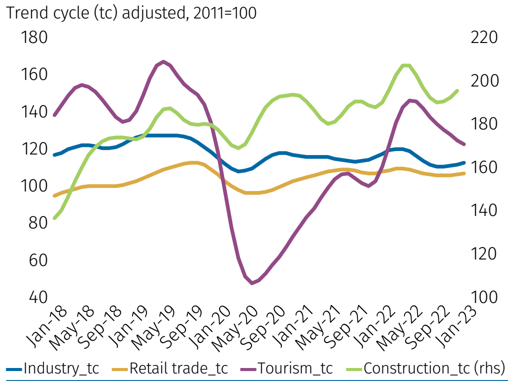
Unlocking North Macedonia's development prospects would require deeper attention to pending reforms. Policy actions need to be focused on rebuilding sustainability and resilience to shocks to prevent future setbacks to growth. Improving tax compliance and widening the tax base should be a priority, along with improved targeting of social spending and building energy resilience. Government support to shield the economy from high energy prices needs to be targeted and temporary to incentivize energy efficiency and the green transition. Reducing business regulatory costs, deepening trade agreements, increasing market competition, increasing labor market participation, and accelerating the green transition would all be supportive of more sustainable, inclusive, and resilient growth in an environment of pronounced uncertainty.

Economic growth slowed with overlapping crises...



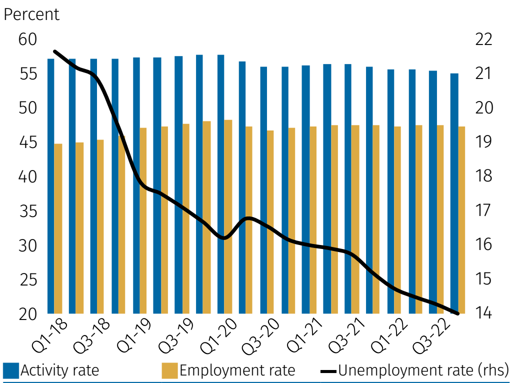
Sources: State Statistics Office; World Bank staff calculations.

...and high-frequency indicators point to a further slowdown ahead.



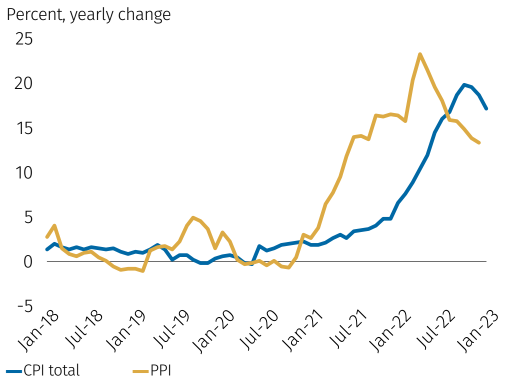
Source: State Statistics Office; World Bank staff calculations.

Further labor market recovery seems to be on hold as the employment rate remains stagnant.



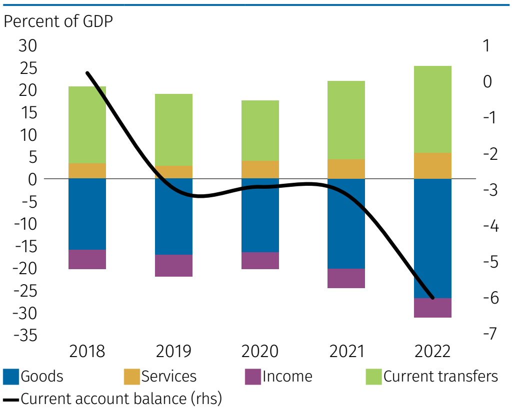
Source: State Statistics Office.
Note: LFS 2022 makes use of the 2021 census data, making a break in the series.

Domestic inflation started to decelerate after reaching a peak in October 2022...



