WORLD BANK GROUP

**WESTERN BALKANS** REGULAR ECONOMIC REPORT
No. 22 | Fall 2022

# Beyond the Crises

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Regular Economic Report No.22 | Fall 2022

# Beyond the Crises

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The cutoff date for the data used in this report was September 30, 2022.

## 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, Christos Kostopoulos, and Richard Record (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 (Growth section), Sanja Madžarević-Šujster, Joana Madjoska, Klea Ibrahimi (Labor section), Leonardo Lucchetti, Carlos Gustavo Ospino Hernandez, Anna Fruttero, Zurab Sajaia, Jonathan Karver (Poverty section), Milan Lakićević, Besart Myderrizi (Fiscal section), Hilda Shijaku, Isolina Rossi (Monetary section), Alper Oguz, Jane Hwang (Financial sector section), Sandra Hlivnjak, Tihomir Stučka (External section), Richard Record, Lazar Šestović, Collette Mari Wheeler, Philip George Kenworthy, Shijie Shi, Sinem Kilic Celik (Outlook section), Alper Oguz, Jane Hwang, Ismail Fontan, Vahe Vardanyan (Spotlight).

Research assistance was provided by Suzana Jukić. Diane Stamm provided assistance in editing, and Budy Wirasmo in typesetting. The cover image was created by Sanja Tanić.

The dissemination of the report and external and media relations are managed by an External Communications team comprised of Paul Clare, Sanja Tanić, Lundrim Aliu, Anita Božinovska, Ana Gjokutaj, Jasmina Hadžić, Gordana Filipovic, and Mirjana Popović.

The team is grateful to Xiaoqing Yu (Regional Director for the Western Balkans); Lalita Moorty (Regional Director, Equitable Growth, Finance and Institutions); Jasmin Chakeri (Practice Manager, Macroeconomics, Trade, and Investment Global Practice); and the Western Balkans Country Management team for their guidance in preparation of this report. The team is also thankful for comments on earlier drafts of this report received from the Ministries of Finance and Central Banks in Western Balkans countries.

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

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# Abbreviations

| | |
|---|---|
| CAD | current account deficit |
| CEE | Central and Eastern Europe |
| CESEE | Central, Eastern and Southeastern Europe |
| CIT | corporate income tax |
| CPI | Consumer Price Index |
| € | euro |
| EBA | European Central Bank |
| ECAPOV | Central Asia Regional Collection |
| ECB | European Central Bank |
| eop | end-of-period |
| EPS | Elektroprivreda Srbije (Serbia) |
| EU | European Union |
| FAO | Food and Agriculture Organization |
| FDI | foreign direct investment |
| FX | foreign exchange |
| GDP | gross domestic product |
| H1 | first half |
| ICT | information and communications technology |
| IMF | International Monetary Fund |
| KM | convertible mark; the monetary unit of Bosnia and Herzegovina |
| LFS | Labor Force Survey |
| lhs | left-hand scale |
| NBS | National Bank of Serbia |
| NPLs | nonperforming loans |
| PMI | Purchasing Managers Index |
| pp | percentage points |
| PPG | public and publicly guaranteed |
| PPP | purchasing power parity |
| Q1 | first quarter |
| rhs | right-hand scale |
| SILC | Survey of Income and Living Conditions |
| SMEs | small and medium-sized enterprises |
| SOEs | state-owned enterprises |
| UNCTAD | United Nations Conference on Trade and Development |
| VAT | value-added tax |
| y-o-y | year-over-year |

### *Country abbreviations*

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

# Beyond the Crises

# 1. Overview

**The economies of the Western Balkans continue to face a turbulent external environment, placing households, firms, and governments under acute stress.** Just as the post-COVID recovery of 2021 began to fade and the region returned to a normalized rate of economic growth, the Western Balkan region now faces a new combination of challenges. The war in Ukraine, and the resultant sharp increase and energy prices and slowdown in global growth, is weighing on economic performance in all six economies. Higher energy and food prices have pushed inflation to levels unseen for many years, eroding purchasing power and business confidence. Monetary tightening in advanced economies is pushing up financing costs and weakening external demand.

**Economic growth proved to be robust in the first half of 2022, above expectations.** Private consumption and investment were the key drivers of growth. Rising wages and remittances, together with increasing private credit, have supported private consumption. Investment was particularly strong in North Macedonia, Serbia, and in Bosnia and Herzegovina, partially as countries accumulated inventories to avoid supply chain bottlenecks and accelerated investment in the energy sector. Sustained export growth, especially in Kosovo together with Albania, Montenegro, and Serbia, has also acted as a key growth driver. However, growth momentum is beginning to slow in the face of mounting headwinds.

**Building on performance seen in 2021, employment levels reached historical highs in several countries by mid-2022.** The employment rate increased in all countries and now averages 46 percent, a 3-percentage point increase over mid-2021, although still low compared to the EU27. All sectors contributed to the job market recovery, with services (including tourism) playing an especially strong role. As a result, labor shortages have emerged as a key concern highlighted by businesses across the region. The unemployment rate in the Western Balkans declined to a historic low of 13.5 percent by mid-2022, equivalent to a decline in unemployment of 151,000 people. The broad-based recovery in the labor market has also benefitted vulnerable groups, with youth unemployment also seeing a notable decline to 27.1 percent, albeit from a high level. Similarly, labor force participation among women has increased to 53.0 percent by mid-2022 (up 2.6 percentage points) as women returned to the labor market. However, more recent data suggests that the labor market is beginning to cool with employment slowing amid high inflation and increased uncertainty.

**Poverty has continued to decline in 2022, but sharply higher inflation poses risks to poverty reduction going forward.** Poverty in the Western Balkans is expected to fall by approximately 1 percentage point in 2022, considering the good performance in the first half of 2022, and the anticipated slowdown. This is equivalent to bringing about 144,000 people out of poverty. At the same time, inflation, particularly for food and energy, is negatively affecting the less well-off relatively more than other income groups as they tend to spend more of their budget on these products and have fewer coping mechanisms to maintain purchasing power. In the absence of government support, the severity of the energy and food price shocks could result in a 13-percent increase in the number of the poor in the region, according to the World Bank simulation.

**Fiscal spending pressures following the energy and food price shocks have offset revenue buoyance brought by high inflation and halted fiscal consolidation.** The average fiscal deficit in 2022 is expected to increase by 0.4 percentage points as a share of GDP compared to in 2021. On the one hand, high inflation has helped to boost revenue in nominal terms, especially for indirect taxes such as VAT. But on the other hand, public expenditure has increased significantly as governments have been taking measures in response to rising inflation and the energy crisis. All Western Balkan countries have adopted policies to mitigate the impact of inflation on the most vulnerable households, but the fiscal impact of the energy price shock has been most significant in energy-importing Serbia, North Macedonia, and Kosovo. In some cases, losses incurred by energy utilities are creating significant contingent liabilities, increasing fiscal risks. In such an environment, public debt remains elevated in the Western Balkan economies, although nominal GDP growth is helping to bring debt burden indicators as a share of GDP moderately downwards. Public and publicly guaranteed debt is expected to decline to 52.7 percent of GDP in 2022, from 56.4 percent in 2021, but still above the pre-COVID peak, while financing conditions are tightening as global monetary policy attempts to tame the inflation shock. Yields on outstanding Eurobonds issued by Western Balkan countries widened noticeably in 2022, with some of them pushing close to as high as 10 percent.

**During 2022, inflation in the Western Balkans has soared due to a combination of supply- and demand-side factors.** Food and energy prices were already rising before the outbreak of war in Ukraine accelerated upward pressures. Inflation is now expected to remain in double digits for 2022 in all Western Balkan countries except for in Albania. Food inflation reached as much as 25 percent in Bosnia and Herzegovina, Montenegro, and North Macedonia. While commodity price increases have been the most significant drivers of inflation, price pressures are increasingly broad-based.

**Financial sector stability has been maintained, but a growth slowdown and higher inflation will inevitably test the financial sector.** Non-performing loans remain on a downwards trajectory (at 4.4 percent on average in March 2022) and the direct impact of the war in Ukraine on the region's banking sector has been limited. Capital buffers have held broadly stable, as has bank profitability. Loan growth has remained strong, averaging 10.2 percent year-on-year by mid-2022, helping to propel growth. However, tighter global financing conditions, a slowdown in both domestic and external demand, as well as weakening business and consumer confidence will surely impact the region's financial sector.

**The region's export boom has begun to slow, just as imports have sharply increased due to the higher cost of food and energy, widening current account deficits.** Deficits are widening in all countries of the Western Balkans, and in some cases such as Kosovo, Montenegro and Serbia have reached double digits. For the region, the current account deficit is expected to widen from 4.9 percent of GDP in 2021, to 8.7 percent of GDP in 2022. Exports, of both goods and services, have remained strong across the region, but the pace of growth has begun to slow. At the same time, import growth increased, largely determined by higher prices for imported food, electricity, oil and gas. Foreign direct investment flows, along with remittances, have remained resilient during the first half of 2022. However, the outlook for trade and investment is inevitably tied to the economic outlook for the region's primary trading partners which are among Europe's advanced economies.

**While growth in the first half of 2022 proved to be relatively robust, it is clear that the region is now heading into another storm.** A confluence of indirect supply and demand shocks are expected to weigh heavily on the region's outlook, keeping inflation high and dampening consumer and investor confidence. Financing conditions are tightening, the risks of a winter COVID-19 flare-up remain, and global supply chains continue to be stressed. Economic activity is also slowing sharply in advanced economies, especially in the Eurozone, which is a key source of demand for Western Balkans goods and services, and a source of investment and remittances. As a result, growth in the Western Balkans has been further revised downward for 2023 (by 0.3 percentage points) to 2.8 percent.

**In the short term, governments should prioritize policy support to the vulnerable, ensuring that measures are targeted and timebound to minimize fiscal risks.** With limited fiscal space, no-regret reforms that would boost medium-term growth at limited fiscal costs should be a priority for policymakers. This would include measures to increase the level of market competition, remove entry barriers to business, increase retention and reinvestment among foreign investors, reduce barriers to female labor force participation, improve the quality of education, and raise standards of governance, including digitalization. The ongoing crisis also underpins the importance of accelerating the green transition in the region away from volatile hydrocarbons toward cleaner electricity generation, as well as greener production, finance, and consumption patterns.

**The transition towards a low-carbon, environmentally sustainable economy is not only good for longer-term growth, but also as a response to the current crisis.** Such a transition requires significant investments. The financial sector has an important role to play in facilitating this transition. However, so far green finance has fallen short in terms of the required scale and scope, both globally and particularly in the Western Balkans. The Spotlight in this edition of the *Western Balkans Regular Economic Report* sheds some light on the agenda ahead of the region in order to green its financial sector.

**Table 1.1.** Western Balkans Outlook, 2019–2024

| | 2019 | 2020 | 2021 | 2022e | 2023f | 2024f |
|---|---|---|---|---|---|---|
| *Real GDP Growth* (percent) | | | | | | |
| Albania | 2.2 | -3.5 | 8.5 | 3.2 | 2.3 | 2.5 |
| Bosnia and Herzegovina | 2.8 | -3.1 | 7.5 | 4.0 | 2.8 | 3.2 |
| Kosovo | 4.8 | -5.3 | 10.5 | 3.1 | 3.7 | 4.2 |
| North Macedonia | 3.9 | -6.1 | 4.0 | 2.1 | 2.7 | 2.9 |
| Montenegro | 4.1 | -15.3 | 13.0 | 6.9 | 3.4 | 3.1 |
| Serbia | 4.3 | -0.9 | 7.4 | 3.2 | 2.7 | 2.8 |
| *WB6* | *3.7* | *-3.2* | *7.6* | *3.4* | *2.8* | *3.0* |
| *Real GDP Components Growth* (percent) | | | | | | |
| Consumption | 3.1 | -1.3 | 5.3 | 3.1 | 2.6 | 2.6 |
| Investment | 2.4 | -1.5 | 3.7 | 2.1 | 1.1 | 1.0 |
| Net exports | -1.6 | -0.4 | -1.3 | -1.9 | -0.9 | -0.6 |
| Exports | 3.7 | -5.9 | 9.9 | 4.8 | 3.2 | 3.2 |
| Imports (-) | 5.4 | -5.4 | 11.2 | 6.8 | 4.1 | 3.8 |
| Consumer Price Inflation (percent, period average) | 1.5 | 0.9 | 3.3 | 10.9 | 6.4 | 3.0 |
| *External Sector* (percent of GDP) | | | | | | |
| Goods exports | 28.5 | 27.6 | 31.8 | 32.6 | 32.7 | 33.1 |
| Trade balance | -13.6 | -13.6 | -12.7 | -15.5 | -15.0 | -13.5 |
| Current account balance | -6.1 | -5.6 | -4.9 | -8.7 | -8.3 | -7.1 |
| Foreign direct investment | 4.9 | 5.3 | 5.8 | 5.2 | 5.3 | 5.1 |
| External debt | 76.7 | 89.8 | 88.4 | 83.9 | 81.5 | 79.3 |
| *Public Sector* (percent of GDP) | | | | | | |
| Public revenues | 35.5 | 34.9 | 36.3 | 35.4 | 35.3 | 35.4 |
| Public expenditures | 36.9 | 42.7 | 39.2 | 38.7 | 38.1 | 37.6 |
| Fiscal balance | -1.3 | -7.9 | -2.9 | -3.3 | -2.8 | -2.2 |
| Public and publicly guaranteed debt | 50.3 | 60.8 | 56.4 | 52.7 | 52.7 | 52.9 |

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

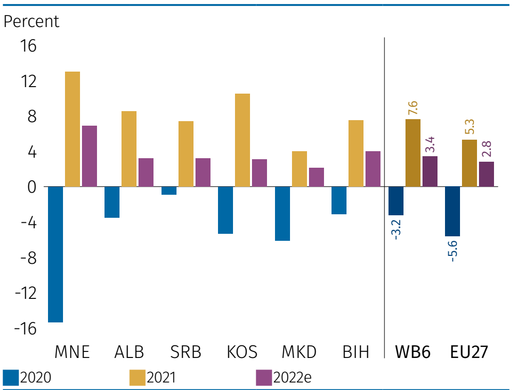
# 2. Global headwinds weigh on the recovery

**Following a strong rebound in 2021, growth, although still robust, was on a decelerating path in the first half of 2022.** In Q1 of 2022, the Western Balkan economies remained resilient overall, supported by sizable policy actions at the EU, euro area, and national levels. First-quarter growth was particularly strong in tourism-based economies and in Serbia. However, growth decelerated in Q2, as countries had to deal with the direct consequences of the war and is projected to continue decelerating in the second half of the year reflecting higher base levels of growth in Q3 and Q4 2021 and the stronger global headwinds.

**Rising prices, monetary policy tightening, and supply-side constraints have created headwinds to a stronger recovery.** With average inflation surpassing 13 percent in the Western Balkan region in July 2022, consumers and firms have been faced with rising costs and reduced purchasing power. As a response, central banks in the region have stepped up efforts to control inflation and tame inflationary expectations by raising policy rates. In the current environment, however, these important actions, taken at a time when the recovery is losing strength, and when the economies are facing supply-side constraints including labor shortages, have contributed to the significant headwinds. Overall, growth in the region is expected to reach 3.4 percent in 2022, 0.6 pp above the average growth expected in the EU (Figure 2.1).

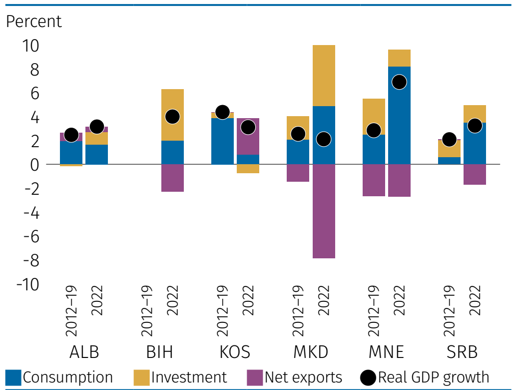
**Private consumption and investment were the key drivers of growth in the first half 2022.** Both business and consumer confidence remained strong, and despite increasing energy and food prices, consumption contributed significantly to growth in the first half of the year (Figure 2.2). Rising wages and remittances, together with increasing private credit, have supported private consumption. Investment was particularly strong in Bosnia and Herzegovina where it has been mostly driven by infrastructure works and private

**Figure 2.1.** Real GDP growth started to decelerate but is projected at 3.4 percent for the year...




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

**Figure 2.2.** ...as consumption and investment remain strong in most countries.




*Source:* National statistical offices; World Bank staff estimates.
*Note:* Factor contributions to real GDP growth.

investment, as well as North Macedonia and Serbia but mostly due to the rise in inventories. In contrast, in Kosovo, a slowdown in private investment amid higher construction input prices and a low capital execution rate in the public sector is expected to lead to a negative contribution of investment to growth for 2022.

**With investment playing a key role in economic growth, the recovery seems structurally different from past experience and bodes well for the region despite the global headwinds.** Compared to the years after the 2008-09 global financial crisis, between 2012 and 2019, when low investment contributed on average 1 percentage point (pp) to GDP growth, the contribution of investment to growth has been significantly higher in 2021 and 2022, at 3.7 and 2.1 pp, respectively (Figure 2.2). While total investment is playing a stronger role in this post-COVID-19 recovery, the composition of investment is slow to change as most businesses seem to still be behind on the digital and green investment agenda (Box 2.1). In all Western Balkan countries, the higher costs of energy and materials are expected to weigh on private investment going forward, leading to a potential delay in the execution of planned investment, and overall muted contributions of investment to growth.

**Box 2.1.** What are firms struggling with in the Western Balkans region?

**Several challenges constrain business growth, reflected in low productivity growth in the region.** Challenges include access to finance, anti-competitive practices of competitors, lack of or expensive technology, and lack of skills (Figure 2.3). While access to finance has always been reported as a significant challenge in the region, the other growth constraints have become particularly acute in the recovery phase, with shortages of key inputs such as technology and skills becoming more severe, and still high regulatory barriers to entry and conduct, and weak competition policies unaddressed.

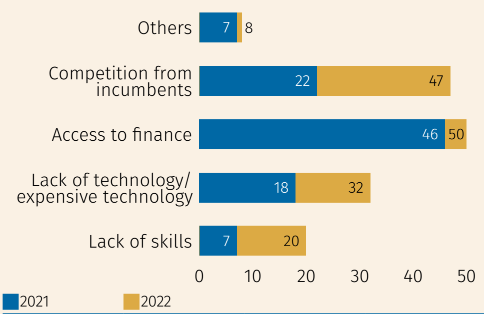
**Contrary to isolationist trends, economic integration emerges as a way ahead.** The quality of regional cooperation is deemed important or very important by the majority of businesses within the region, with the majority of businesses confirming the benefits received from the regional free trade agreement (the 2006 Central European Free Trade Agreement). Businesses in the Western Balkans also continue to believe in the benefits of EU accession, even though they have become less optimistic regarding timelines, implementation, and competitiveness vis-à-vis other EU countries.