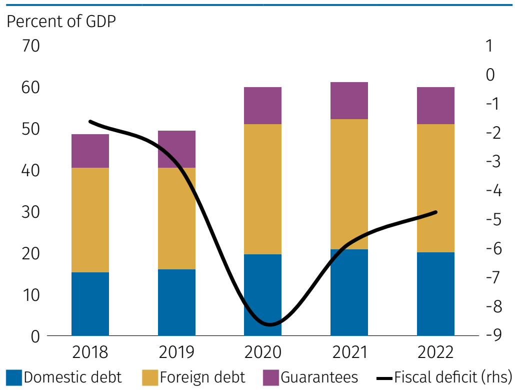
Source: State Statistics Office.

...although external imbalances widened significantly, with high import prices and import-intensive stockpiling.



Source: Central bank.

The public debt decreased with the help of inflation amidst a rise in expenditure arrears.



Sources: Ministry of Finance and World Bank estimates.
Note: Fiscal deficit includes Public Enterprise for State Roads

NORTH MACEDONIA Selected Economic Indicators	2020	2021	2022e	2023f	2024f	2025f
Real GDP growth (percent)	-4.7	3.9	2.1	2.4	2.7	2.9
Composition (percentage points):						
Consumption	-1.5	5.1	0.7	1.1	1.6	2.9
Investment	-5.7	0.3	7.1	2.8	1.7	0.9
Net exports	2.5	-1.4	-5.7	-1.5	-0.5	-0.9
Exports	-7.4	7.4	9.2	4.6	4.3	4.0
Imports (-)	-9.9	8.9	14.8	6.1	4.9	5.0
Consumer price inflation (percent, period average)	1.2	3.2	14.2	9.1	3.0	2.0
Public revenues (percent of GDP)	29.9	32.5	32.4	33.5	33.5	34.1
Public expenditures (percent of GDP)	38.1	37.9	36.9	38.4	37.8	37.4
Of which:						
Wage bill (percent of GDP)	7.2	6.9	6.5	6.6	6.4	6.2
Social benefits (percent of GDP)	17.6	16.9	16.6	16.7	16.5	16.6
Capital expenditures (percent of GDP)	3.1	4.2	4.2	5.9	6.4	6.0
Overall fiscal balance (percent of GDP)	-8.2	-5.4	-4.5	-4.8	-4.2	-3.3
Primary fiscal balance (percent of GDP)	-7.0	-4.1	-3.3	-3.3	-2.5	-1.6
Overall fiscal balance with the Public Enterprise for State Roads included	-8.6	-5.8	-4.8	-5.0	-4.4	-3.5
Public debt (percent of GDP)	50.8	52.0	50.9	51.5	53.1	54.1
Public and publicly guaranteed debt (percent of GDP)*	59.8	61.0	59.6	61.6	63.8	63.6
Of which: External (percent of GDP)	39.9	39.9	39.1	38.7	38.6	38.0
Goods exports (percent of GDP)	44.4	51.3	57.0	56.5	57.2	58.3
Goods imports (percent of GDP)	61.0	71.6	83.7	81.7	82.0	82.8
Net services exports (percent of GDP)	3.9	4.2	5.7	6.4	6.7	7.1
Goods and services trade balance (percent of GDP)	-12.7	-16.0	-21.0	-18.9	-18.1	-17.4
Remittance inflows (percent of GDP)	3.1	2.9	2.7	2.7	2.6	2.6
Current account balance (percent of GDP)	-2.9	-3.1	-6.0	-4.2	-3.7	-3.2
Net foreign direct investment inflows (percent of GDP)	1.4	3.3	5.2	5.2	5.9	6.2
External debt (percent of GDP)	78.7	81.9	87.5	89.4	89.5	88.9
Real private credit growth (percent, period average)	5.6	2.8	-4.2	–	–	–
Nonperforming loans (percent of gross loans, end of period)	3.3	3.1	3.2	–	–	–
Unemployment rate (percent, average)**	16.4	15.4	14.4	13.7	13.6	13.5
Youth unemployment rate (percent, period average)	35.7	36.1	32.5	–	–	–
Labor force participation rate (percent, period average)	56.4	55.87	55.2	–	–	–
GDP per capita, PPP (current international $)**	13,562	14,096	14,398	14,744	15,142	15,581

Sources: Country authorities; World Bank staff estimates and projections.
Note: *Includes non-guaranteed debt of SOEs, as well. **Data from 2022 are not fully comparable to previous labor data due to the change in the LFS sample based on the 2021 census. Youth unemployment rate is for labor force aged 15–24. e = estimate; f = forecast. – = not available.