**Overall confidence remains well below pre-pandemic levels, with old and new challenges ahead.** Despite the significant jump in 2021, overall confidence remains below the pre-pandemic level in four of the six Western Balkan countries, while for Albania and Kosovo, general confidence has returned to previous highs. However, firms report that economic development, unemployment, corruption, and emigration remain the top concerns in the region. In addition, new challenges lie ahead. With the green transition likely to pick up

*(Box 2.1 continued)*

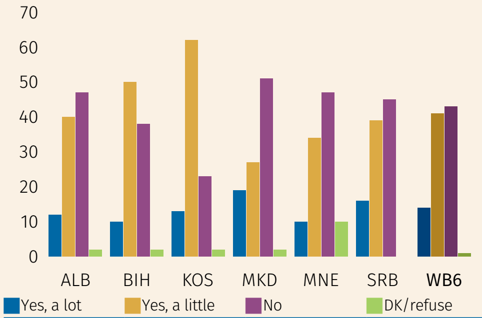
speed in the next few years, most businesses would need to step up their efforts to adjust their operations toward more environmentally friendly operations and investments. As of now, however, the majority have taken no or only minor steps (Figure 2.4).

**Figure 2.3.** Anti-competitive practices of competitors and access to technology are reported as major growth constraints for businesses in the recovery.




*Source:* The 2022 Balkan Business Barometer survey was conducted during mid-February to mid-March 2022 in Albania, Bosnia and Herzegovina, Kosovo, Montenegro, North Macedonia, and Serbia. The Business Opinion survey presented 177 questions to 1203 business owners, managers, or executives. More info is available at: Balkan Barometer | Welcome (rcc.int).
*Note:* Major constraints faced when trying to scale up, as reported by businesses.

**Figure 2.4.** Few Western Balkan firms report being environmentally friendly.




*Source:* Balkan Business Barometer 2022.
*Note:* Share of businesses that reported taking steps to reduce their environmental impact, such as reducing energy consumption, waste reduction or switching to recycled/ sustainable materials.

**Albania, Kosovo, Montenegro, and Serbia, stand out for their export growth.** Exports in Kosovo, particularly for manufactured goods, increased by 29.4 percent y-o-y through July. Diaspora-driven service exports also increased significantly, and travel data suggest that positive momentum continued during the summer season in tourism-led economies, like Albania and Montenegro. In Montenegro, growth of exports outpaced that of imports, supported not only by further tourism recovery but also by higher metal and electricity prices.

**On the production side, services have been the engine of the recovery.** Both industry and construction have struggled in the region, owing in part to rising energy and materials costs; the exception have been construction in Albania and industry in Serbia, which remained important for growth. The contribution of agriculture to the region's economies was modest or negative, due to the rise of input prices and unfavorable climate conditions. All economic sectors were strongly affected by labor market tightening. This applies especially to tourism, but also to other sectors, such as information and communication technology and agriculture. In Albania, a new wave of emigration among Albania's youth is one of the main causes of labor shortages.

# 3. Labor market recovery hit by a new storm[1]

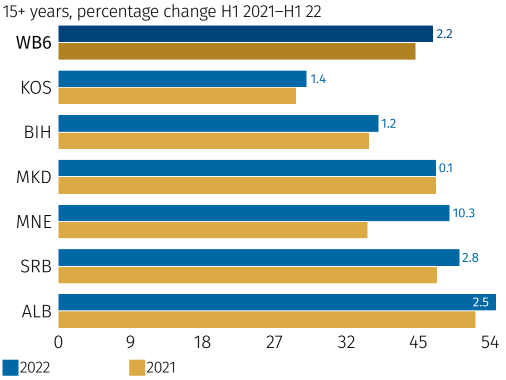
**The region's labor market recovered quickly and by mid-2022, employment levels reached historical highs in several countries.** The growth recovery which began in 2021, led by demand for transport, trade, and tourism workers, and included a booming ICT industry, brought employment to new highs, surpassing pre-crisis levels. Between mid-2021 and mid-2022, around 170,000 jobs were created in the region, of which Serbia had the strongest gains. This was followed by Kosovo, where the Pensions Savings Trust reported that the number of active pension contributors increased by 16 percent in Q2 2022 (y-o-y), equivalent to about 50,000 jobs being added or formalized. The average annual employment growth for the region was 2.7 percent since mid-2021.

**The employment rate increased in all countries and the average for the Western Balkans reached a historical high of 46 percent in June 2022.[2]** Although still low when compared to 61 percent of the EU27, due to a spectrum of structural constraints,[3] this is an increase by over 3 pp since mid-2021 underscoring the magnitude of the recovery. In Albania, the employment rate surpassed 55 percent, while the largest increase in the employment rate was recorded in Montenegro (Figure 3.1). In Kosovo, despite recent gains, only 31.7 percent of the working-age population is employed. North Macedonia observed the smallest increase in the annual employment rate.

**In fact, in 2022, labor shortages emerged as a key concern raised by businesses** (Box 3.1). Similar to advanced economies in Europe, the

**Figure 3.1.** The employment rate reached a historical high in the Western Balkans...

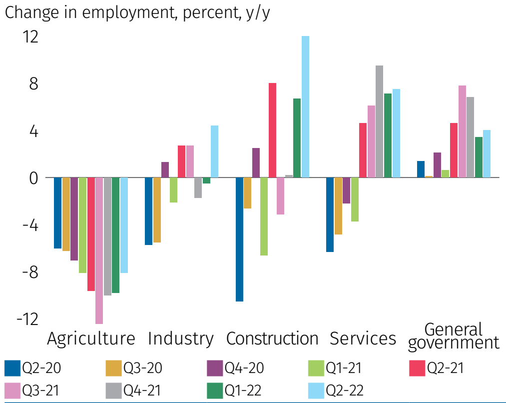
15+ years, percentage change H1 2021–H1 22




*Source:* National statistics offices; World Bank staff estimates.

**Figure 3.2.** ...with services and construction having the highest job creation rates.

Change in employment, percent, y/y




*Source:* National statistics offices; 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 employment, pension insurance, and unemployment data for Kosovo helped provide an approximate picture of the labor market in 2022.

2 The employment rate is the region's simple average.

3 See for example for North Macedonia (https://documents.worldbank.org/en/publication/documents-reports/documentdetail/809991603810854005/republic-of-north-macedonia-action-plan-for-recovery-of-growth-and-jobs) or Montenegro (https://documents.worldbank.org/en/publication/documents-reports/documentdetail/787451545030793133/montenegro-growth-and-jobs).

post-COVID growth recovery has resulted in a sharp increase in unfilled vacancies, and a widening of the skills mismatches that firms in the region have reported for some time. Some of the countries of the Western Balkans—Albania, North Macedonia, and Serbia—are looking at liberalizing the work permit regimes to enable cross-border labor mobility.

**All sectors except agriculture contributed to the job market recovery** (Figure 3.2). During the summer, a rebounding tourism sector boosted employment, followed by a rise in trade, ICT, as well as transport. The construction sector also observed an increase in employment across countries, except in North Macedonia. Employment in agriculture continued to shrink, except in Albania and Bosnia and Herzegovina.

**However, more recent data suggests signs that the labor market is cooling, as the effects of the energy crisis are more widely felt.** North Macedonia and Serbia observed a slowdown in employment growth in industry already from Q1 2022 showing signs of the impact of the global energy crisis on their export industries. Services show strong resilience and growth in the post-pandemic period.

**Box 3.1.** Employment prospects improved but multiple challenges remain.

**After experiencing the sharpest fall in 2020, public and business expectations regarding employment and economic opportunities have improved.** In 2022, the Balkan Barometer expectation index for the Western Balkans increased for both firms and citizens but is still below 2019 except for in Albania and Kosovo. In addition, most firms expect to either keep the same workforce or increase employment levels in the next 12 months. Around 60 percent of firms in the Western Balkans expect that their workforce will remain unchanged; an outlier is Kosovo where around 78 percent of firms expect to increase the number of people employed (Figure 3.3).

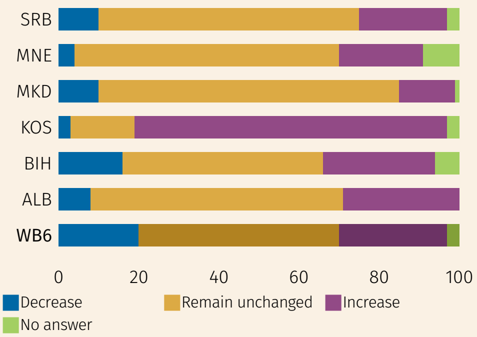
**Yet, even though firms' expectations have improved, they still face significant challenges related to staff availability and behavioral changes** (Figure 3.4). More than 43 percent of firms in the region have issues finding the right staff and 36 percent suffer staff behavioral changes (such as low productivity and absence) due to the pandemic. In Albania and Kosovo, the problem is more pronounced, with over half of firms dealing with these issues. Only Montenegro is an exception, where just 10 percent of firms report problems with the staff availability.

**Unable to fill vacancies domestically, firms reported a preference for hiring more foreign workers.** More than 42 percent of firms in Montenegro and 74 percent of firms in Albania report a preference to employ workers from abroad; and half of the firms in the region are open to hiring workers from other countries of the region. Firms in North Macedonia are the least interested in hiring workers from abroad (Figure 3.5).

*(Box 3.1 continued)*

**Figure 3.3.** Employment prospects are solid in the Western Balkans...

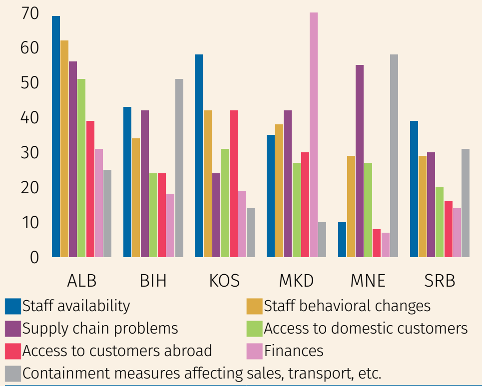
Percent of firm respondents




*Source:* Balkan Business Barometer 2022 survey.

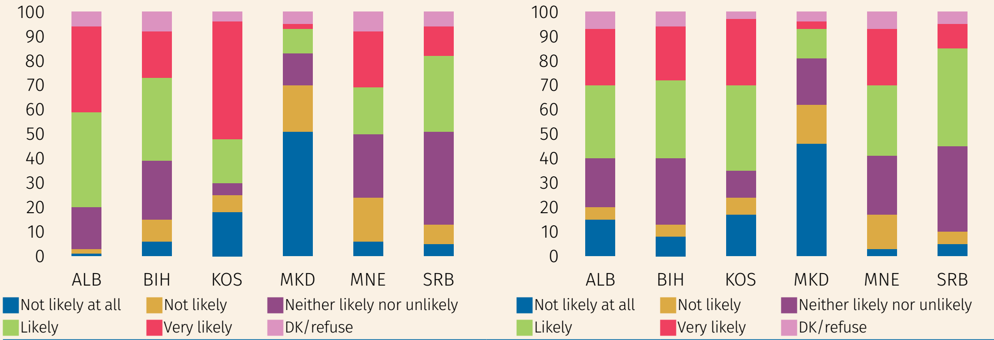
**Figure 3.4.** ...but post-pandemic labor market challenges loom, including increased labor shortages.

Problems affecting firms due to COVID-19, percent of respondents




*Source:* Balkan Business Barometer 2022 survey.

**Figure 3.5.** Regional labor market is gaining importance...




*Source:* Balkan Business Barometer 2022 survey.

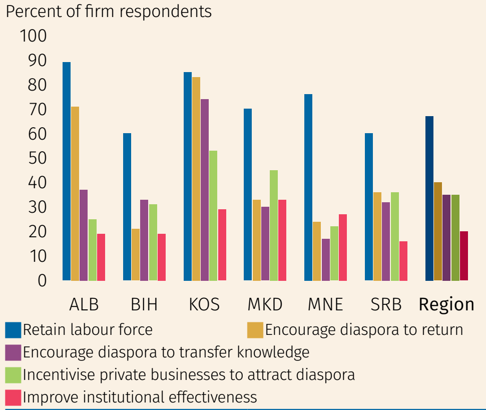
**While firms report labor force shortages, some 39 percent of Western Balkan citizens are considering leaving and working abroad.** Thirty percent of the respondents who are thinking of leaving are actively taking steps to inform themselves about new opportunities, reviewing and applying to vacancies. In addition, five percent are in the process of leaving and will leave soon. There is a strong preference to migrate towards EU countries and less to the countries in the region. Almost 80 percent express that they would not consider migrating to other Western Balkan countries, even if their academic and professional qualifications were recognized and valued. This contrasts with firms' attitude to being more open to hiring workers from within the region.

**Although wage differentials with the destination markets for migrants from the Western Balkans may explain some of the differences between the firms' and workers' sentiments, strengthening the education system and offering better job opportunities might help**

*(Box 3.1 continued)*

**with retaining the workforce and decrease the brain drain** (Figure 3.6). Almost 30 percent of workers feel that the education system failed to provide the adequate skills that their job needs and 62 percent express that they are not learning new skills or advancing their skills. However, more than half of the respondents expressed that they would be ready to improve and get additional qualifications to get a job. From the firm side, more can be done to offer training opportunities for their workers. Forty-five percent of firms responded that they do not regularly review the skills and training needs of individual employees, and only 21 percent of firms do. Further, policies to encourage the diaspora to either return home or contribute with their know-how should be encouraged, along with improving education system effectiveness.

**Figure 3.6.** ...but further measures are needed to to curb the problem of labour force shortages and brain drain.




*Source:* Balkan Business Barometer 2022 survey.

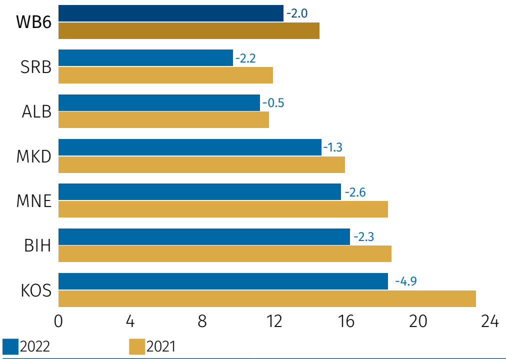
**Unemployment fell in five Western Balkan countries, resulting in an annual decline in unemployment of 151,000 people by June 2022.** The unemployment rate in the Western Balkans declined by 2.2 pp to 13.5 percent in mid-2022 as more people found employment (Figure 3.7). This reflects a broad-based decline in all countries, with Serbia reaching its pre-crisis low of 8.9 percent. The unemployment rate in Bosnia and Herzegovina and Kosovo also dropped significantly, by 2.3 pp and 4.3 pp, respectively, compared to a year ago, although remained the highest in the region at 15.7 and 16.2 percent, respectively. In Montenegro, the late start of the tourism recovery will likely lead to reduction in unemployment in the second half of the year. A similar pattern is expected in Albania, which also had a successful summer tourism season. North Macedonia observed a continued decline in the unemployment rate but largely on account of a decline in the activity rate—its unemployment rate fell to 14.5 percent in mid-2022, the lowest on record.

**The broad-based recovery in the labor market has also benefitted vulnerable groups.** Youth unemployment declined to 27.1 percent in mid-2022, the lowest on record, and down by 5.5 pp y-o-y. Around 30,000 young people were moved out of unemployment over the year, with the largest improvements recorded in Serbia and Bosnia and Herzegovina, accounting for two-thirds of this success. Serbia now has the lowest youth unemployment rate in the region—at 18.7 percent—while, despite improvements, the youth unemployment rate in Bosnia and Herzegovina is the largest in the region—at above 36 percent.

**In parallel with increased employment, the labor force participation rate also**

**Figure 3.7.** Unemployment rate declined in all countries.

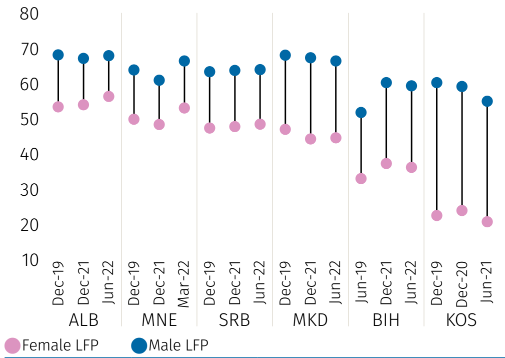
Unemployment rate, 15+ years, percent, and H1 2021–H1 22 change, percentage points




*Source:* National statistics offices; World Bank staff estimates.

**Figure 3.8.** More women returned to labor market than men in 2022.

Labor force participation, percentage change, latest 2022–2021




*Source:* National statistics offices; World Bank staff estimates.
*Note:* LFP stands for labor force participation.

**rose due to the relatively larger number of women returning to the labor market.** The participation rate increased to 53 percent for the region, up 2.6 pp compared to mid-2021. While the participation rate of women is still lagging that of men, at mid-2022, the female participation rate stood at 43.1 percent (compared to men of 63.1 percent), an increase of 0.6 pp from end-2021 (Figure 3.8). In Bosnia and Herzegovina, however, the female participation rate declined to 36.1 percent in June 2022. The largest improvement was in Montenegro (4.7 pp) as the tourism sector recovered, but the female labor force participation rate is still the highest in Albania at 56.3 percent (another record).

**However, the recovery of the labor market is likely to slow later in 2022 and into 2023.** Labor shortages and high inflation in the Western Balkans have created wage pressures, which may slow the pace of hiring by firms. The region's economies are announcing increases in the minimum wages to offset the real income decline due to inflation. However, recent evidence suggests that wage growth in the region has been outpacing productivity growth, putting competitiveness at risk (Box 3.2). As firms try to offset the impact of increased labor costs (amidst pressures from other input prices, including energy), defensive restructuring, like furloughs, can take place, as is already happening in the car supply industry. The prolonged crisis will likely hurt the industry even more as demand from EU countries declines amidst recessionary developments. Weakened corporate balance sheets after multiple crises could lead to a deterioration of the labor market trends from late 2022 and into 2023.

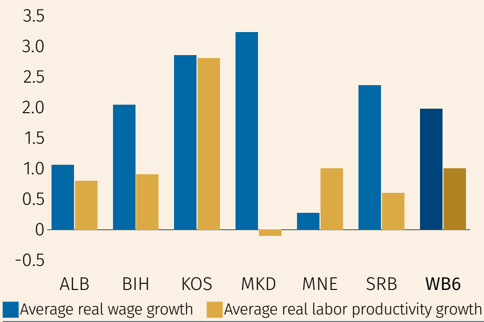
## **Box 3.2.** Wages and productivity in the Western Balkans: call for reforms.