Serbia

- Growth decelerated in the second half of the year to average 2.3 percent in 2022, but the labor market shows resilience.
- Surging food and energy prices pushed overall inflation to 11.9 percent in 2022, its 15-year high.
- Although the current account deficit almost doubled, it was fully financed by net foreign direct investment (FDI). External debt declined compared to 2021.
- Strong revenue performance and controlled spending have reduced the fiscal deficit to 3.1 percent of GDP, which led to a reduction in public debt.
- Risks remain tilted to the downside but are now more muted as the peak of the energy crisis and inflation shock appear to have passed.

Recent Economic Developments

Economic activity decelerated strongly in the second half of 2022. After a resilient performance in H1 of 4.0 percent,[7] growth slowed to an estimated 0.7 percent in H2. While private consumption, supported by employment growth and lending to households, led growth throughout the year, its contribution to growth gradually declined toward the end of the year as inflation bit into real disposable income. During H2, investment dampened growth despite an increase in public investment, providing for a marginal negative contribution of investment to annual growth. Stockbuilding of inventories has, however, made a significant positive contribution to growth. Primarily due to an increase in energy imports (electricity, coal, oil, and gas) real imports growth marginally outpaced that of exports, resulting in a negative contribution of net exports to growth.

On the production side, service sectors, and particularly trade, ICT, tourism, and professional services, led growth, while the agriculture and construction sectors contracted. Agricultural output declined for the second year in a row due to a major drought and significantly higher input prices. The value of construction works declined by 11 percent in real terms, and a decline in construction permits issued in December (-12.2 percent) and in January (-7.9 percent) suggests prolonged weaker construction activity. After a slowdown in the third quarter, industrial production bounced back in the last quarter, primarily supported by the mining sector.

Improvements in the labor market have led to record-high employment and activity rates. Labor Force Survey (LFS) data for 2022 show continuous advances in the labor market, as the employment rate reached a record high of 50.3 percent, while the share of active population increased to 55.5 percent, benefiting from stronger participation of women (at 47.9 percent). As such, the unemployment rate declined from 11 percent in 2021 to 9.4 percent in 2022. Administrative data point to a robust performance in January 2023 as well—the number of registered employed increased by 3 percent. In 2022, both average gross and net wages increased by 13.8 percent in nominal

7 All comparisons are year over year, unless otherwise indicated.

terms. Wage growth was more pronounced in the private sector, where the average net wage increased by 17 percent, whereas public sector wages increased by 7.3 percent. Overall, given the average inflation rate of 11.7 percent in the same period, the average net wage increased by 1.7 percent in real terms.

Inflation peaked at a 15-year high. In 2022, inflation averaged 11.9 percent, reaching 15.1 percent in December. High inflation was, to a large extent, explained by food and energy prices, which accounted for 65 percent of the increase in inflation. Food prices alone accounted for half of annual inflation, as they grew by 19.4 percent over the year. In February 2023, inflation surged to a new high of 16.1 percent but is expected to decelerate after Q1. As a response to rising inflation, the National Bank of Serbia (NBS) has increased the key policy rate each month since April 2022, reaching 5.75 percent in March 2023. The dinar held relatively steady during 2022 (0.2 percent nominal appreciation against the euro), primarily due to timely and effective NBS interventions in the foreign exchange market, where the NBS net purchased EUR 1 billion. During 2023, relative stability of the exchange rate continued and the NBS net purchased EUR 165 million in the first two months. NBS official foreign currency reserves increased to a historic high of EUR 21.2 billion in February 2023, covering close to 6 months of imports of goods and services.

The banking sector is well capitalized and liquid. The December capital adequacy ratio was at 20.1 percent, while the share of liquid assets to total assets stood at 39.6 percent. Nonperforming loans continued declining and reached a record low of 3.0 percent of total loans by end-December. The return on assets increased from 1.2 percent in 2021 to 1.9 percent in 2022, while the return on equity increased from 7.8 percent in 2021 to 13.8 percent in 2022, its highest since 2018. Due to a high base and monetary tightening, credit growth has been slowing since June, and in December, the total stock of loans was up by 7.1 percent, led by increases in households and public enterprises. In December, total deposits were up by 6.9 percent, driven by stronger private sector and household deposits.

The current account deficit widened to 6.9 percent of GDP but was lower than initially expected. Most of Serbia's current account deficit in 2022 was explained by energy imports in H1, due to a surge in the prices of energy, metals, and other raw materials. In 2022, total energy imports increased by almost EUR 4 billion to EUR 6.9 billion. As a result, the trade deficit increased by over 50 percent to 11.7 percent of GDP, as an increase in the net services surplus of 65 percent was not sufficient to cover the widening deficit in the trade of goods. The primary income deficit widened by 46 percent mainly due to dividend payments and reinvested earnings, while higher remittances led to a higher net transfer surplus. The widening current account deficit was still fully financed by net FDI, which increased by 17.7 percent as manufacturing investments remained strong. At an estimated 68.5 percent of GDP in September 2022, external debt remained flat.

The fiscal deficit declined to 3.1 percent of GDP in 2022. Strong revenue performance and controlled spending led to a better-than-planned decline in the fiscal deficit, from 4.1 percent of GDP in 2021. Total revenue increased by 13.4 percent in nominal terms; more than half of this growth was explained by stronger VAT and social security contribution collection. High inflation and the surge in imports drove VAT revenues, while social contributions increased on the back of rising formal employment and wages. Personal and corporate income tax collection was also robust, the latter increasing by 31.2 percent. Total government expenditure growth was more moderate, mainly driven by capital budget transfer loans (up by 299.2 percent), capital spending (up by 8.9 percent), and social transfers (up by 9.3 percent). Spending on subsidies, in contrast, declined by 22.2 percent, as the government phased out pandemic-induced fiscal support.

Public and publicly guaranteed debt declined to 55.6 percent of GDP from 57.1 percent in 2021. In December 2022, Serbia signed a USD 1 billion loan agreement with the United Arab Emirates at 3 percent interest, and the IMF Board approved a two-year Stand-by Arrangement for Serbia of EUR 2.4 billion, of which EUR 1 billion has been disbursed. In January 2023, Serbia issued two Eurobonds—a five-year Eurobond of USD 750 million at a coupon rate of 6.25 percent, and a 10-year Eurobond of USD 1 billion at a coupon rate of 6.5 percent. The proceeds will be mainly used for debt service and to ensure fiscal buffers.

Outlook and Risks

The growth outlook remains positive, with risks tilted to the downside. Over the medium term, the economy is expected to grow steadily at around 3 percent annually. The main driver of growth over the medium term will be consumption (with average contribution to GDP growth of 2.2 percentage points annually during 2023–25), and to a lesser extent investment (on average contributing 0.7 percentage points to annual growth), while net exports will increasingly make a negative contribution to growth as imports are projected to increase faster than exports.

Faster growth would be possible if structural reforms were implemented to boost potential output, through increased human capital (improving the quality of education and increasing the level of labor force participation), higher productivity (particularly by attracting higher-quality FDI), and an improved business environment (including regulatory predictability and strengthened market competition).

Inflation is expected to return to the target band only in 2024. The NBS remains committed to inflation targeting (3 percent +/- 1.5 percent), although inflation remained well above the target band in 2022. The NBS increased the key policy each month since April 2022 and lowered the money supply, a policy that is expected to continue over the coming months should inflation remain persistently elevated. This will greatly depend on changes in the international prices of food and energy. Reserves will remain at comfortable levels, and it is expected that the NBS will continue to intervene on the foreign exchange market to prevent excessive short-term fluctuations in the exchange rate on both sides.