**Sluggish productivity growth evidenced in the aftermath of the global financial crisis was pronounced in the Western Balkans.** Most of the slowdown in labor productivity in the Western Balkans came from reduced total factor productivity growth, along with subdued investments.[4] At the same time, despite considerable underreporting of wages and high informality, wage growth surpassed productivity growth across the region in the run-up to the COVID-19 crisis, contrasting trends observed for the EU27.[5]

**Even with low levels of productivity[6], real gross wages noted steady growth before the crisis in all the economies of the Western Balkans.** During 2015–19, the gap between productivity and wage growth was most pronounced for North Macedonia, where minimum wage hikes and public sector pay rises spurred wages while average productivity growth went negative. In the same period, wages increased less than productivity in Montenegro which has the highest wage level in the Western Balkans. The wage–productivity differential for the region reveals that wages grew nearly twice as fast as productivity (Figure 3.9).

**Figure 3.9.** Wages grew twice as fast as productivity before the pandemic...

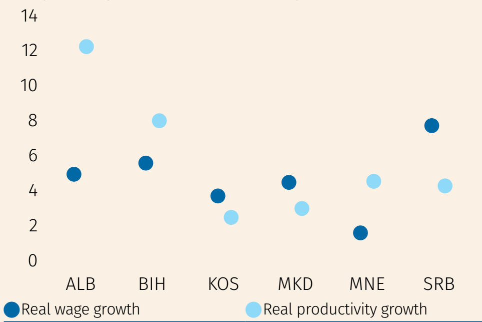
Real gross wage and labor productivity growth (2015–2019)




*Source:* Eurostat, national statistical offices, World Bank staff calculations.

**Figure 3.10.** ...with productivity gaining strength from 2021.

Real gross wage and labor productivity growth, 2021




*Source:* Eurostat, national statistical offices, World Bank staff calculations.

**Post-pandemic, labor productivity picked up and outstripped wage increases in some Western Balkan countries** (Figure 3.10). The outbreak of the global pandemic in 2020 led to a region-wide drop in productivity of 6 percent, while the trend of rising wages continued undeterred by the severe contraction in economic activity. A surge in productivity growth in 2021 exceeded growth in wages for some of the countries in the region (Albania, Bosnia and Herzegovina and Montenegro). However, for North Macedonia, Kosovo, and Serbia, even in the first year after the emergence of the pandemic, the wages and productivity growth divide continued.

4 Dieppe, Alistair. 2021. Global Productivity: Trends, Drivers, and Policies. Washington, DC: World Bank.
5 ILO 2021. Global wage report 2020-21: Factsheet for the European Union.
6 Labor productivity is calculated as gross value added divided by total employment.

*(Box 3.2 continued)*

**With productivity below the EU average[7] and wages racing ahead, Western Balkan economies face a challenging roadmap to narrow income gaps with advanced economies.** Repeated adverse shocks (epidemics, wars, financial crises) undermined productivity and hindered years of progress towards income convergence. Going forward, wage sprints amidst low productivity may dim external competitiveness and hamper private investment. With new crises looming on the horizon, sustained commitment to a strong reform agenda tackling education shortcomings, persistent informality, feeble investment, infrastructure gaps, weak governance, misallocation of resources, and lack of economic diversification can boost productivity and accelerate the convergence.

7 OECD 2021. Multi-dimensional analysis of development in the Western Balkans.

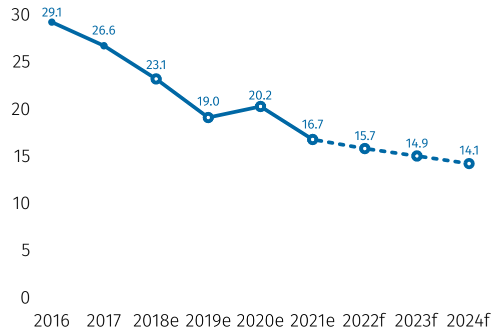
# 4. Significant headwinds could hamper poverty reduction in 2022–23

**Owing to a broad-based growth recovery, poverty is estimated to have resumed its decline in 2021.** Before COVID-19 hit in 2020, the region had made significant progress in reducing poverty, based on the upper middle-income class poverty line of US$6.85/ day in 2017 Purchasing Power Parity (Figure 4.1).[8] Between 2016 and 2019, the poverty rate is estimated to have dropped by about 10 pp to approximately 19 percent. Improvements in well-being came to a halt when the pandemic-induced crisis pushed all six economies into a recession in 2020. As a result, poverty is estimated to have increased by over 1 pp, equivalent to roughly 155,000 new poor that year. As economies in the region experienced a robust economic recovery in 2021, poverty is estimated to have decreased by 3.5 pp, equivalent to lifting an estimated 547,000 people out of poverty.

**Poverty is projected to moderately decline in 2022, although many challenges pose risks to poverty reduction going forward** (Table 4.1). Just as the region was beginning to recover in 2021, the energy crisis and the war in Ukraine cut short the recovery and generated additional inflationary pressures. First, the war in Ukraine could negatively affect the economic recovery of the EU and could also reduce the demand for exports from the Western Balkan countries and thus affect jobs in such industries. Second, the slower economic recovery in the EU could affect the non-labor income of Western Balkan households by limiting remittances from the diaspora. Finally, tighter fiscal space creates challenges in implementing government support measures to protect household incomes.

**Figure 4.1.** Poverty likely decreased in 2021, but the region is experiencing significant challenges for poverty reduction going forward.

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




*Source:* World Bank estimates and projections based on 2018 income data from the Survey of Income and Living Conditions (SILC) for Montenegro; 2019 for Albania, North Macedonia, and 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 LCU, e = estimate, f = forecast.

**Given slower economic growth in 2022, poverty in the region is projected to fall by approximately 1 percentage point, equivalent to about 144,000 people.** In Albania, according to baseline projections, poverty is projected to fall further in 2022 by 2 percentage points. However, persistent inflationary pressures could severely reduce real income growth especially among poor and

8 Poverty data are now expressed in 2017 PPP prices, versus 2011 PPP used in previous editions. As price levels across the world evolve, global poverty lines must be periodically updated to reflect the increase of the value of the lines in nominal terms. The new global poverty lines of US$2.15, US$3.65, and US$6.85 reflect the typical national poverty lines of low income, lower middle-income, and upper middle-income countries in 2017 prices.

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

| Year | Poverty estimates and projections (%) | | | | |
|---|---|---|---|---|---|
| | ALB | KOS | MKD | MNE | SRB |
| 2017 | 37.3 | 34.2 | 23.1 | 17.8 | 22.1 |
| 2018 | 34.2 | 32.3 | 20.8 | 18.5 | 17.3 |
| 2019 | 29.6 | 28.9 | 19.1 | 17.9 | 12.1 |
| 2020 | 31.6 | 32.4 | 20.8 | 20.0 | 12.2 |
| 2021 | 25.4 | 26.4 | 16.1 | 18.0 | 10.5 |
| 2022 | 23.4 | 25.0 | 15.9 | 17.1 | 9.9 |
| 2023 | 22.3 | 23.3 | 15.4 | 16.7 | 9.3 |
| 2024 | 21.0 | 21.6 | 14.9 | 16.3 | 8.8 |

*Source:* Calculations based on ECAPOV (ECA Poverty database) harmonization using SILC-C data for Albania (ALB), North Macedonia (MKD), Montenegro (MNE), and Serbia (SRB), and HBS data for Kosovo (KOS).
*Note:* Black=Actual. Orange=Nowcasted/projected. Income measures in the SILC and consumption measures in the HBS are not comparable. Poverty is defined as living on less than US$6.85 per day per person in revised 2017 PPPs. Bosnia and Herzegovina is excluded due to lack of comparable data.

vulnerable households and dampen poverty reduction. In Bosnia and Herzegovina, lower growth in the EU could affect the non-labor income of households by limiting remittances, on which the country is particularly dependent. In Kosovo, the strong 2021 recovery is estimated to have reduced poverty by 6 pp below its 2020 level. In 2022, although poverty is expected to further decline to 25 percent, downside risks related to food and energy prices could hit Kosovo especially hard as it is a net importer of both—if diaspora travel remittances and wages fall behind inflation, real incomes could be significantly reduced, and poverty might not fall as projected. In North Macedonia, partially because of government programs and partially because of a strong labor market rebound, poverty is estimated to have resumed its decline in 2021 and continued into 2022; yet, inflation creates challenges for poverty reduction in 2022. The tax reform in Montenegro contributed to growth in disposable incomes, but the adverse impact of surging inflation is estimated to greatly slow further poverty reduction. In Serbia, while employment continued to grow, and nominal wages increased, rising food and energy prices, together with phasing out of government support programs are expected to raise the cost of living and weaken the gains from economic growth leading to a much slower projected poverty reduction in 2022.

**The increase in prices is now expected to be long-lasting in some countries in the region.** According to the 2022 Balkan Barometer perception survey, approximately 79 percent of citizens in the region are mostly unsatisfied or completely dissatisfied with the price level in 2022, compared to 55 percent in 2021.[9] Inflation, particularly in food and energy prices, affects the less well-off relatively more than higher income groups as the less fortunate tend to spend more of their budget on food and energy and have fewer coping mechanisms to maintain purchasing power.[10]

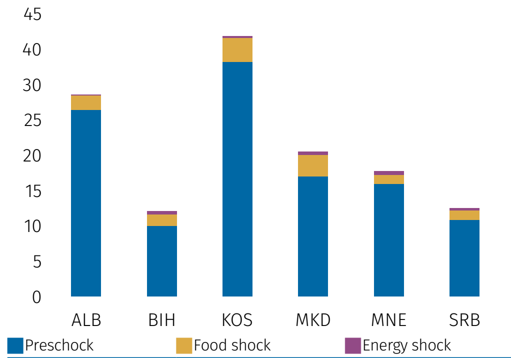
**The substantial increases in food prices represent a major concern for the welfare of**

9 Balkan Barometer | Welcome (rcc.int).
10 World Bank: Western Balkans Regular Economic Report #20 and #21.

**households in the region, particularly those at the lower end of the income distribution scale, which have fewer means to offset these increases.** By July 2022, food prices in the Western Balkan countries had increased by 21.3 percent compared to July 2021 (the increase varied between 13.9 and 25.5 percent among countries, Table 4.2). The effects of food price increases are disproportionally greater for the less well-off: the share of food expenditure for the first decile ranges from approximately 68 percent in North Macedonia to 34 percent in Bosnia and Herzegovina, while the share of food expenditure for the top decile stood at 46 percent in Kosovo to 23 percent in Montenegro. In the absence of any government response measures, the increase of food prices would significantly increase the estimated poverty rate (by upper middle-income standards)[11] ranging from 1.5 pp in Montenegro to 3.8 pp in Kosovo, according to the Bank simulations[12] (Figure 4.2).

**Figure 4.2.** Food and energy inflation would push a large share of vulnerable people into poverty in the absence of government support measures.

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




*Source:* World Bank staff simulations based on most recent surveys: 2019 income data from the SILC for Albania, North Macedonia, and Serbia; 2018 Montenegro; 2017 for Kosovo; and 2015 HBS in BiH.
*Note:* Preshock refers to actual or nowcasted poverty estimates in 2019 based on real GDP per capita growth. Except for BiH, welfare is estimated in U.S. dollars using 2017 PPPs in all countries. Poverty in BiH is based on a KM 205 per capita monthly threshold and the per capita welfare measure is reduced to 2007 prices. Therefore, the poverty rate in BiH is not strictly comparable with the rest of the countries. “Preshock” refers to poverty rates before shocks (food and energy prices increases), “Food Shock” refers to a simulated increase in poverty rates after food price increases; and “Energy Shock” refers to the simulated poverty rate increase after energy price increases. The figure does not assume government support. Shocks are actual food and energy price increases y-o-y in July 2022. The magnitude of the shock is described in Box 4.1.

**Energy prices have also surged in the region, though they have not increased as much as food prices.** The average annual increase in the price of energy for the region for July 2022 was 13.1 percent (Table 4.2). Importantly, the increase does not reflect the full effect of energy price increases in the global market as governments have cushioned the impact of these increases on their citizens through fiscal outlays. The increases in energy prices have ranged from 4.5 percent in Albania to 18.2 percent in Bosnia and Herzegovina. The share of the household budget spent on energy is smaller and more evenly distributed than the share of the budget spent on food. For the bottom decile, it ranges from 15 percent in Albania to 7 percent in Kosovo; for the top decile, from 19 percent in North Macedonia to 6 percent in Albania. Hence, the impact of energy price increases on poverty is also expected to be smaller and less regressive. Yet, higher energy prices could contribute to increases in poverty by more than a half percentage point in some of the Western Balkan countries (not accounting for government support).

**Higher food and energy prices are expected to negatively affect welfare along the entire distribution in all six countries.** The estimated price incidence curve (Figure 4.3) depicts the percentage reduction in welfare at each percentile of the distribution ranked by welfare

11 Because comparable data are lacking, poverty in Bosnia and Herzegovina is based on a KM 205 monthly threshold.

12 The results of the simulation should be interpreted as changes from a counterfactual welfare distribution, which has not been affected by high inflation or the COVID-19 pandemic, to a simulated distribution affected by a significant inflationary shock. The counterfactual year chosen is 2019, therefore the simulation uses the latest available data nowcasted up to that year.

**Box 4.1.** Simulating food and energy price shocks.

**A distributional analysis of the welfare impact of rising food and energy prices and of government response measures was carried out for the six Western Balkan economies.**[13] We estimate the change in the overall consumption surplus in response to the y-o-y food and energy price increases as of July 2022 and assuming an elasticity of -0.25[14]. The impact of higher food and energy prices is assessed separately, and the joint effect is the sum of both impacts.

**To assess the impact of higher prices on consumption, the analysis uses the latest harmonized Household Budget Survey (HBS) in each country, which provides granular information on consumption items.** To measure the impact on internationally comparable income poverty rates and to model the mitigating effect of government transfers, the analysis uses the latest available EU Survey of Income and Living Conditions (SILC), which reports household income (including government transfers). To assess the combined effect of the two channels, we assume that the percentage change in welfare of each percentile is equal in the HBS and the SILC. Poverty is based on per capita household income in Albania, Kosovo, North Macedonia, Serbia, and Montenegro and on per capita household consumption in BiH. To simulate the impact of higher prices, poverty estimates are nowcasted in 2019 based on real GDP per capita growth. Table 4.2 shows all relevant parameters and data sources used in the simulations.

**Table 4.2.** Simulation parameters and data sources.

| Country | Average | ALB | BIH | KOS | MNE | MKD | SRB |
|---|---|---|---|---|---|---|---|
| Household Budget Survey year | | 2018 | 2015 | 2017 | 2015 | 2019 | 2019 |
| Income data from EU SILC-C year | | 2019 | N/A | 2017 | 2018 | 2019 | 2019 |
| Food price increase (%, July 2022, y-o-y) | 21.9 | 13.9 | 25.5 | 22.1 | 25.4 | 24.3 | 20.3 |
| Energy price increase (%, July 2022, y-o-y) | 13.1 | 4.5 | 18.2 | 15.3 | 15.7 | 15.8 | 9.1 |

per person due to rising food and energy prices combined. The average impacts measured in terms of welfare losses are substantial, ranging from -4.9 percent in Albania to -10.2 percent in North Macedonia. Behind these averages, the effects are markedly regressive in all countries; they range from a decline between 13.2 and 5.7 percent in the poorest decile to 7.8 and 4.5 percent in the top decile of the distribution. The share of people who are not beneficiaries of social transfer programs, but are a vulnerable group without any kind of support who are simulated to become poor due to higher food and energy prices—ranges from approximately 76 percent in Albania to over 94 percent in North Macedonia and Kosovo.

13 Based on Ferreira, F., A. Fruttero, P. Leite, and L. Lucchetti. 2013. "Rising Food Prices and Household Welfare: Evidence from Brazil in 2008." *Journal of Agricultural Economics*. 64 (1), 151-176. and R. Laderchi, C., Olivier, A., and Trimble, C. 2013. "Balancing act: Cutting energy subsidies while protecting affordability." Europe and Central Asia Reports No. 76820, Washington, DC: The World Bank.

14 The simulations only account households as consumers, and thus hurt by increases in the prices of the commodities they consume. They do not account for them as producers, who may benefit from increases in the prices of the commodities they produce.

**Figure 4.3.** Household welfare is expected to fall along the welfare distribution.

Simulations of income loss due to price shocks, percent


*Source:* World Bank simulations based on most recent surveys as in Figure 4.2.
*Note:* Welfare is estimated in U.S. dollars using 2017 PPPs. Income measures in the SILC and consumption measures in the HBS are not strictly comparable. The figure shows the simulated welfare percentage changes after the combined food and energy price increases. The graph does not assume government support. Shocks are actual food and energy price increases y-o-y in July 2022. The magnitude of the shock is described in Box 4.1.

**All countries have social transfer programs that can be used as a tool to mitigate the impact of shocks, but their effectiveness depends on the coverage and generosity of the program and the specific size and regressivity of the shock.** The impact of the energy and food price shocks on the number of poor is estimated to vary substantially across the region. Our simulations result in a 13-percent increase in the number of poor in the region, with the highest increase of about 21 percent in Bosnia and Herzegovina and North Macedonia, to the lowest of 8.4 percent in Albania (Table 4.3). Social transfer program[15] coverage of the overall population also varies across countries, ranging from 26.2 percent in Montenegro to 3.4 percent in Kosovo. Most of the new poor would not be covered by the programs. Increasing benefits to existing beneficiaries would be effective in supporting their income but would leave a large percentage of the population unprotected, especially in Kosovo. Moreover, the size of the average benefit in Kosovo is extremely low relative to the size of the welfare loss.[16] A program targeting the new poor would be effective in containing the increase in poverty rates, as this vulnerable group is likely to be close to the poverty line. However, the expansion of coverage to the new poor would result in higher income inequality among the poor (that is, worsening of poverty gap and poverty gap squared).[17] Moreover, traditional poverty-focused programs are difficult to expand horizontally, as shown during the COVID-19 crisis. Other tools need to be considered to support the energy

**Table 4.3.** Coverage and generosity of social transfers programs is uneven.

| Country | ALB | BIH | KOS | MNE | MKD | SRB | Region |
|---|---|---|---|---|---|---|---|
| Estimated percentage change of poor people (%) | 8.4 | 21.0 | 10.8 | 11.7 | 20.8 | 15.8 | 13.0 |
| Program coverage post shock (%) | 25.4 | - | 3.4 | 26.2 | 14.8 | 22.0 | 17.7 |
| Program benefit / Average income loss of the poor (%) | 66.3 | - | 6.2 | 139.7 | 52.4 | 74.1 | 55.3 |

*Source:* World Bank estimates based on most recent surveys as in Figure 4.2.
*Note:* Welfare is estimated in U.S. dollars using 2017 PPPs. Income measures in the SILC and consumption measures in the HBS are not strictly comparable.

15 Social transfers refer to government assistance programs targeted to the poor. These are typically captured in the EU-SILC surveys as "benefits specifically intended to combat social exclusion". For example, these transfers include the Guaranteed Minimum Assistance program in North Macedonia, or the Ndihma Ekonomike program in Albania.