The fiscal deficit and public debt are expected to remain on their downward path. Based on the Fiscal Strategy 2023–25 approved along with the budget for 2023, the government plans to reduce the fiscal deficit gradually over the medium term and to reach a primary fiscal surplus by 2025. This would lead to a reduction of public debt to an estimated 51.5 percent of

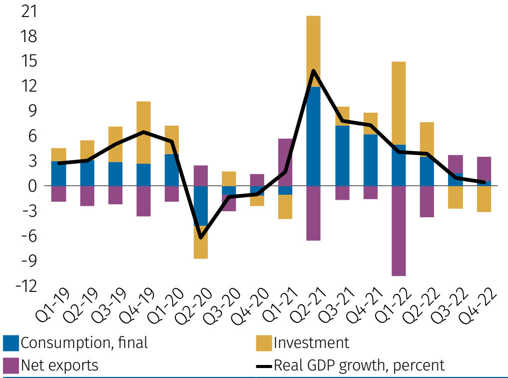
GDP in 2025. To ensure the commitment to these fiscal targets, in December 2022, the government changed the deficit ceiling fiscal rule and introduced two new rules for the wage bill and spending on pensions. Commitment to the rules, together with improving corporate governance of SOEs through a comprehensive reform program, will be critical to enhance Serbia's fiscal sustainability over the medium term.

The positive outlook is clouded by multiple risks. First, although the peak of inflation is expected in Q1 2023, it could increase further depending on changes in international food and energy prices, which would in turn further reduce household disposable income and dampen growth through lower consumption, but also lead to even higher costs of financing. The second-most-important risk is associated with the EU's economic outlook and performance of Serbia's other main trading partners. Most of Serbia's exports go to the EU (65 percent) and to the Western Balkans (about 16 percent), which makes it highly dependent on developments and on the pace of recovery in these two regions.

Finally, the energy crisis has shown the importance of greener and more resilient economic growth. Despite improvements since 2000, Serbia's economy is still almost twice as energy intensive as the EU's and relies heavily on fossil fuels for its electricity generation and industrial output. To accelerate the transition toward a more sustainable and greener economy, Serbia's strong commitment to a green growth agenda would require equally strong action.

Growth decelerated sharply in H2 2022...

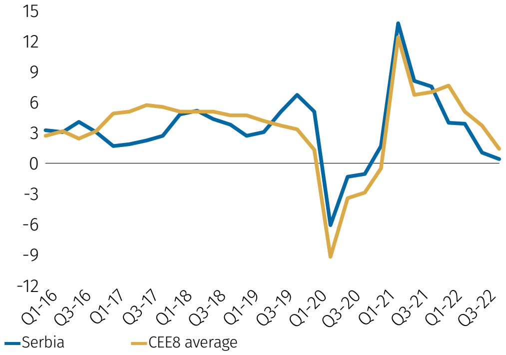
Contribution to growth, percentage points



Source: Statistics Office of the Republic of Serbia.

...more sharply than in the CEE countries.

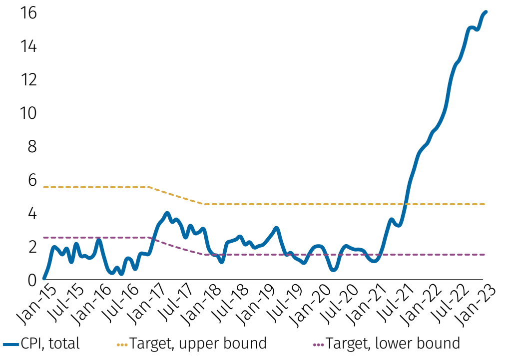
Growth rates, y-o-y



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

Inflation reached a new peak in February 2023...

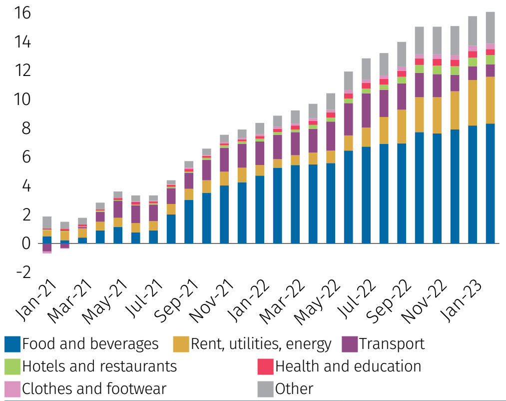
Annual change in percent



Source: Statistics Office of the Republic of Serbia.

...still largely driven by surging food prices.

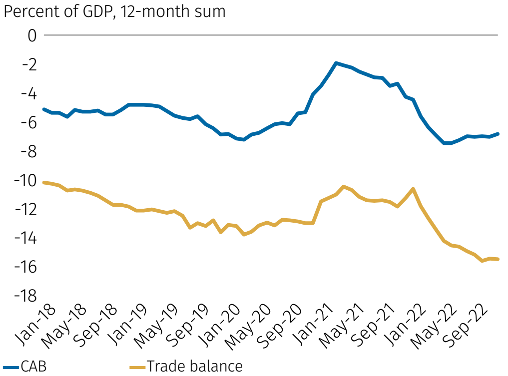
Contribution in pp



Source: Statistics Office of the Republic of Serbia.

The CAD deficit moderated in the second half of 2022...

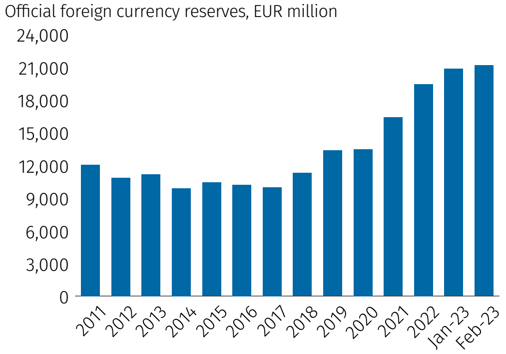
Percent of GDP, 12-month sum



Source: National Bank of Serbia.

...and FX reserves reached a record high in February.

Official foreign currency reserves, EUR million



Source: National Bank of Serbia.

SERBIA Selected Economic Indicators	2020	2021	2022e	2023f	2024f	2025f
Real GDP growth (percent)	-0.9	7.5	2.3	2.3	3.0	3.8
Composition (percentage points):						
Consumption	-0.8	6.0	2.6	1.9	2.0	2.9
Investment	-0.2	2.6	1.8	0.6	0.6	1.5
Net exports	0.1	-1.0	-2.1	-0.2	0.4	-0.6
Exports	-2.3	10.4	10.4	2.1	2.9	4.2
Imports (-)	-2.4	11.4	12.5	2.3	2.4	4.7
Consumer price inflation (percent, period average)	1.6	4.0	11.9	8.2	4.0	3.5
Public revenues (percent of GDP)	41.0	43.3	43.4	41.8	41.3	41.6
Public expenditures (percent of GDP)	49.0	47.4	46.6	44.9	43.5	43.0
Of which:						
Wage bill (percent of GDP)	10.5	10.0	9.7	9.7	9.7	9.7
Social benefits (percent of GDP)	14.7	13.6	13.1	13.0	13.3	13.4
Capital expenditures (percent of GDP)	5.3	7.4	7.2	6.9	6.8	6.8
Fiscal balance (percent of GDP)	-8.0	-4.1	-3.1	-3.1	-2.2	-1.4
Primary fiscal balance (percent of GDP)	-6.0	-2.4	-1.6	-1.3	-0.4	0.4
Public debt (percent of GDP)	53.9	54.5	52.6	52.3	50.5	49.6
Public and publicly guaranteed debt (percent of GDP)	57.8	57.1	55.6	55.5	53.1	51.5
Of which: External (percent of GDP)	33.4	37.0	36.0	36.0	34.3	33.2
Goods exports (percent of GDP)	34.3	39.4	44.6	44.5	43.8	43.1
Goods imports (percent of GDP)	45.5	50.7	60.1	58.4	56.1	54.7
Net services exports (percent of GDP)	2.4	2.6	3.8	3.7	3.6	3.5
Trade balance (percent of GDP)	-8.8	-8.7	-11.7	-10.3	-8.8	-8.1
Net remittance inflows (percent of GDP)	4.5	4.7	6.1	5.5	5.1	4.9
Current account balance (percent of GDP)	-4.1	-4.2	-6.9	-6.3	-5.4	-5.1
Net foreign direct investment inflows (percent of GDP)	6.3	6.9	7.1	5.6	5.5	5.6
External debt (percent of GDP)	65.8	68.4	67.9	64.3	61.1	59.7
Real private credit growth (percent, period average)	9.2	3.7	-2.7	–	–	–
Nonperforming loans (percent of gross loans, end of period)	3.7	3.6	3.0	–	–	–
Unemployment rate (percent, period average)	9.7	11.0	9.4	–	–	–
Youth unemployment rate (percent, period average)	27.3	26.5	24.3	–	–	–
Labor force participation rate (percent, period average)	52.2	54.7	55.5	–	–	–
GDP per capita, PPP (current international $)	19,556	21,642	22,901	27,330	29,096	31,409
Poverty rate (percent of population)	10.1	10.2	9.8	9.6	9.3	9.1

Sources: Country authorities; World Bank estimates and projections.
Note: PPP = purchasing power parity. – = not available.