16 In some surveys, income data can be less reliable than consumption data and the two do not always align. For instance, in BiH, household income has systematically been about a third lower than household consumption in part because imputations are applied to consumption but not income measures (World Bank. 2015. Rebalancing Bosnia and Herzegovina: A Systematic Country Diagnostic. Washington, D.C.: World Bank Group). As such, we do not measure government income support in BiH.

17 The poverty gap index captures the depth or intensity of poverty and measures the extent to which individuals fall below the poverty line as a proportion of the poverty line. Compared to the poverty headcount, the poverty gap has the advantage of detecting changes among the income of the poor that are not enough for them to cross the poverty line. The squared poverty gap index captures the inequality among the poor by giving more weight to larger poverty gaps.

vulnerable, such as subsidies to the energy bill and incentives to transition to more sustainable type of heating and to keep them from resorting to more polluting methods (Box 4.2).

**Box 4.2.** Attitudes towards transition to more sustainable and efficient heating in the Western Balkans.

**The current state of residential heating across the six Western Balkan countries highlights a set of challenges that pose a direct threat to greening the economy in the medium and long term.** On the one hand, residential heating—overwhelmingly favoring traditional heating sources relying on inefficient and heavily polluting solid fuels (very much the norm across the region)—is a large source of pollution emissions in the winter (as is combustion from residential cooking throughout the year). Ambient concentrations of particulate matter 2.5 (PM2.5) emissions are well above EU standards, in many cases leading to a disproportionate number of premature deaths relative to other countries in Europe. On the other hand, these residential heating practices can be explained by norms, culture, habit, and the tremendous sensitivity of many (especially poorer) households to energy prices and access to modern heating fuels, since traditional heating practices rely on access to cheap wood, coal, or other solid fuels to heat their homes. As a result, effectively shifting to cleaner, more sustainable (and energy efficient) practices where affordability concerns and reluctance to upgrade are high will require a deep understanding of both structural (e.g., financial, legal) and behavioral (e.g., psychological, cognitive, emotional, cultural, and social) factors, including rethinking the design and implementation of support programs. This transition will likely require holistic solutions that address attitudes, perceptions, beliefs, and knowledge about its costs and benefits. Understanding the non-financial barriers can help to improve the design and implementation of programs and policies to support these transitions by considering holistic engagement strategies and simplifying the journey for households at various stages.

**A behavioral diagnostic carried out in 2022 to better understand these challenges and explore policy solutions in a subset of countries looked at demand- and supply-side factors constraining changes in the behavior of households.** The diagnostic centered around online and phone surveys was implemented in Bosnia and Herzegovina, Kosovo, North Macedonia, and Serbia to understand the barriers to and enablers of a change in behaviors and the role governments can play in facilitating this change (especially in the context of limited and/or fragmented subsidy and grant programs to support these transitions).

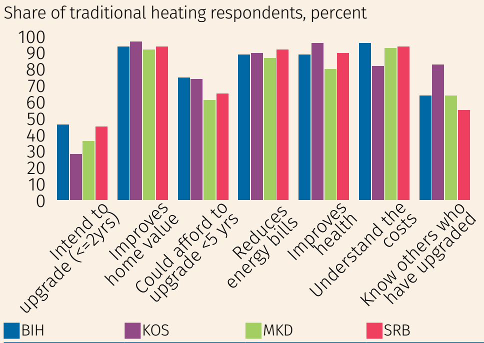
**The results from the diagnostic survey suggest that attitudes among respondents are quite progressive, but intentions to upgrade heating remain low, and key bottlenecks to behavioral change exist, complicating transitions to more sustainable heating practices.** Among traditional heating user respondents (generally using inefficient and dirty

*(Box 4.2 continued)*

stoves or boilers burning low-grade wood, coal, and/or waste), 41 percent are unwilling to upgrade their heating technology, while 21 percent are unsure about upgrades (Figure 4.4). Among 38 percent willing to upgrade, only half of these would do so in the next two years (similar results are found for intentions to thermally renovate dwellings). Despite these low intentions to upgrade soon, attitudes about sustainable heating practices are progressive: an overwhelming majority of respondents to the survey across the four countries are aware of the costs and benefits of upgrades and know someone who has upgraded, even among those using traditional technologies. Low intentions appear to be driven mainly by affordability concerns and competing priorities within the home (for example, structural investments not related to the heating technology), and by low trust in the institutions that are meant to support these transitions (financial institutions and local, regional, and national government actors). Focus group discussions among lower income segments revealed similar attitudes and preferences.

**Support programs provided by governments in the Western Balkans should be designed and implemented in such a way that can influence the attitudes, beliefs, and preferences of the target population toward investments in cleaner more efficient technologies.** This means properly communicating the benefits (and costs) of the program, managing expectations of participation, and simplifying the choice architecture in a way that motivates action and persistence in terms of program participation and heating practices. Low awareness of support programs and perceived exclusion should be countered with holistic engagement strategies, while lack of trust in traditional messengers would benefit from dialogue between early adopters and hesitant households.

**Figure 4.4.** Intentions to upgrade heating technology and attitudes towards sustainable heating.



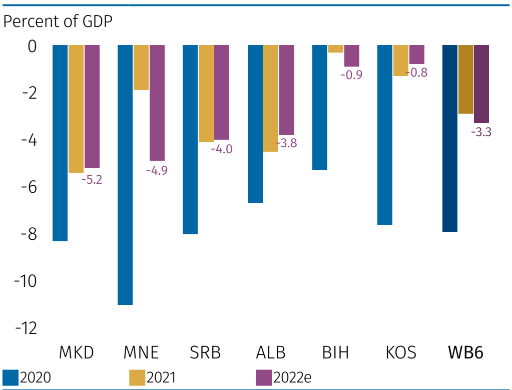

*Source:* World Bank survey 2022.
*Note:* This figure plots the share of respondents using traditional heating technologies that: (i) would be willing to upgrade their heating technology with a modern one at some point in the next two years (respondent are first asked if they plan to upgrade, and among those who say yes, are asked about the time frame for this upgrade); and (ii) somewhat or strongly agree with a set of statements capturing attitudes about sustainable heating (relative to somewhat or strongly disagree or don't know enough about the issues). The six sets of bars on the right side of the graph capture the level of agreement with the corresponding statements (shortened in the figure for improved visibility): (from left to right): "Upgrades of heating systems or ceiling or wall insulation improve the value of a home"; "I could afford to upgrade my heating system or ceiling or wall insulation in the next five years"; "A modern source of heating or ceiling or wall insulation reduces energy bills"; "A modern source of heating improves the health of household members"; "I understand the costs associated with upgrading to a modern source of heating or ceiling or wall insulation"; and "Most people I know in my community have upgraded their heating technology to a modern one (e.g., a wood pellet stove/boiler or heat pump)".

# 5. Fiscal policy faces renewed pressures

**Fiscal consolidation halted amid pressures to mitigate the impact of surging inflation and rising energy costs.** After promising consolidation momentum in 2021, Western Balkan countries are facing renewed fiscal pressures and risks. The regional average[18] deficit is expected to increase by 0.4 pp of GDP compared to 2021 (Figure 5.1), driven by a deterioration in fiscal balances in Montenegro and Bosnia and Herzegovina, which nonetheless continues to run a low deficit level. Albania and Kosovo should see the fiscal deficit declining by more than half a percentage point of GDP, while in Serbia and North Macedonia, fiscal deficits are expected to maintain previous year levels. Nevertheless, the average fiscal deficit for the region remains double the pre-pandemic rate, and the risks of a further deterioration due to higher energy subsidies during the winter season remain high.

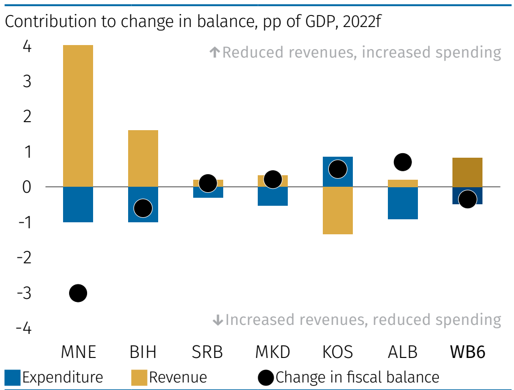
**Inflation is boosting revenue growth across the region.** All Western Balkan countries recorded strong nominal revenue growth of above 10 percent y-o-y during the first half of 2022, with Albania's public revenues growing fastest at 19.2 percent during this period. Given the rise in international commodity prices, indirect taxation is providing the greatest boost to revenue growth. In Montenegro, indirect tax revenues continued to grow despite the reduction of the VAT rate for hospitality services and the excise rate on fuel, but social security contributions and the personal income tax declined following the removal of healthcare contributions and introduction of tax allowances. In North Macedonia, the reduced VAT rate for energy was not renewed in July to help contain the growing deficit. Except for Kosovo, public revenue is expected to only keep pace with the surging inflation, remaining broadly constant from a year before as a share of GDP. In Kosovo, and to a lesser degree in BiH, revenue growth is expected to

**Figure 5.1.** Fiscal deficits levels remain high against renewed pressures…




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

**Figure 5.2.** …remaining broadly unchanged from 2021 in Western Balkan biggest economies.




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

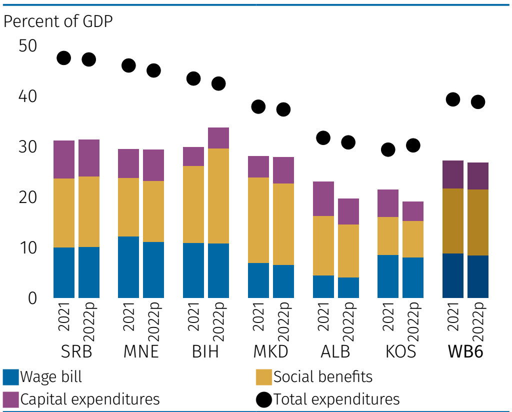
18 Unweighted average of fiscal deficit levels in Western Balkan countries.

provide a positive contribution to containing the level of the fiscal deficit (Figure 5.2).

**Public expenditure continued to increase following the adoption of measures to respond to surging inflation and the energy crisis.** After consolidating by 3.5 pp of GDP in 2021, in all Western Balkan countries but Kosovo and Bosnia and Herzegovina public expenditure is expected to decrease by an average of 0.5 pp of GDP y-o-y during 2022 (Figure 5.3). In Albania, expenditure levels are expected to decline by 0.9 pp of GDP driven by a significant drop in public investment. In nominal terms, however, most Western Balkan countries are experiencing significant growth of recurrent expenditure. Bosnia and Herzegovina, and North Macedonia, and to a lesser degree Montenegro, are also seeing a significant increase in capital expenditure, with North Macedonia planning to embark on the construction of a major highway. All Western Balkan countries adopted measures to mitigate the impact of inflation on the most vulnerable households, while Kosovo, Albania, and North Macedonia are increasingly spending on energy subsidies. In Serbia, support provided to energy companies for importing gas, coal, and electricity was not entirely shown as a direct budget expenditure, but rather as a below-the-line transaction. The upcoming electoral cycle in Bosnia and Herzegovina is also exerting upward expenditure pressures. While the automatic stabilizers, as noted in the earlier edition,[19] should automatically react to the business cycle, with revenues decreasing and some spending increasing in times of crisis, their relatively small size observed in the 2020 episode, points to the need to reinforce the automatic features of the tax and expenditures systems.

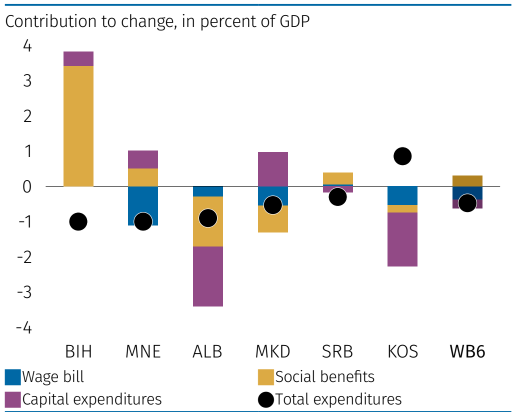
**Social protection spending continues to drive expenditure growth.** Social protection spending is expected to increase by a regional average of 0.3 pp of GDP in 2022; however, in Bosnia and Herzegovina, social benefits are expected to increase the fastest by 3.4 pp, reaching the highest level in the region at 18.7 percent of GDP (Figure 5.4). Budget

**Figure 5.3.** Expenditure levels remain high, marginally increasing in most countries.




*Sources:* National statistical offices; Ministries of Finance; and World Bank estimates.
*Note:* 2022p = 2022 projected.

**Figure 5.4.** Capital underspending helped contain expenditures in Kosovo and Albania.




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

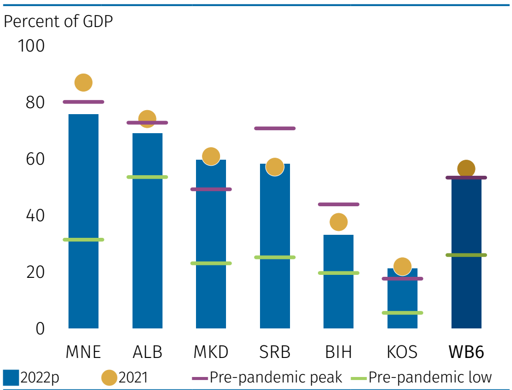
19 World Bank Western Balkans Regular Economic Report #21, Spring 2022.

allocations for social assistance have increased across the region. In Albania, Montenegro, and Kosovo pension benefits also increased in response to inflation. The governments in Serbia and North Macedonia also announced an increase in pensions starting from November 2022. At the same time, wage bill spending is increasing in nominal terms across the region. In Bosnia and Herzegovina and Serbia, the wage bill is expected to remain broadly the same as last year, while real public wages are expected to decline in Kosovo, Albania, and North Macedonia.

**Public and publicly guaranteed (PPG) debt remains elevated in most countries, despite the recent drop in the debt to GDP ratios.** Despite lower-than-expected real growth in the region in 2022, high GDP deflators are resulting in higher-than-expected nominal GDP. This translates into a reduction of PPG as a share of GDP in all countries in the region, but Serbia, where it will increase marginally. The average PPG as a share of GDP is expected to decline to 52.7 percent in 2022 from 56.4 percent in 2021 (Figure 5.5). The decline will likely be most prominent in Montenegro, where it is expected to reach 11.3 pp, both because of the denominator effect, given the strong growth in GDP, but also because most of the 2022 financing needs are covered from the deposits accumulated through the Eurobond issuance in 2020. Similarly, Albania's PPG as a percent of GDP is also expected to decline significantly, by 5.1 pp, as the country used its 2021 Eurobond receipts to cover financing needs in 2022. In contrast, Serbia's PPG as a percent of GDP is expected to increase by 1 pp to 58.1 percent of GDP. Unlike other Western Balkan countries, North Macedonia's and Kosovo's PPG debt as a percent of GDP remain above their pre-pandemic levels. Particularly higher is PPG debt in North Macedonia—which increased by 10 pp—because of extensive COVID-19 support during 2020–21.

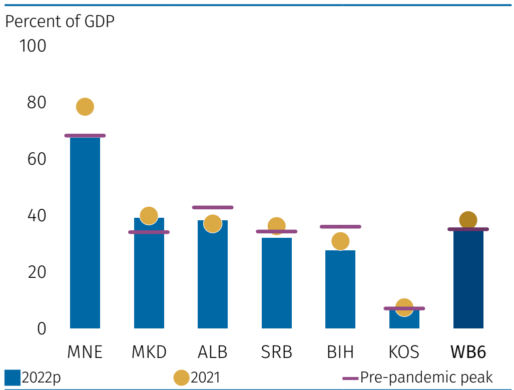
**External PPG debt is expected to continue to decline in 2022 but to remain above the pre-pandemic high** (Figure 5.6). The anticipated decline of external PPG from 38.2 percent of GDP in 2021 to 35.1 percent of GDP for the region is expected to mostly come from an increase in the nominal GDP. Serbia's external PPG debt to GDP is the only one among the Western Balkan countries where an increase of 1 pp is anticipated. Albania and Montenegro

**Figure 5.5.** Public and publicly guaranteed debt declined in most countries...




*Sources:* National statistics offices; World Bank staff estimates.

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




*Sources:* National statistics offices; World Bank staff estimates.

are expected to recorded declines of 4.3 pp and 11 pp, respectively, as they use Eurobond proceeds from previous years to service debt in 2022. Given the appreciation of the U.S. dollar against the euro and regional currencies, countries with a higher share of U.S. dollar-denominated debt that have not hedged against the foreign exchange risk are more vulnerable to the surging dollar. Serbia and Albania have the highest share of U.S. dollar-denominated debt among the Western Balkan countries, followed by Bosnia and Herzegovina. After a series of successful Eurobond placements in the past two years, none of the Western Balkan countries issued Eurobonds in 2022, amid high uncertainty and rapidly increasing financing costs.

**Financing conditions are rapidly tightening** (Box 5.1). Surging inflation has triggered more aggressive than expected monetary tightening by the U.S. Federal Reserve and the European Central Bank (ECB), which have increased their policy rates by a cumulative 225 and 50 basis points, respectively, between March 2022 and mid-September 2022. It is expected that both the U.S. Federal Reserve and the ECB will hike interest rates significantly again in 2022. The cost of financing has thus rapidly increased. Most Western Balkan countries have a significant share of external debt and are vulnerable to these developments, particularly countries with high total debt burdens and limited fiscal space. S&P Global Ratings has, however, affirmed countries' credit ratings and stable or positive outlooks; Fitch affirmed North Macedonia's BB+ rating with a negative outlook (Table 5.1). Yet, all countries have a non-investment speculative grade, with North Macedonia's and Serbia's rated as speculative and other countries in the region rated as highly speculative.

**Table 5.1.** Country credit ratings are still at non-investment grades.

| | Moody's | S&P Global Ratings | Fitch |
|---|---|---|---|
| Albania | B1 (stable) | B+ (stable) | — |
| Bosnia and Herzegovina | B3 (stable) | B (stable) | — |
| Montenegro | B1 (stable) | B (stable) | — |
| North Macedonia | — | BB- (stable) | BB+ (negative) |
| Serbia | Ba2 (stable) | BB+ (positive) | BB+ (stable) |

*Note:* — = not available.

**Box 5.1.** High medium-term refinancing needs facing rising cost of capital.

**The synchronous tightening of monetary and fiscal policies across the globe, and particularly amongst major economies, is resulting in tightening financial conditions.** These developments leave many emerging and developing countries highly vulnerable, among which are the Western Balkan countries, though the degree of vulnerability varies among countries.

**Over the past years, most Western Balkan countries have become increasingly reliant on external funding.** By 2021, all countries but Kosovo and Bosnia and Herzegovina[20]

20 With the exception of its entity Republika Srpska, which has placed Eurobonds in 2018 and 2021.

*(Box 5.1 continued)*

were exploiting the favorable financing conditions by issuing Eurobonds. These placements were part of countries' debt management strategies to extend maturities and develop and diversify their investors pool. During the pandemic, countries relied heavily on international markets: in 2020 alone, Albania, Montenegro, North Macedonia, and Serbia raised a total of EUR5.1 billion in Eurobonds, which were used to refinance debt and finance widening deficits. In 2021, Serbia and Albania placed Eurobonds with longest maturities of 15 and 10 years, respectively, while Serbia also placed a green bond with a record-low interest rate of 1 percent. Nevertheless, the favorable financing conditions and increasing volumes of borrowing have kept public debt levels elevated for most countries, with North Macedonia's public debt now well above the pre-pandemic high.