Key Economic Indicators

Key Economic Indicators	2020	2021	2022e	2023f	2024f	2025f
Real GDP growth (percent)						
Albania	-3.3	8.9	4.8	2.8	3.3	3.3
Bosnia and Herzegovina	-3.0	7.4	4.0	2.5	3.0	3.5
Kosovo	-5.3	10.7	3.5	3.7	4.4	4.2
North Macedonia	-4.7	3.9	2.1	2.4	2.7	2.9
Montenegro	-15.3	13.0	6.1	3.4	3.1	2.9
Serbia	-0.9	7.5	2.3	2.3	3.0	3.8
WB6	*-3.0*	*7.8*	*3.2*	*2.6*	*3.1*	*3.5*
Consumer price inflation (percent, period average)						
Albania	2.2	2.6	6.7	4.0	3.5	3.0
Bosnia and Herzegovina	-1.1	2.0	14.0	5.0	2.1	1.9
Kosovo	0.2	3.4	11.6	6.0	3.3	2.5
North Macedonia	1.2	3.2	14.2	9.1	3.0	2.0
Montenegro	-0.3	2.4	13.0	7.9	4.0	2.8
Serbia	1.6	4.0	11.9	8.2	4.0	3.5
WB6	*1.0*	*3.3*	*11.8*	*7.0*	*3.4*	*2.9*
Public expenditures (percent of GDP)						
Albania	32.6	32.1	30.5	30.6	30.2	30.2
Bosnia and Herzegovina	46.8	41.3	44.8	44.9	44.4	44.1
Kosovo	33.0	28.8	28.2	29.0	29.0	29.8
North Macedonia	38.1	37.9	36.9	38.4	37.8	37.4
Montenegro	55.5	45.9	44.6	44.1	43.6	43.0
Serbia	49.0	47.4	46.6	44.9	43.5	43.0
WB6	*42.5*	*38.9*	*38.6*	*38.7*	*38.1*	*37.9*
Public revenues (percent of GDP)						
Albania	25.9	27.5	26.8	28.2	27.8	27.8
Bosnia and Herzegovina	41.6	41.1	43.8	45.0	45.3	45.2
Kosovo	25.4	27.4	27.6	27.9	26.7	26.9
North Macedonia	29.9	32.5	32.4	33.5	33.5	34.1
Montenegro	44.4	44.0	39.4	39.3	39.1	38.8
Serbia	41.0	43.3	43.4	41.8	41.3	41.6
WB6	*34.7*	*36.0*	*35.6*	*35.9*	*35.6*	*35.7*
Fiscal balance (percent of GDP)						
Albania	-6.7	-4.6	-3.7	-2.4	-2.4	-2.4
Bosnia and Herzegovina	-5.2	-0.3	-1.0	0.1	0.9	1.1
Kosovo	-7.6	-1.3	-0.5	-1.1	-2.3	-2.9
North Macedonia	-8.2	-5.4	-4.5	-4.8	-4.2	-3.3
Montenegro	-11.0	-1.9	-5.2	-4.9	-4.5	-4.2
Serbia	-8.0	-4.1	-3.1	-3.1	-2.2	-1.4
WB6	*-7.9*	*-3.0*	*-3.0*	*-2.7*	*-2.4*	*-2.0*