**The Western Balkan countries have relatively high medium-term refinancing needs at the time of financial tightening.** Average time to maturity (ATM) for the region is estimated at 6.3 years,[21] below the OECD average of 7.7 years. Countries' external debt amortization in 2023–24 averages 2 percent of GDP per year; however, country level differences are significant. Serbia, with an ATM of 8.1 years on total debt and external debt amortization of 1.9 percent of GDP over 2023-24, faces lower refinancing risk. On the other hand, despite relatively low external debt amortization of 0.6 percent of GDP in 2023–24, Albania is most exposed to refinancing risk with an ATM of 4.7 years. Montenegro's external debt amortization of 4 percent of GDP in 2023–24 is the highest in the region, while its ATM is 5.6 years. Kosovo, Bosnia and Herzegovina, and Albania have domestic debt ATMs of about 3 years, well below the regional average. North Macedonia faces a higher level of refinancing risk on external debt, with external debt amortization of 2.7 percent of GDP in 2023–24 and an ATM of just 4.7 years.

**The rapidly changing financing conditions are making Eurobond issuances much more expensive.** As a result of aggressive tightening of the U.S. Federal Reserves in response to 40-year high inflation in the U.S., global investors are pulling money out of other markets to invest in higher-yielding U.S. assets. The widening of global financial pressures is leaving Western Balkan countries in a vulnerable position. Yields on outstanding Eurobonds issued by Western Balkan countries have widened in 2022, with some of them pushed close to 10 percent (Table 5.2). In all countries but Albania, yields on Eurobonds maturing in 3 years are higher than those maturing in 5 years, reflecting that markets price higher risks for bonds maturing sooner.

**Domestic cost of government financing is also increasing in the Western Balkans.** In Kosovo, which does not issue Eurobonds, the average yield on a 5-year fixed coupon bond increased from 2.5 percent at end-March to 3.3 percent at end-August 2022. Domestic auctions have also shown a similar trend in Albania; the average yield for a 5-year fixed coupon

21 Based on 2020 and 2021 reported ATM.

*(Box 5.1 continued)*

bond resulted at 3.43 percent by end-January 2022 and for the same type of instrument the yields went up to 5.14 percent at end-July 2022. North Macedonia issued mainly 15-year bonds during this part of 2022, and the yields on such instruments increased from 2.6 percent in January to 4.2 percent in early September 2022. In Serbia, 10-year bonds were auctioned at 6.8 percent during September in the domestic market; the last 10-year bond was auctioned in September 2021 with an accepted rate of 2.5 percent.

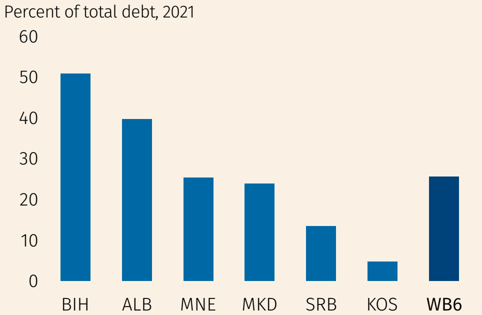
**Table 5.2.** Yields and spreads on outstanding Eurobonds surged.

| | Coupon | Maturity | Yield in % (last price) | Spreads (basis points) |
|---|---|---|---|---|
| Albania | 3.5 | 16/06/2027 | 5.84 | 581.8 |
| Albania | 3.5 | 09/10/2025 | 6.33 | 631.4 |
| Montenegro | 2.785 | 16/12/2027 | 9.75 | 973.2 |
| Montenegro | 3.375 | 21/04/2025 | 8.20 | 818.8 |
| North Macedonia | 3.675 | 03/06/2026 | 6.17 | 615.2 |
| North Macedonia | 2.75 | 18/01/2025 | 5.95 | 593.0 |
| Serbia | 3.125 | 15/05/2027 | 6.43 | 641.5 |
| Serbia | 1.5 | 26/06/2029 | 7.67 | 765.5 |
| Republic of Srpska | 4.75 | 01/01/2023 | 6.18 | 616.7 |
| Republic of Srpska | 4.75 | 01/01/2026 | 6.55 | 652.8 |

*Source:* https://www.boerse-frankfurt.de/en, accessed on 20 September 2022.
*Note:* Spreads refer to spreads with yields on German bonds with similar residual maturity.

**Notwithstanding higher cost of raising new debt and refinancing, the structure of debt will have an immediate impact on interest expenditures.** On average, a quarter of total debt portfolios in the Western Balkans consists of variable interest debt agreements and instruments; with four out of six countries having more than 1/5 of their sovereign debt portfolios tied to variable-rate interest (Figure 5.7). Serbia and Kosovo are the least vulnerable to the immediate impact of the surging interest rates. Surging dollar will also translate into higher debt servicing costs of debt denominated in USD, where Albania and Serbia are the most exposed among Western Balkan countries, with 10.8 percent and 12.6 percent of external debt.

**Figure 5.7.** Share of variable-rate debt is high in several countries.




*Source:* Ministries of Finance, Bank staff estimates.

**Limited fiscal space, elevated public debt, and increased cost of financing are straining governments' abilities to respond to the current crises.** All Western Balkan governments have implemented support measures to combat the cost-of-living crisis, and unlike COVID-19 support, most of it was not targeted. All countries except Bosnia and Herzegovina and Montenegro have provided subsidies to the energy state-owned enterprises and are expected to be under pressure for further support as the winter season approaches. Serbia, North Macedonia, and Montenegro reduced their excise rates on fuel, the latter by 50 percent for three months to combat the inflationary impact on households and businesses. A similar measure is under consideration in Bosnia and Herzegovina but is stalled in the Parliament. North Macedonia allocated an additional 0.6 percent of GDP for anti-crisis measures within the budget revision in May 2022.

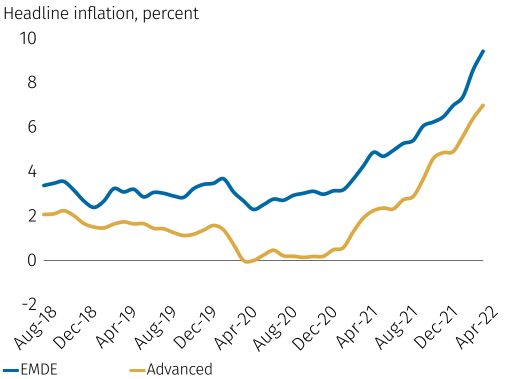
**An increase in expenditure arrears in several countries is further narrowing governments' fiscal space.** For example, North Macedonia's expenditure arrears reached 3 percent of GDP because of overdue payments of the health sector, state enterprises, and local governments. Similarly, repayment of Montenegro's health expenditure arrears of 1.2 percent of GDP created additional pressures on spending. Further, contingent liabilities coming from state-owned enterprises and public-private partnerships pose significant fiscal risks in Albania, North Macedonia, and Serbia. Considering the narrow fiscal space most countries have, efforts should be made toward boosting tax compliance, optimizing spending, and revisiting tax exemptions and subsidies provided to ensure a reduction in debt and sustainability of their public finance.

# 6. Soaring inflation poses new policy trade offs

**Inflation has risen to record highs globally on the back of rebounding demand, supply constraints, and surging commodity prices, particularly, since the outbreak of the war in Ukraine in February 2022.** In July 2022, the global median headline Consumer Price Index (CPI) rose to 9.4 percent y-o-y, the highest level since 2008 (Figure 6.1).[22] Several factors are behind the increase in inflation. Rising energy costs are contributing significantly to mounting inflationary pressures (Figure 6.2). The cutoff of natural gas to several European countries, including the shut-down of the Nord Stream pipeline, has pushed the gas prices to record highs. In September 2022, Brent crude oil stood at US$90.2 per barrel, more than 20 percent increase over a year. Global food prices suffered sharp increases through June 2022, though they have been on a declining trend since, due to, among other factors, the resumption of exports from ports in the Black Sea in Ukraine. However, food prices in August 2022 were still 11 percent higher than last year,[23] disproportionally affecting disposable incomes of the poor, given that food items account for a higher share of their consumption basket. Food price increases have been partially made worse by the growing number of food trade restrictions put in place by many countries. As of September 2022, at least 20 countries have implemented 29 food export bans, and at least seven have implemented 12 export-limiting measures.[24]

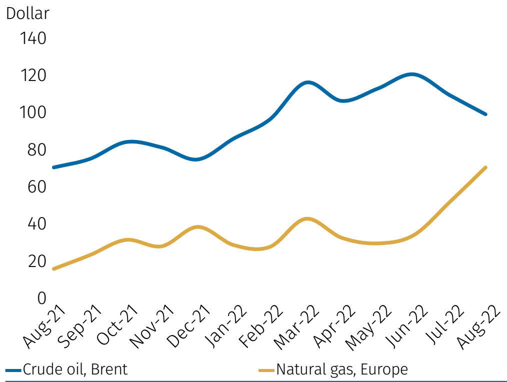
**While commodity prices continue driving up headline inflation numbers, price pressures are increasingly broad-based** (Figure 6.3). Increases in prices were particularly pronounced for commodities of which Russia and Ukraine are large exporters, such as natural gas, fertilizers, grains and metals. Moreover, pandemic-related effects linked to shortages of materials, equipment and workers also continue to impact price increases. While food

**Figure 6.1.** Inflation has reached record highs globally.




*Sources:* World Bank Global Economic Prospects 2022.

**Figure 6.2.** Soaring energy prices are still driving up inflation.




*Source:* World Bank Commodity Price Data
*Note:* Prices are US$ per barrel for oil and US$ per Metric Million British Thermal Unit (mmbtu) for gas.

22 July 2022 estimates of inflation may differ from other World Bank reports due to data release schedules.
23 World Bank Commodity Price Data.
24 World Bank Food Security Update, September 2022.

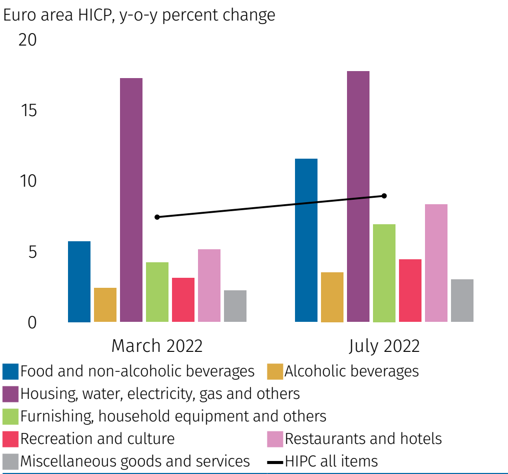
and energy prices have mainly driven the sharp rise in headline inflation, core inflation has also risen globally (Figure 6.4).

**The degree of inflation persistence is uncertain and the risk of higher inflation becoming further entrenched in expectations is significant.** Mounting inflation prompted central banks across the world to step-up policy interventions, withdrawing monetary support and raising interest rates faster to ease inflation pressures. In many emerging markets and developing economies that have adopted inflation targeting, inflation increased above target. As a result, central bank monetary policy tightening is taking place more rapidly than anticipated at the start of the year and faster than in advanced economies. In the short term, expectations of further price increases could become entrenched into price-setting behavior, resulting in the greater persistence of inflation. At the same time, raising interest rates and tighter financing conditions could weigh on economic activity.

**Monetary authorities are facing a few trade-offs in calibrating their monetary policy stance.** Despite stagnant economic growth, mounting price pressures encourage central banks to tighten their policy stance to reduce inflation expectations. At the same time, tighter monetary policy will inevitably have consequences for the economy, including those associated with the negative impact on bank's balance sheets and on debt financing for businesses and households. Countries without independent monetary policy have limited room to mitigate the impact of rising inflation, exacerbated by the war in Ukraine. In such contexts, supply-side policies aimed at boosting competitiveness and enhancing productivity, and reducing energy dependence are critical.

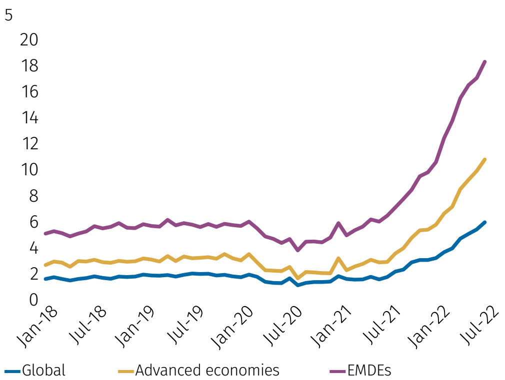
**Between January and July 2022, inflation in the Western Balkans soared in all countries in the region** (Figure 6.5). A combination of supply- and demand-side factors played a role in driving up price pressures. On the one hand, supply constraints drove food and energy prices to record highs and they were amplified

**Figure 6.3.** Price pressures are increasingly broad-based...



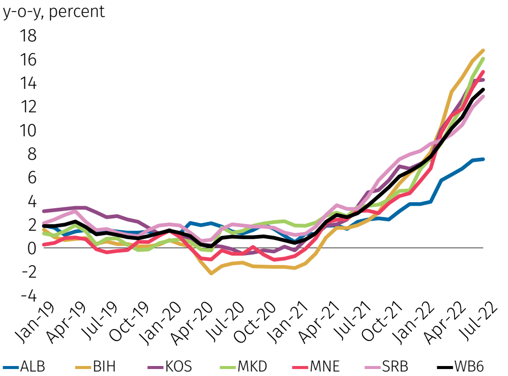

*Source:* World Bank staff calculations based on Eurostat data.
*Note:* HIPC = Harmonized Index of Consumer Prices.

**Figure 6.4.** ...and the core inflation is rising globally.



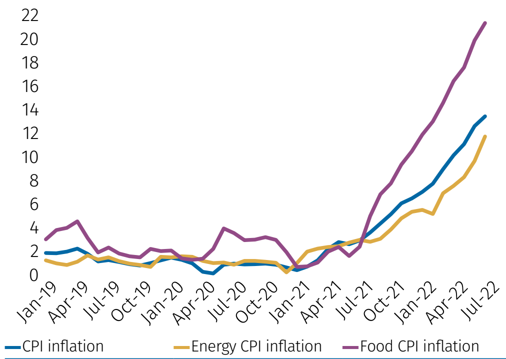

*Source:* Global Economic Prospects.
*Note:* EMDEs = emerging markets and developing economies.

**Figure 6.5.** Western Balkan countries experienced rapid increases in headline inflation during 2022…



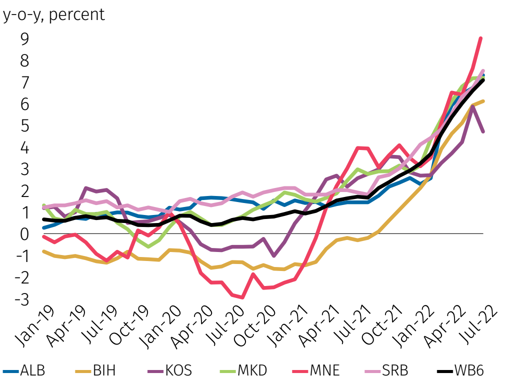

*Source:* National statistics agencies.

**Figure 6.6.** …as commodity and food price increases were amplified by the war in Ukraine.



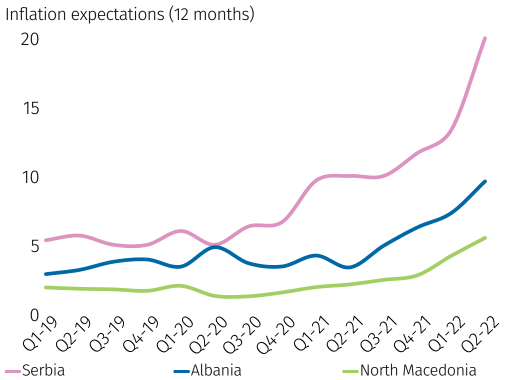

*Source:* National statistics agencies.

**Figure 6.7.** Persistent commodity price shocks were transmitted to broader prices causing core inflation to increase…




*Source:* National statistics agencies.

**Figure 6.8.** …de-anchoring inflation expectations in the Western Balkans.

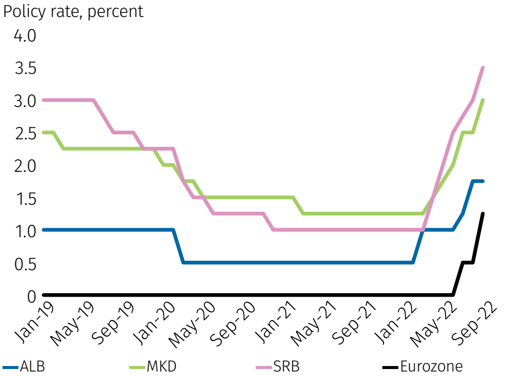



*Source:* Central banks' surveys.

by the war in Ukraine (Figure 6.6); on the other, lingering demand-supply imbalances from the COVID-19 recovery continue to weigh on prices at the regional level. In July, annual headline inflation reached 7.5 percent in Albania and up to 16.7 percent in Bosnia and Herzegovina. Energy tariff controls and a mild currency appreciation prevented a similar pickup of inflation in Albania. Food and energy inflation continue to represent key components of the overall increases. The Consumer Price Index (CPI) for food rose above 24 percent in Bosnia and Herzegovina, Montenegro, and North Macedonia. Energy CPI trends were also on the rise, with growth reaching 15.7 percent in Montenegro to 18.1 percent in Bosnia and Herzegovina. Finally, since January 2022 core inflation increased in almost all countries in the region (Figure 6.7). Higher increases were observed in Montenegro, Serbia, and Albania where in July 2022 core inflation reached 9.4 percent, 7.5 percent, and 7.3 percent, respectively.

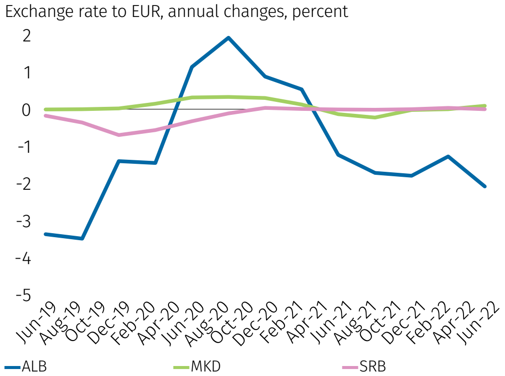
**In countries with flexible or managed exchange rate regimes, central banks responded by tightening monetary policy, in line with the Eurozone.** In Serbia, the central

**Figure 6.9.** Central banks responded to inflation by tightening monetary policy.




*Source:* Central banks.