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

Key Economic Indicators (continued)	2020	2021	2022e	2023f	2024f	2025f
Public debt (percent of GDP)						
Albania	73.0	71.5	62.1	60.3	59.4	58.5
Bosnia and Herzegovina	36.1	34.0	32.5	32.3	32.3	31.8
Kosovo	22.0	21.2	19.5	19.7	20.5	22.0
North Macedonia	50.8	52.0	50.9	51.5	53.1	54.1
Montenegro	105.3	84.0	70.8	69.0	70.3	69.6
Serbia	53.9	54.5	52.6	52.3	50.5	49.6
WB6	*56.9*	*52.9*	*48.1*	*47.5*	*47.7*	*47.6*
Public and publicly guaranteed debt (percent of GDP)						
Albania	75.8	75.4	65.4	63.6	62.7	61.8
Bosnia and Herzegovina	38.8	37.6	33.0	34.0	35.5	33.8
Kosovo	22.4	21.6	19.8	20.0	20.8	22.3
North Macedonia	59.8	61.0	59.6	61.6	63.8	63.6
Montenegro	108.7	86.8	72.5	70.6	71.8	71.1
Serbia	57.8	57.1	55.6	55.5	53.1	51.5
WB6	*60.5*	*56.6*	*51.0*	*50.9*	*51.3*	*50.7*
Goods exports (percent of GDP)						
Albania	6.0	8.3	10.8	11.0	11.0	11.0
Bosnia and Herzegovina	26.3	36.6	41.3	42.8	43.7	44.8
Kosovo	6.6	8.9	10.4	11.1	11.9	12.9
North Macedonia	44.4	51.3	57.0	56.5	57.2	58.3
Montenegro	9.8	10.6	13.2	12.6	12.5	12.5
Serbia	34.3	39.4	44.6	44.5	43.8	43.1
WB6	*27.2*	*32.5*	*36.8*	*37.0*	*37.0*	*37.1*
Trade balance (percent of GDP)						
Albania	-14.3	-13.5	-10.4	-12.8	-13.0	-12.9
Bosnia and Herzegovina	-13.3	-13.2	-16.5	-15.2	-15.3	-15.4
Kosovo	-38.9	-30.0	-32.1	-34.6	-36.6	-38.1
North Macedonia	-12.7	-16.1	-21.0	-18.9	-18.1	-17.4
Montenegro	-35.0	-19.4	-23.4	-22.1	-20.9	-20.0
Serbia	-8.8	-8.7	-11.7	-10.3	-8.8	-8.1
WB6	*-14.0*	*-13.0*	*-15.3*	*-14.7*	*-14.1*	*-13.7*
Current account balance (percent of GDP)						
Albania	-8.5	-7.8	-6.0	-7.1	-7.1	-7.0
Bosnia and Herzegovina	-3.3	-2.7	-5.2	-4.1	-3.9	-3.7
Kosovo	-6.6	-8.2	-10.1	-9.9	-9.7	-9.2
North Macedonia	-2.9	-3.1	-6.0	-4.2	-3.7	-3.2
Montenegro	-26.1	-9.2	-13.3	-12.4	-11.9	-11.1
Serbia	-4.1	-4.2	-6.9	-6.3	-5.4	-5.1
WB6	*-5.5*	*-4.8*	*-6.9*	*-6.3*	*-5.8*	*-5.5*

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

Key Economic Indicators (continued)	2020	2021	2022e	2023f	2024f	2025f
External debt (percent of GDP)						
Albania	60.5	62.7	54.3	51.8	50.0	-
Bosnia and Herzegovina	69.7	62.4	60.5	60.0	59.1	57.4
Kosovo	37.2	37.4	38.0	-	-	-
North Macedonia	78.7	81.9	87.5	89.4	89.5	88.9
Montenegro	221.6	190.0	162.5	151.4	145.9	141.2
Serbia	65.8	68.4	67.9	64.3	61.1	59.7
WB6	*88.9*	*83.8*	*78.4*	*75.6*	*73.8*	*72.3*
Unemployment rate (period average, percent)						
Albania	11.7	11.5	11.0	-	-	-
Bosnia and Herzegovina	15.9	17.4	15.4	-	-	-
Kosovo	25.9	20.7	-	-	-	-
North Macedonia	16.4	15.7	14.4	13.7	13.6	13.5
Montenegro	17.9	16.7	14.7	-	-	-
Serbia	9.7	11.0	9.4	-	-	-
WB6	*16.3*	*15.5*	-	-	-	-

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

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