**Figure 6.10.** Exchange rate pressures varied among Western Balkan countries.




*Source:* Central banks.

bank increased its key policy rate several times, reaching 3.5 percent at the end of the third quarter. The increase in inflation expectations (Figure 6.8) also prompted a faster monetary policy normalization in Albania, where the central bank raised its key policy rate to 1.75 percent in August 2022 (Figure 6.9). In North Macedonia, the policy rate was increased to 3 percent in five rounds by early September. Exchange rate pressures differed among the Western Balkan countries; while in North Macedonia the central bank intervened to keep the stability of the exchange rate, decreasing foreign exchange reserves by 20 percent, in Albania currency appreciation vis-à-vis the euro prevented a more rapid pass through from imported inflation. In Serbia, the nominal dinar exchange rate was stable throughout 2022 (Figure 6.10).

# 7. Financial sector resilience tested with new challenges ahead

**Financial sector stability has been preserved throughout the pandemic shock while new risks loom.** Non-performing loans (NPLs) in the region continued to decrease (4.4 percent on average as of March 2022), while profitability and capital buffers were preserved. So far, the Western Balkan financial sector navigated the heightened uncertainty and volatility without any significant disruptions, but challenges lie ahead, including the fallout from the war in Ukraine, prolonged supply chain disruptions, inflationary pressures, tightening global liquidity, weak domestic political stability, and the energy crisis.

**The initial direct impact of the war in Ukraine on the Western Balkan banking sector has been limited and manageable.** Two main transmission channels have been in effect. The first comprises sanctioned banking groups with Russian capital that were operating in the Western Balkans. These groups faced liquidity problems and were rapidly taken over by other local banking groups, thereby containing further negative financial sector impacts.[25] The second comprises foreign banking groups with concentrated cross-border exposures and equity positions in Russia and Ukraine. These triggered some concerns regarding whether they would face deterioration in loan quality and capital erosion due to declining ratings. However, while imposed sanctions had a negative impact on some European banking groups[26] with exposure to Russia and Ukraine, the European Banking Authority (EBA)[27] and European Central Bank (ECB)[28] announced that this exposure was limited, and that European banking groups could withstand any potential write-off of these positions. Furthermore, Western Balkans subsidiaries of these groups remained more isolated from the turmoil as they are predominantly funded by local deposits. Nevertheless, although regional groups remain committed to their exposures in the Western Balkans, with no sign of deleveraging, this channel still needs to be monitored closely as strategies and growth prospects in the Western Balkans may change should additional pressures arise from exposures to Russia and Ukraine.

**Second-round impacts of the war in Ukraine are more concerning from a financial stability perspective, especially under a scenario of prolonged conflict.** Under such a scenario, increases in food and energy prices can add to inflationary pressures that were already high, primarily due to a strong rebound in demand, supply-chain disruptions and record-high commodity prices. Multiple factors may lead to asset-quality deterioration and put pressure on corporate and household balance

25 Sanctions include freezing assets, exclusion from SWIFT which provides services related to the execution of financial transactions and payments between banks worldwide and prohibiting engaging in U.S. dollar activities. Sberbank Europe AG, a fully owned subsidiary of Sberbank Russia, faced a liquidity crisis, which impacted three Sberbank subsidiaries, one in Serbia and two in Bosnia and Herzegovina. All three subsidiaries were rapidly taken over by other local banking groups.

26 According to EBA French, Italian, and Austrian banks reported the highest volume of exposures to Russian counterparts while Austrian, French, and Hungarian banks had the largest exposure to Ukraine.

27 EBA Risk Dashboard: https://www.eba.europa.eu/eba-risk-dashboard-indicates-limited-direct-impact-eu-banks-russian-invasion-ukraine-also-points.

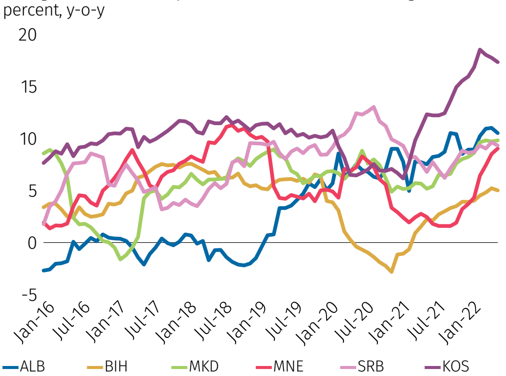
28 https://www.reuters.com/business/finance/all-large-euro-zone-banks-can-withstand-russian-write-off-ecb-says-2022-04-20/?utm_source=newsletter&utm_medium=email&utm_campaign=global-investor&utm_term=Reuters%20Global%20Investor%20-%202021%20-%20Master%20List.

sheets. *First*, potential corporate vulnerabilities remain from the global pandemic, which can come from slow recovery in some sectors such as food, accommodation, and entertainment and weakened creditworthiness of borrowers, which may have been more difficult to detect during the pandemic when there was ample public-sector support provided to the private sector. *Second*, increased costs for inputs, including energy and commodities, and disruption of supply chains may contribute to an increase in corporate defaults, particularly in those sectors that could not fully recover after the pandemic. In addition, a tightening of financing conditions and access to financing may exacerbate the situation for companies that are already highly leveraged. *Third*, the impact on households of increasing inflation and shrinking disposable income may put pressure on consumer and mortgage loans. The mortgage loan channel is moving more slowly as price increases (energy, commodities) have not been fully passed on to consumers because government support programs have partially absorbed these costs.

**Despite the downside risks, loan growth continued to be strong in Western Balkans countries, averaging 10.2 percent y-o-y as of June 2022.** Average loan growth in the region has been increasing continuously since March 2021 (Figure 7.1), after registering its lowest growth rate (4.5 percent y-o-y) in the post-pandemic period. The average loan growth rate as of June 2022 was significantly higher than in June 2019 (7 percent, y-o-y) and has been accelerating since January 2022. Starting from March 2022, on average, corporate loan growth surpassed household loan growth in the region for the first time since January 2013 in North Macedonia, Montenegro, and Serbia while household loans still drive the loan growth in Albania, Kosovo, and Bosnia and Herzegovina (Figure 7.2). Surging corporate loan demand may be a sign of liquidity needs driven by price increases in energy, commodities, and overall higher inflation. While all countries have registered positive loan growth in 2022, strongest growth was registered in Kosovo (17.3 percent y-o-y) and Albania (10.5 percent y-o-y), while the weakest was in Bosnia and Herzegovina (5 percent y-o-y).

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

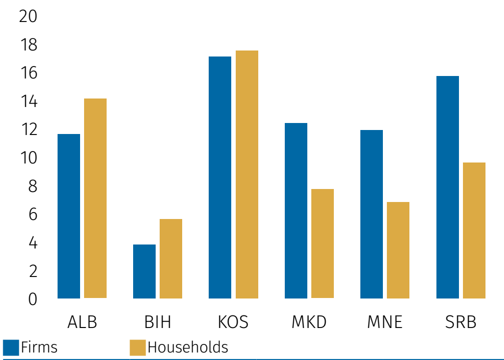
Change in nonfinancial private sector credit outstanding, June 2022, percent, y-o-y




*Sources:* IMF International Financial Statistics; central banks.

**Figure 7.2.** Corporate loan growth surpassed household loan growth in half of the countries.

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

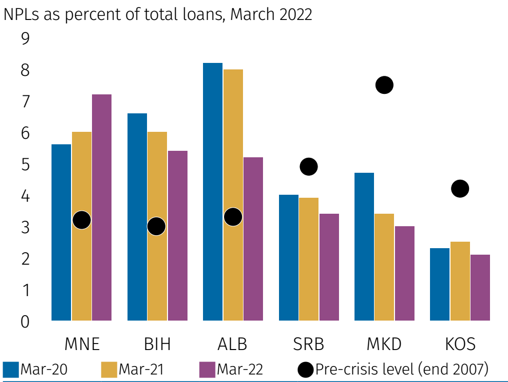



*Source:* Central banks.

**Loan demand in the region is expected to remain strong in the next six months, while supply conditions are predicted to deteriorate, possibly creating a mismatch between credit demand and supply.** According to the results of the Central, Eastern and Southeastern Europe (CESEE) Bank Lending Survey, loan demand is expected to remain strong, favoring short-term liquidity needs of firms (working capital) at the expense of fixed investments. However, a tightening is predicted on the supply side as a result of increased uncertainty and a worsened economic outlook. The tightening is expected to be widespread across all segments but appears more relevant for small and medium-sized enterprises (SMEs) and large corporates, as a worsening economic outlook puts pressure on firm balance sheets and banks become more risk averse.[29] Tightening of supply conditions will mostly be driven by increasing selectivity of banks in search of credit-worthy customers rather than bank deleveraging or significant deterioration in funding conditions for regional and local banks. Cross-border banking groups continue to see high or medium market potential in most of the region's banking markets. In addition, positive funding conditions—easy access to retail and corporate deposits—will likely remain in the next six months, although, according to the CESEE Bank Lending Survey, less favorable than before.

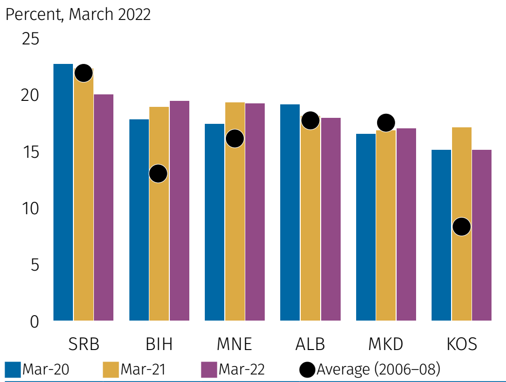
**The regional average NPL ratio continued to decline in March 2022, marking its lowest level since both the pandemic and the post-global financial crisis period** (Figure 7.3). The NPL ratio decreased by 0.1 percentage points from December 2021 to 4.4 percent in March 2022. The regional average of 4.4 percent is slightly below the 5 percent threshold the European Banking Authority defines as a high NPL ratio; nevertheless, NPL ratios are still higher than the region's average in Montenegro (7.2 percent), Bosnia and Herzegovina (5.4 percent), and Albania (5.2 percent). NPLs have continued to increase only in Montenegro compared to its December 2021 level. Kosovo's NPLs remained the lowest in the region, while Albania registered the largest drop in NPLs in the post-COVID period (3 percentage points since March 2020).

**Figure 7.3.** NPLs continued a downward trend in all countries except Montenegro.




*Sources:* IMF Financial Soundness Indicators; central banks.

**Figure 7.4.** Banks' capital buffers were preserved.




*Sources:* IMF Financial Soundness Indicators; central banks.

29 Central, Eastern and Southeastern Europe (CESEE) Bank Lending Survey.

**Capital buffers in the Western Balkan countries remained broadly stable, while bank liquidity has slightly decreased compared to December 2021.** As of March 2022, bank capital adequacy averaged 18.1 percent, far above the regulatory minimum, and slightly lower compared to December 2021, at 18.2 percent (Figure 7.4). The ratio of liquid to total assets averaged 28 percent, which is the lowest level in the post-COVID period, potentially reflecting liquidity needs of firms and households and increasing loan demand. The loan-to-deposit ratios were well below 100 across the board (78.9 percent on average in March 2022) while increasing slightly, indicating a faster loan growth compared to deposit growth.

**Although the impact of the pandemic on bank credit risk in the Western Balkans has been largely mitigated by the comprehensive government support measures, new pressures on asset quality have been building up due to the war in Ukraine and the possible economic consequences.** While some sectors (for example, hospitality) have not fully recovered from the effects of the pandemic and some supply chain constraints persist, potential second- and third-round effects of the war in Ukraine may generate knock-on effects across industries due to rising costs and put an additional burden on low-income households. Banks operating in the region are expecting a deterioration of credit quality going forward, significantly affecting both the retail and corporate segments.[30] These expectations are supported by some signs of corporate vulnerabilities such as elevated stage 2 loans[31]—which is a good indicator of future NPLs, vulnerable sectors (food, accommodations, and hospitality), and increasing liquidity needs of the companies. As of December 2021, regional average stage 2 loans were at 10 percent, much higher than NPLs, at 4.4 percent. In addition, results of the follow-up Enterprise Surveys[32] conducted in the region post-COVID indicate that, on average, 63 percent of the firms surveyed reported decreased liquidity or cash flow availability since the beginning of the pandemic (Box 7.1).

**Regional average bank profitability has remained stable since March 2021 but is still below pre-COVID levels.** Profitability as measured by return on assets remained unchanged at 1.4 percent in March 2022 compared to December 2021. In early 2021, bank profitability started to recover from the initial COVID impact, while it remained stagnant since March 2021. As of March 2022, Kosovo had the highest profitability (2.4 percent), while Albania had the lowest (0.8 percent). The CESEE Bank Lending Survey also confirms this outcome, showing that all the international banks operating in Kosovo reported a higher return on assets compared to their group profitability, while in Albania this ratio was 50 percent. It will be important to monitor profitability, considering the risks for the outlook. If asset quality deteriorates as expected in the next six months, this would put additional pressures on

30 Central, Eastern and Southeastern Europe (CESEE) Bank Lending Survey.

31 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.)

32 Additional rounds of Enterprise Surveys (ES) were conducted between June 2020 and January 2022 of five of the six Western Balkan countries to follow up the impact of the COVID-19 crisis on firms. Follow-up surveys were conducted of the companies surveyed during the regular ES cycles before 2020. Available follow-up surveys are for Albania (June 2020); Serbia, Montenegro, and BiH (February 2021); and North Macedonia (January 2022).

profitability, with increasing impairment costs, and would jeopardize the economic recovery.

**Going forward, authorities need to keep their focus on monitoring credit risks and the evolution of distressed loans, on the potential spillovers from the second-round effects of the war in Ukraine, and on increasing prices.** Regulators and banks need to act in a timely manner and take the necessary preemptive measures to prevent a new buildup of NPLs. In the current environment, with high uncertainty, bank loan monitoring and control capacity, including robust early-warning systems to allow the identification of distressed borrowers, are of utmost importance. Loan classification and staging should be kept accurate, enabling the proper monitoring and evaluation of bank risks, as well as sufficient and timely provisioning. Banks should also be prepared to act quickly in the case of new NPL inflows, by maintaining the capacity to allow early intervention, with sustainable measures to support viable borrowers when necessary (Box 7.1).

**Box 7.1.** NPL resolution in the post-COVID environment.

**While it was expected that NPLs would spike in response to economic hardship caused by the pandemic, data show that the average NPL rate in the Western Balkans region continued to decrease during the last five years, falling from 11.6 percent in December 2016 to 4.5 percent in December 2021.** One of the main reasons for the continuation of the downward trend in the NPL rate was an unprecedented response from authorities and regulators by introducing borrower relief and regulatory forbearance measures after the COVID-19 crisis.

**In most Western Balkan countries, these temporary measures had expired by the time of the writing of this report.** Hence, the NPL rate might resume an upward trend in some countries, as banks will be able to apply the qualitative assessment of "unlikeliness to pay" criterion in a more precise manner. The assessment of a borrower's unlikeliness to pay was one of the most difficult and controversial issues during the period when borrower relief and regulatory forbearance measures were in place. Anecdotal evidence shows that many banks in the region rescheduled eligible loans during this period by granting "grace" periods, thereby postponing the full payment of interest and principal by borrowers. This might delay the crystallization of NPLs for another six to 12 months.

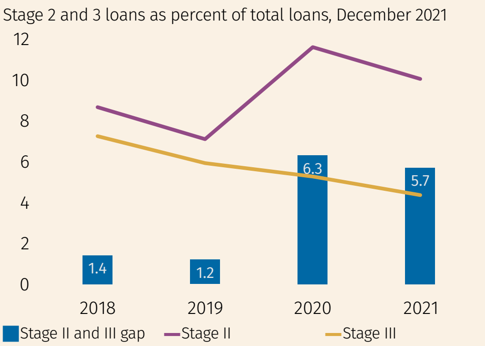
**Additional economic headwinds stemming from current geopolitical tensions, the war in Ukraine, tightening of monetary policies by the major central banks, a substantial increase in inflation, and the energy crisis (particularly in Europe) may well cause an increase in NPLs in the coming quarters.** The first indications of an upcoming new inflow of NPLs in banks are early warning signals of corporate financial vulnerabilities. A good early warning indicator of upcoming loan servicing problems by corporates is delayed payments to supply chains. Analysis of previous crises shows that usually after a steep increase in delayed

*(Box 7.1 continued)*

days for payables and receivables, companies start defaulting on their bank loans. Results of the follow-up Enterprise Surveys conducted in the region during the post-COVID period indicate that, on average, 58 percent of the firms surveyed reported delayed payments to suppliers, landlords, and tax authorities since COVID-19 began.

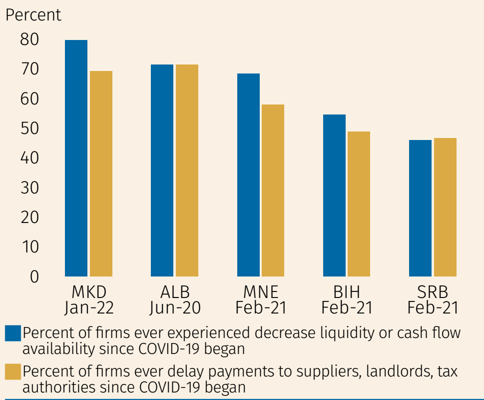
**Another good predictive indicator is the interest coverage ratio.** Moody's identified a strong correlation (0.75) between this ratio two quarters earlier and the default rate of U.S. high-yield corporate debt. In addition to these early warning indicators, close attention should be paid to the gap between stage 2 and stage 3 loans (for countries that have introduced IFRS 9a) (Figure B.7.1.1). Analysis of Western Balkan countries shows that this gap increased from 1.2 percentage points in December 2019 to 5.7 percentage points in December 2021, which indicates an increase in loans with a significant increase in credit risk.

**Figure 7.5.** Stage 2 loans remain elevated in the post-Covid period.




*Sources:* FITCH and World Bank staff calculations.

**Figure 7.6.** Firm liquidity needs are surging in the post-COVID environment.




*Sources:* Follow-up Enterprise Survey results.

**Authorities can be better prepared for the upcoming increase in NPLs by preparing in advance, as previous crises reveal the difficulty implementing tough but necessary reforms in the middle of a financial crisis.** While many countries in the region are better positioned for the potential increase in NPLs due to reforms implemented after the global financial crisis, improvements needed in the enabling environment (that is, judicial systems, insolvency regimes, and enforcement frameworks) feature prominently in the analysis conducted by the World Bank. In addition, banks and policy makers can substantially benefit from a corporate financial viability analysis conducted at the national level. These studies can serve as early warning signs of potential upcoming NPL inflows in the banking system and inform authorities' policy decisions in response. The corporate financial viability studies conducted by the World Bank in Europe and Central Asia and the Middle East and North Africa region countries provide useful insights and a solid foundation on which to calibrate a proper policy response.

*Note:* a. International Financial Reporting Standard (IFRS) 9 specifies how an entity should classify and measure financial assets, financial liabilities, and some contracts to buy and sell nonfinancial items.

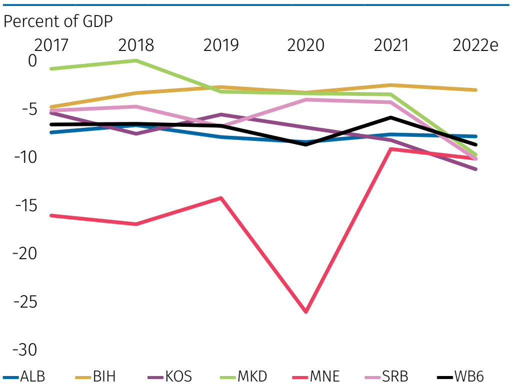
# 8. External imbalances widened despite the export recovery

**The war in Ukraine and the persistence of COVID-19, including the ensuing supply shortages and inflation, have weakened the external sector in the Western Balkans.** In net terms, the Western Balkans economies are large importers of energy, raw materials and manufactured goods and are affected by the war in Ukraine and its impact on commodity prices, and by the impact of COVID-19 on global supply chains. These factors have had an adverse impact on energy trade, have created inflationary pressures and food insecurity, and have caused protectionist policies in many Western Balkan countries, such as export bans on cereals, edible oil, and wood products (logs, firewood, pellets).

**In 2022, the current account deficits (CADs) in all Western Balkan countries are expected to widen.** The broadened external imbalances are in some cases in double digits, as in Kosovo, Montenegro, and Serbia. The largest CAD, at 11.3 percent of GDP, is set to occur in Kosovo, which has a high merchandise trade deficit, while Bosnia and Herzegovina, an electricity exporter, represents the other extreme, with a projected CAD of only 3.1 percent of GDP. The most pronounced widening is likely to be in North Macedonia and Serbia, at about 6.3 pp and 5.8 pp of GDP, respectively. Such a widening of external imbalances in a single year has not occurred since 2007 and provides a window into the significance of the external shock experienced by the countries in the region. Overall, the average CAD for the region is expected to widen from 4.9 percent in 2021 to 8.7 percent of GDP in 2022 (Figure 8.1).

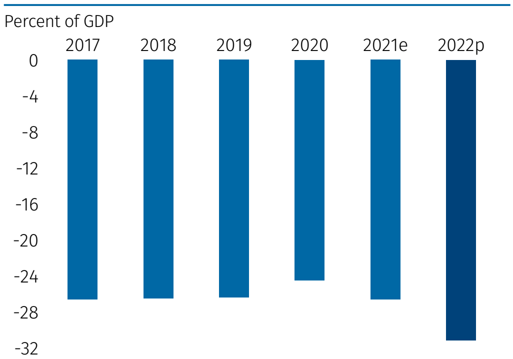
**Higher food, oil, and electricity prices have put pressure on structural merchandise trade deficits.** As import prices surge, the merchandise trade deficit[33] in the Western Balkans is expected to reach almost 31 percent of GDP in 2022, driving the widening CADs (Figure 8.2).

**Figure 8.1.** Current account deficits widened in most countries in the region...




*Sources:* Central banks; World Bank staff estimates.
*Note:* WB6 is the simple average of WB6 CADs. 2021e = 2021 estimated; 2022p = 2022 projected.

**Figure 8.2.** ...as trade deficits widened.




*Sources:* Central banks; World Bank staff estimates.
*Note:* 2021e = 2021 estimated; 2022p = 2022 projected.

33 Exports and imports of goods, simple average of the six countries.

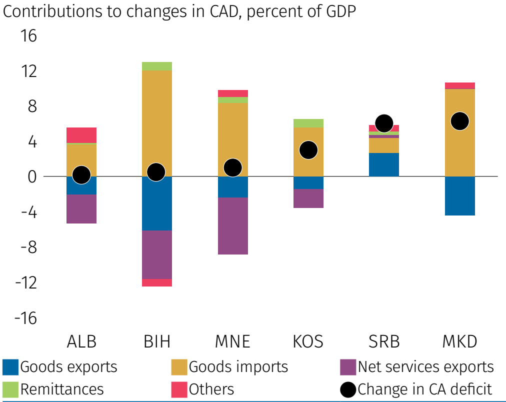
The large merchandise trade deficit is the result of a large increase in imports, from 51.7 percent in 2021 to 58.5 percent of GDP in 2022, alongside a strong increase in exports of goods from 25.4 percent in 2021 to 27.6 percent of GDP in 2022. Although exports are expected to grow strongly in 2022—by 26.5 percent—the increase in imports (24.7 percent) is expected to be equally pronounced and characterized by a much larger base.

**The rise in imports is to a large extent owed to higher food and energy imports, such as electricity, oil, and natural gas.** The price of crude oil rose on average about 50 percent by September 2022 compared to 2021. Other energy imports were equally affected by the war in Ukraine, which has weakened the Western Balkans' already fragile energy security. However, while Serbia, Bosnia and Herzegovina, and North Macedonia are largely dependent on Russia for natural gas, this energy source accounts for only a small proportion of their energy mix. Moreover, Serbia has recently renewed its long-term gas contract with Russia at favorable financial terms, which are about 30 percent higher than the previous contract but significantly below current market prices. Nonetheless, high prices for imported electricity mean that the Western Balkans feel the energy shock heavily. Two countries—North Macedonia and Kosovo—particularly feel the pinch—having declared an energy emergency, predicting shortages in the colder months.

**Growth in exports remained strong in the region.** Growth in exports is estimated to be the highest in Bosnia and Herzegovina, up by 6.1 pp of GDP compared to last year due to windfalls from energy exports, followed by North Macedonia with an increase of 4.4 pp of GDP. In other countries, the expansion in merchandise exports has been more moderate, between 1.4 pp and 2.4 pp of GDP (Figure 8.3). Serbia is the only country where exports of goods are expected to decline in GDP terms compared to last year.

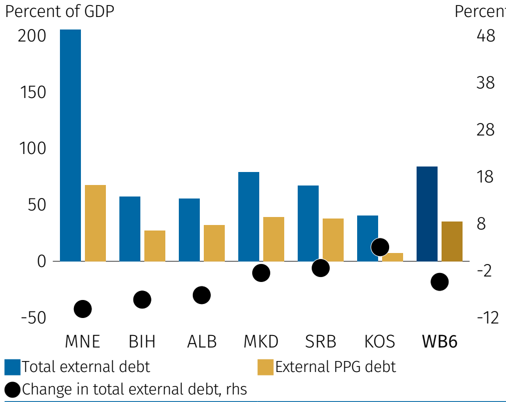
**Net services and remittances largely remain at 2021 levels, which help only in part to offset the soaring merchandise deficits.** Net services exports continue to be an important source of net inflows, especially in Montenegro

**Figure 8.3.** Services and remittances only partly help contain external deficits.




*Sources:* Central banks; World Bank staff estimates.

**Figure 8.4.** External debt is expected to decline in most Western Balkan countries in 2022.




*Sources:* Central banks; World Bank staff estimates.

as tourism inflows are expected to have almost fully recovered in 2022 (Figure 8.3). Visits by workers living abroad account for most travel inflows in Bosnia and Herzegovina, Kosovo, and North Macedonia, whereas Albania and Montenegro have a more prominent tourism sector. In contrast to the net export of services, remittances did not manage to keep up with nominal GDP. In sum, in four countries in the region, inflows of net export services and remittances are projected to offset about two-thirds of the merchandise trade deficit in 2022. The share of remittances is expected to decline, in terms of GDP, across all Western Balkan countries, except North Macedonia. This slowdown in relative remittances may be driven by high inflation and uncertainty in European host countries. North Macedonia and Serbia are different, with much lower levels of net export service and remittances inflows in 2022; thus, for North Macedonia the net export of services and remittances are expected to cover about 27 of the merchandise trade deficit while for Serbia they are expected to cover 42 percent of the merchandise trade deficit.

**External imbalances, on average, continue to be mainly funded by non-debt-creating flows.** Net foreign direct investment (FDI) in the form of equity and reinvested earnings continue to drive the financing of the external shortfalls in the region. In Serbia, Albania, and Montenegro, this was especially pronounced, with estimated net FDI totaling 5.5 percent, 6.3 percent, and 10.3 percent of GDP, respectively, and financing on average about 78 percent of CADs. In Serbia and North Macedonia, intercompany loans, a debt-creating FDI, dominate as the countries continue integrating into EU-centric manufacturing value chains. In Kosovo, meanwhile, net FDI inflows decelerated somewhat as a share of GDP, as profit repatriation is expected to increase, and are expected to finance only one-third of the CAD, same as for North Macedonia. This is a large shift for North Macedonia, which has seen its external account deficit typically financed by net FDI inflows. Given the importance of FDI in supporting the current account, external borrowing remains a smaller—but no less important—source of financing. Total external debt is on the decline for the region, projected at an average of 84.4 percent of GDP, after peaking at close to 90 percent in 2020 (Figure 8.4).

**Continued net financial inflows have supported the buildup of foreign exchange reserves.** By end-September 2022, foreign exchange reserves remained strong for the region, and prudent adequacy levels were maintained for all countries. This is despite some pressures on exchange rates in several countries to defend their currencies, which was addressed through interventions at the foreign exchange markets that initially reduced reserves. In the case of North Macedonia, a decline in reserves in spring 2022 was around 20 percent, which has been partly recovered since.

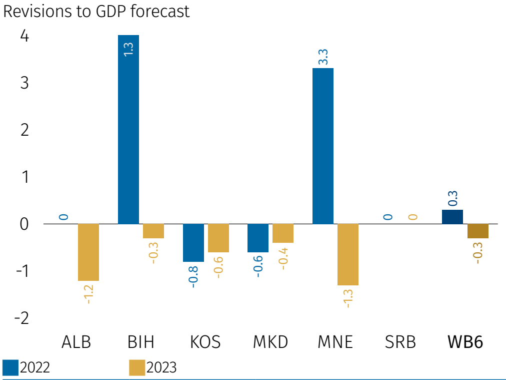
# 9. The region heads into another storm

**The outlook for the Western Balkans continues to be buffeted by global events, generating significant uncertainty and downside risks.** After the strong post-COVID recovery of 2021 (Table 1.1), a growth slowdown was inevitable as economic expansion normalized. However, the start of the war in Ukraine triggered a series of shockwaves that have weighed heavily on the growth outlook for 2022 and for 2023. Energy and food prices have dramatically increased, pushing inflation upward to levels unseen for many years. Similarly, monetary tightening and a slowdown in growth in advanced economies present the region with a challenging combination of higher financing costs and weaker external demand. Meanwhile, the risks of a winter COVID-19 flare-up remain, and global supply chains continue to be stressed.

**Growth in the Western Balkans during the first half of 2022 proved to be relatively robust.** Growth momentum was sustained across the region through the first two quarters of the year as the consumption, investment, and export rebound of 2021 was sustained into the following year. Initial fears that the region's economies would be directly affected by the fallout of the war proved to be overblown. Economies and sectors most exposed to either Russian or Ukrainian demand, such as Montenegro's tourism sector and investment flows into Serbia, held up comparatively well.

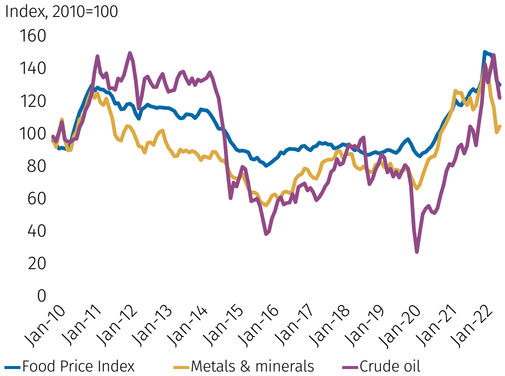
**However, it is now clear that the region is heading into a perfect storm.** By mid-2022 it became apparent that a confluence of indirect supply and demand shocks would weigh heavily on the region's outlook, pushing inflation sharply upward and dampening consumer and investor confidence. Economic activity is also slowing sharply in advanced economies, especially in the Eurozone, which is a key source of demand for Western Balkans goods and services, and a source of investment and remittances. As a result, growth in the Western Balkans has been further revised downward for 2023 (by 0.3 percentage points) to 2.8 percent (Figure 9.1). This downgrade is in line with revisions to global growth (Box 9.1), including

**Figure 9.1.** Growth projections have been revised downward in 2023 since spring 2022.




*Source:* World Bank staff calculations.

**Figure 9.2.** Commodity prices may have peaked.




*Source:* UN FAO and World Bank.

a projected full-year recession in the Eurozone in 2023.

**Gas prices have increased dramatically over the year, although prices for other commodities appear to have peaked** (Figure 9.2). Prices for traded commodities increased rapidly as the world recovered from COVID-19, placing net importers under acute pressure. However, food prices (as measured by the United Nations Food and Agriculture Organization Food Price Index) appear to have peaked, stabilizing at 138.0 points in August. Similarly, the index of international metals and minerals has risen only marginally over the past year to 103.8 points in August. Oil prices also appear to have peaked due to increased fears for global growth, with the index dropping slightly to 121.4 in August. Most significantly for Europe, prices for natural gas have multiplied due to Russian supply restrictions, raising also electricity and heating prices, placing energy importing economies (including Kosovo, North Macedonia, and Serbia) under acute pressure. This pressure is expected to intensify during the coming winter heating season, especially for those economies that either have limited storage capacity or are dependent on spot-market purchases to meet their energy import requirements.

### **Box 9.1.** Global economy under continued shocks.

**Two years after the onset of the Covid-19 pandemic, the global economy continues to be rocked by a series of large shocks[34].** Geopolitical tensions are casting a long shadow, with the Russian Federation's invasion of Ukraine magnifying pre-existing supply-side challenges and intensifying volatility in commodity markets. China, the main engine of emerging markets (EMDE) expansion in the pre-pandemic decade, is facing another year of markedly weak growth under the strains of pandemic-related lockdowns and real estate sector stress. Meanwhile, stubbornly high, and persistent inflation across both advanced economies and EMDEs has given rise to a sharp and highly synchronized global monetary tightening cycle. Indeed, the aggregate number of policy rate hikes reached a record-high in July 2022. Alongside, the withdrawal of pandemic-related support programs has seen a precipitous decline in government spending-growth, from an unprecedented high of 18 percent of global GDP in 2020 to 3 percent in 2022, a level more in line with its 2010-19 average.

**The confluence of these factors has motivated sharp downward revisions to consensus forecasts for global growth in 2022 and 2023.** In January 2022, consensus forecasts were for global GDP growth of 4.1 percent in 2022 and 3.3 percent in 2023. By August, these projections had been downgraded to 2.8 percent for 2022 and 2.3 percent for 2023. Consensus growth projections for 2022 and 2023 have been downgraded for most countries—more than 90 percent of advanced economies and 80 percent of EMDEs for 2023. In contrast, expectations for global inflation in 2023 have increased substantially.

34 This box is based on: Guénette, J.-D., M.A. Kose, and N. Sugawara. 2022. "Is a Global Recession Imminent." EFI Policy Note 4, World Bank, Washington, DC.

*(Box 9.1 continued)*

**With the growth outlook already weak, global recession risks have risen.** The modest but positive growth envisioned by consensus forecasts would not necessarily be a bad outcome—the breakneck growth rate of 2021 was not sustainable, as demonstrated by the widespread evidence of overheating. However, a sharp slowdown into a period of weak growth leaves the global economy vulnerable to further shocks. Moreover, policy responses may be constrained by pandemic-era debt surge, which has curtailed fiscal policy space, and need for monetary authorities to curb inflation. In this context, additional large shocks could be the trigger for the next global recession, defined as negative global per capita growth (Kose, Sugawara, and Terrones 2020).

**The history of global recessions suggests reason to be concerned.** There have been five global recessions since 1970, in 1975, 1982, 1991, 2009 and 2020. They have occurred when the world economy has experienced exceptionally large supply shocks (oil shock in 1973–74; pandemic in 2020), financial turmoil, often linked to accumulated financial imbalances (1982, 1991, and 2009), or sharp shifts in policy (1982). The current circumstances share some key characteristics with periods preceding previous global recessions. Indicators of global economic activity, such as world industrial production, trade, and oil consumption have tended to slow down in the two years before global recessions. Resembling this experience, several high-frequency activity indicators have weakened over the past year, including manufacturing export orders, equity prices and consumer confidence.

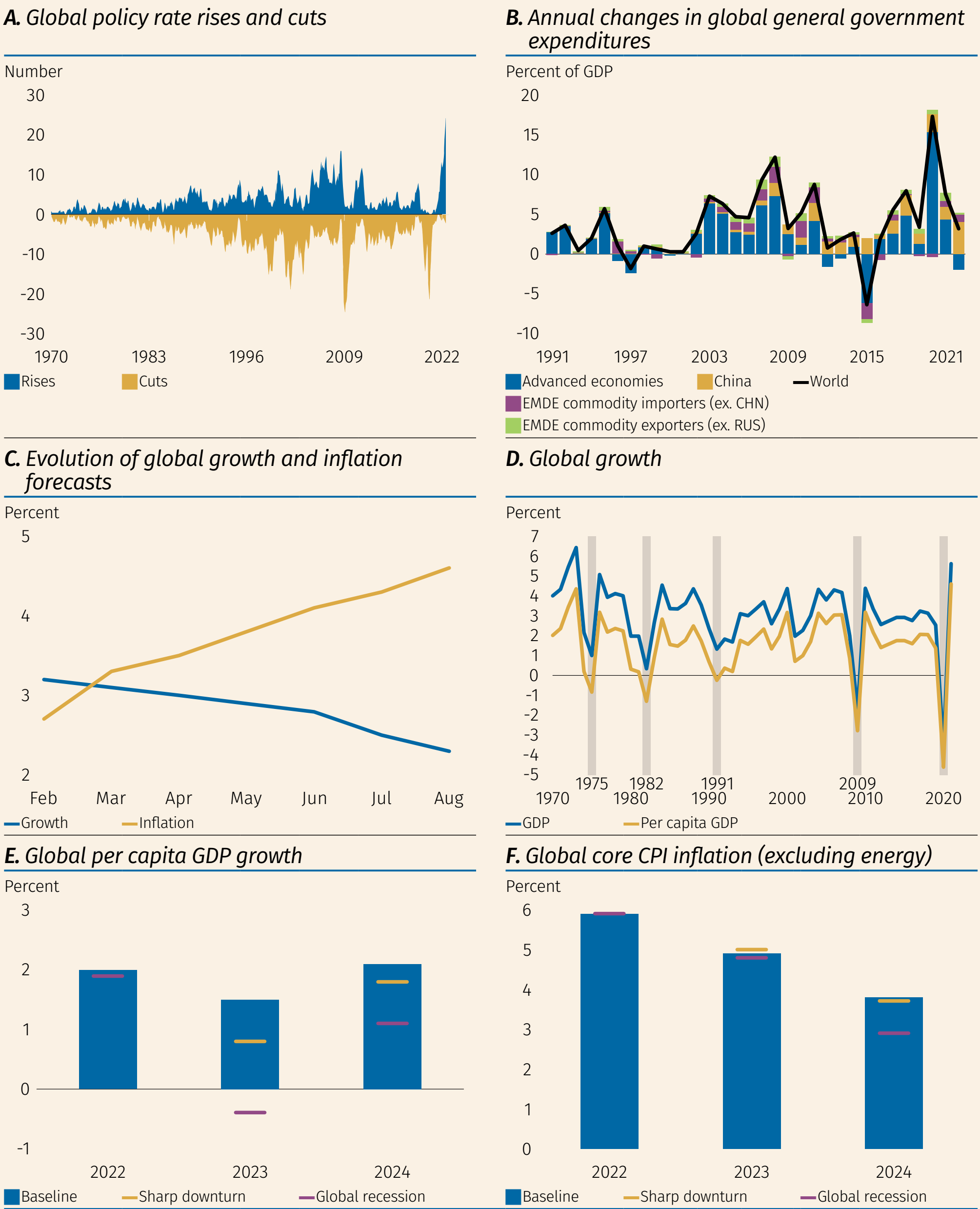
**In the global recession scenario, more substantial increases in inflation expectations are countered with much larger-than-expected synchronous policy tightening, triggering financial stress that tips the global economy into recession.** Core inflation would decline to 2.9 percent by 2024, close to target, but at a high cost. In 2023, the global economy would experience a recession similar in magnitude to 1982, with growth slowing to 0.5 percent. 2024 would see only a subdued recovery, to 2 percent growth, reflecting the absence of countercyclical policy support in advanced economies, and adverse spillovers combined with limited policy space in EMDEs. The global recession scenario illustrates the importance of the value of clarity and consistency in formulating and communicating monetary policy (Ha et al. 2022; Kose et al. 2019; Shin 2022). Transparency in the conduct of policy reduces the risk of abrupt market dislocations and financial stress.

**Heading into 2023, policymakers face a difficult challenge to successfully navigate an environment of weak growth and high inflation.** Monetary policy must be employed consistently to restore, in a timely manner, price stability. The lesson from history is that making the necessary policy adjustments in a timely fashion is essential to contain inflation, and thus avoid the more severe output costs associated with larger policy interventions later. Fiscal policy needs to prioritize medium-term debt sustainability while providing targeted support to vulnerable groups. Policymakers need to stand ready to manage potential spillovers

*(Box 9.1 continued)*

from the globally synchronous withdrawal of policies supporting growth. On the supply side, measures can be put in place to ease the constraints that confront labor markets, energy markets, and trade networks. This should help combat inflation, while also improving long-term growth.

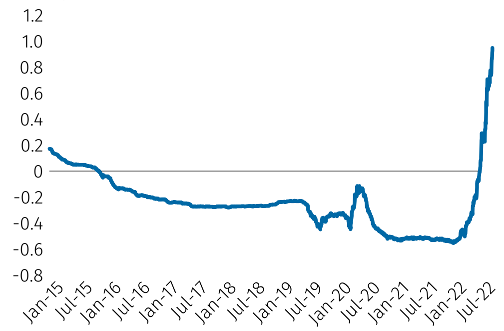
**Figure 9.3.** Global Developments and Growth Scenarios.



*(Box 9.1 continued)*

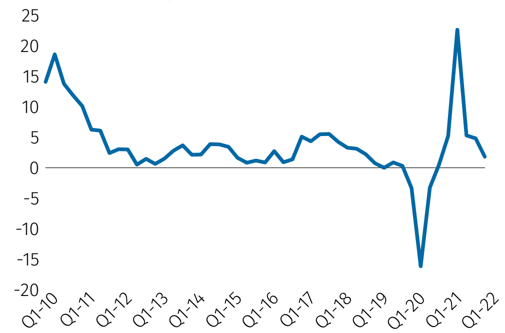
*Source:* Bank for International Settlements; Consensus Economics; Haver Analytics; International Monetary Fund; Kose, Sugawara, and Terrones (2020); Oxford Economics; World Bank.
*A.* Three-month average of the number of policy rate rises and cuts over the month for 38 countries including euro area. The last observation is July 2022.
*B.* Nominal and real (CPI-adjusted) short-term interest rates (Treasury bill rates or money market rates, with the maturity of three months or less). Global interest rates are weighted by GDP in U.S. dollars. Sample includes 118 countries, though the sample size varies by year. Data for 2022 are based on the numbers in the first two quarters of the year.
*C.* Consensus forecasts of global growth are weighted by GDP in U.S. dollars based on 86 countries, and consensus inflation forecasts are based on median based on 83 countries. The last observation is August 2022.
*D.* Shaded areas indicate global recessions in 1975, 1982, 1991, 2009, and 2020. The last observation is 2021.
*E.-F.* These scenarios are produced using the Oxford Economics Global Economic Model.

**Figure 9.4.** Financing costs have risen as advanced economies tighten monetary policy.




*Source:* Bloomberg.

**Figure 9.5.** Trade is weakening as the global economy slows.




*Source:* UNCTAD.

**Inflationary pressures are expected to remain elevated, with risks that higher energy and food costs translate into a sustained wage-price spiral.** Average inflation rose sharply over the course of 2022, with all economies (except Albania) seeing inflation moving into double digits by midyear. The trend is still upward as regulated energy price adjustments in several countries have yet to be passed on to end users. Low-income households, which spend a higher proportion of their income on energy and food costs, have been particularly affected by the inflation spike. Minimum wages have been increased across the region, and labor market tensions have started to become apparent. Inflation is projected now to average 10.9 percent in the Western Balkans for 2022 as a whole before starting to trend downward in 2023.

**Tighter global financing conditions will raise refinancing costs.** As advanced economies, led first by the United States and now the Eurozone, look toward taming the global inflation shock, global monetary conditions are tightening (Figure 9.4). This is expected to raise the costs of financing for both sovereigns and corporates, restricting access to the Eurobond market for Western Balkan economies with market access. Euro Interbank Offered Rates (Euribor) have risen especially sharply. Where governments are unable to meet their financing needs in their domestic markets, there is likely to be increased recourse to international financial institutions for budget support.

**Slowing global growth, especially in the Eurozone, will dampen demand for the region's exports.** Strong export earnings, both for manufactures and for services (especially tourism) helped propel the recovery from COVID-19. However, with a slowdown (or even a recession) in the Eurozone, which is by far the largest trading partner for the Western Balkan economies, export growth is expected to slow sharply. Growth in global demand for merchandize exports dropped significantly in 2022 (Figure 9.5). Remittance flows may also weaken, if advanced economies that host the Western Balkan diaspora enter pronounced slumps. While suppressed global demand may reduce stresses on global supply chains, this will be partially offset by periodic COVID-19-related movement restrictions in China.

**In such an environment, investor sentiment is expected to remain subdued.** High-frequency data sources, such as the Purchasing Managers Index (PMI), point toward sharply weaker business sentiment (Eurozone PMI data dropped below 50 in July 2022, indicating a shift from manufacturing expansion to contraction). Foreign direct investment flows, as well as domestic investment decisions, are likely to be put on hold amid considerable uncertainty. Financial sector risks will also need to be closely monitored. While nonperforming loan numbers remain low for the region, credit quality may deteriorate if there is a protracted growth slowdown.

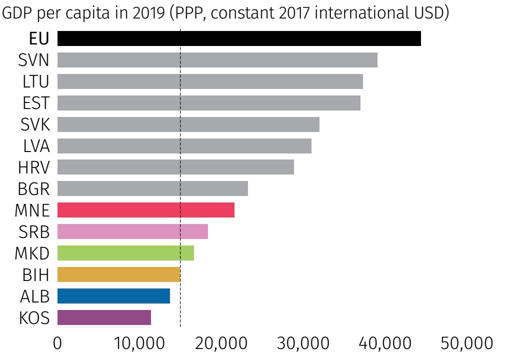
**Governments will face acute fiscal pressures due to a combination of energy relief needs and higher financing costs.** This occurs at a time when fiscal buffers are already depleted due to COVID-19 policy support. Fiscal risks will need to be closely monitored as energy generation and distribution firms struggle to finance their operations and in several countries are prevented from fully passing on higher costs to end users. Fiscal deficits are expected to widen to an average of 3.3 percent of GDP in 2022, from 2.9 percent in 2021. After a decline in public and publicly guaranteed debt to 53 percent of GDP in 2022, debt is expected to stay roughly at the same level in 2023.

**External deficits are likely to widen due to deteriorating terms of trade.** Higher import costs for energy and food will push current account deficits wider, especially in those economies that are most import dependent. For the Western Balkans as a whole, the current account deficit is projected to increase from 4.9 percent of GDP in 2021 to 8.7 percent of GDP in 2022, and to remain elevated into 2023.

**In the short term, governments should prioritize policy support to the vulnerable, ensuring that measures are targeted and timebound.** The recovery of 2021 saw an improvement in fiscal balances across all six economies of the Western Balkans. However, one year of positive growth was not enough to see a significant increase in fiscal space. As such, policy support should ideally be targeted toward low-income households and energy-vulnerable consumers, with a clear time period for the cessation of support. Income support is preferable to blanket subsidies, allowing price signals to drive consumer choice and efficient use of energy. Support to energy-vulnerable firms should be provided with caution, especially to state-owned enterprises, and be accompanied by reforms to boost transparency and strengthen market signals.

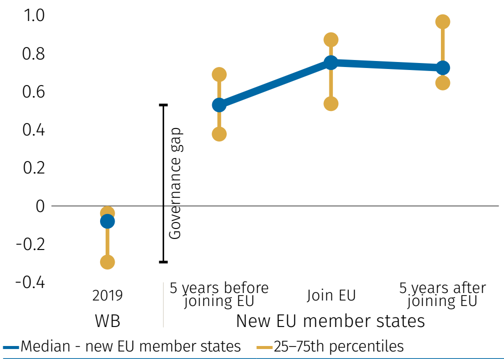
**With limited fiscal space, no-regret reforms that would boost medium-term growth at limited fiscal cost should be a priority.** Convergence with European peers is only possible for the Western Balkans if the rate of potential growth is increased. At a time when

**Figure 9.6.** An increase in potential growth is needed for the Western Balkans to converge with EU per capita income levels.



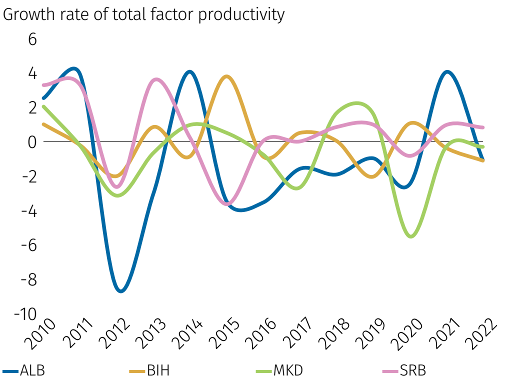

*Source:* World Bank.

**Figure 9.7.** A large governance gap exists between the Western Balkans and EU peers.



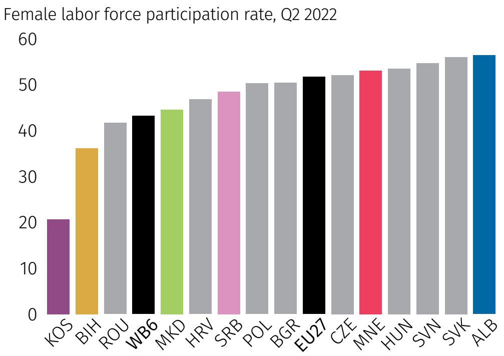

*Source:* World Bank.

**Figure 9.8.** Total factor productivity growth has been sluggish.




*Source:* Total Economy Database.

**Figure 9.9.** Labor force participation, particularly for women, is below that of EU peers.




*Source:* Eurostat and National Statistical Offices.

public sector resources are scarce, it would be appropriate to prioritize reforms with limited fiscal cost that would serve to accelerate potential growth and convergence over the medium term (Figure 9.6). This would include measures to raise standards of governance, including digitalization (Figure 9.7), increase the level of market competition, remove entry barriers to business, and increase retention and reinvestment among foreign investors to boost factor productivity (Figure 9.8), as well as improve skills and reduce barriers to female labor force participation (Figure 9.9). The ongoing crisis also underpins the importance of accelerating the green transition in the region away from volatile hydrocarbons toward cleaner electricity generation, as well as greener production, finance, and consumption patterns. Greening the financial sector and green finance offer new opportunities in the Western Balkans (see Section 10: Spotlight) at lower financial and opportunity costs.

**The medium-term outlook for the Western Balkans remains positive, but short-term risks are heavily tilted to the downside.** The region's fundamentals and the opportunity to achieve economic convergence and integration with Europe remain strong. However, increased intensification of the economic crisis as a result of the prolonged war in Ukraine would place the region under even further stress. Similarly, the risks of political polarization within countries in the Western Balkans remain high. Finally, the risks of a flare-up of COVID-19 remain acute, given the vaccination gap that exists between the Western Balkans and the rest of Europe.

### **Box 9.2.** Raising potential growth will be key to unlocking a medium-term recovery.[35]

**To counter significant headwinds to long-term growth prospects, structural reforms are needed to reignite productivity growth, accelerate the convergence process with average EU incomes, and help reap dividends from the digital and green transition.** Following years of weak growth in the aftermath of the global financial crisis and European debt crisis, potential growth in the Western Balkans is now anticipated to increase. Potential growth in Western Balkans is anticipated to strengthen from 2.2 percent over 2013–21 to an average of 3.2 percent over 2022–30 driven by the expected increase in contributions from investment, in particular the positive impact of EU investment funds, and related structural reforms that would boost the contribution from capital and total factor productivity (TFP) growth over the remainder of the decade.[36] The contribution from labor is anticipated to become a drag on potential growth as the population continues to age and the labor force subsequently shrinks. Still, potential growth estimates remain subject to a high degree of uncertainty given overlapping negative shocks over the last few years from the COVID-19 and the Russian Federation's invasion of Ukraine.

**Although potential growth in the Western Balkans is expected to firm over 2022–30, it is anticipated to remain subdued relative to peers.** The average pace of potential growth is projected to remain weaker than the EMDE average, as lingering structural issues and adverse demographic trends weigh on growth prospects in the Western Balkans. Sluggish improvement in institutional quality, weak perception of government effectiveness and the control of corruption, lack of high-quality job opportunities, and elevated informality and inequality have exacerbated longer-term structural issues like a dwindling supply of labor amid ageing and emigration. These constraints also weigh on foreign investments, private-sector development, and firm productivity. Despite relatively high levels of average years of education, learning outcomes in all six Western Balkan economies trails the OECD average as measured by PISA test scores.[37]

35 Based on the forthcoming work in Kilic Celik et al., Kilic Celik, Kose, and Ohnsorge (2020) and World Bank (2018a).
36 Potential growth is constructed from model-based estimates, which are intended to capture major long-term drivers of growth using a standard Cobb-Douglas production function, where growth of potential GDP can be decomposed into contributions from increased capital stock, labor supply adjusted for human capital, and gains in total factor productivity. Potential labor supply is derived from the labor force participation predicted by a panel regression of labor force participation in five age groups for each gender on education and health indicators, as well as cohort effects. Potential TFP growth is derived from the predicted value of a panel regression of trend TFP growth on education and health indicators, investment, and research and development spending. Potential capital is assumed to match actual capital.
37 OECD, 2018.

*(Box 9.2 continued)*

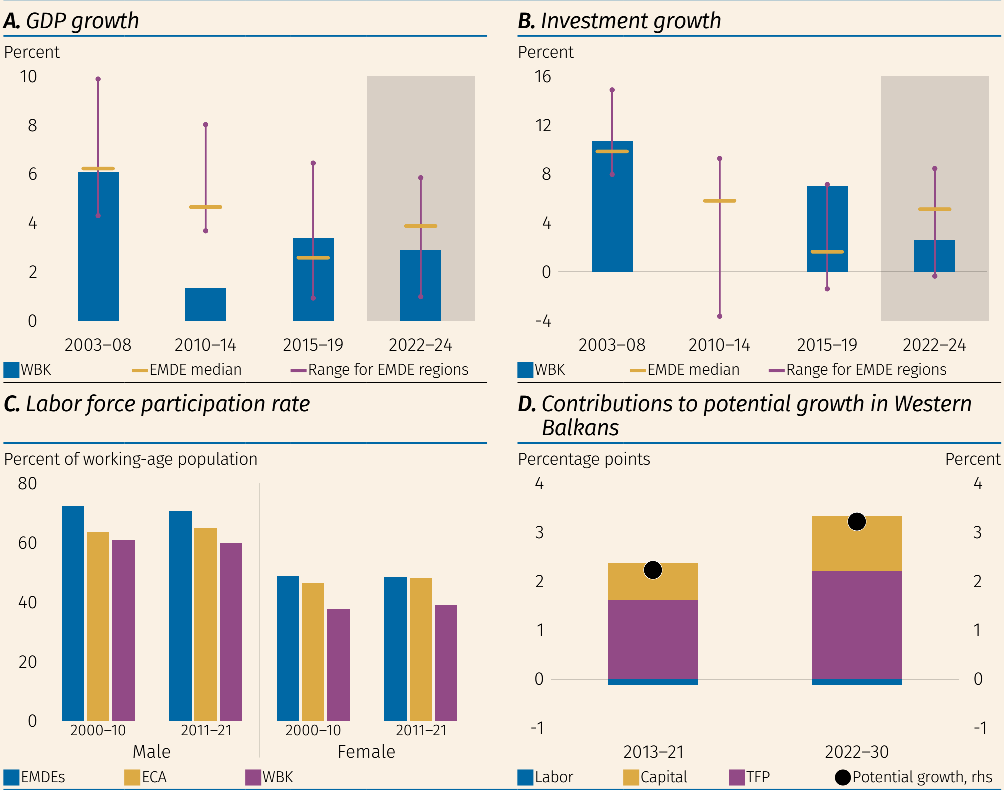
**Compounding these long-standing structural issues are intense cyclical headwinds.** Learning and job losses from the pandemic have weighed on the formation of human capital, with vulnerable populations the worst affected—in part reflecting digital constraints for online education for poorer and rural households and weaker labor market recoveries for lower-skilled workers. The war in Ukraine is exacerbating structural headwinds by denting confidence and disrupting regional value chains and energy supplies. As a result, output in the Western Balkans is anticipated to remain about 5 percent below its pre-pandemic trend in 2023.[38] Over the longer term, the fragmentation of regional trade and finance networks from the war could interrupt the Western Balkans' progress in global value chain (GVC) integration, which had already lagged regional and Asian peers prior to the pandemic.[39]

**Given intense headwinds to long-term growth prospects, it will be critical for economies in the Western Balkans to advance structural reforms and accelerate economic transformation** (Figure 9.10). Significant EU investments over the remainder of the decade can provide an anchor for structural reforms in the Western Balkans. Improving institutional quality could yield large gains in potential growth by bolstering confidence, creating a more favorable business climate, and increasing government effectiveness—in turn strengthening the efficiency of public investment and attracting private investment. Deeper regional integration with the EU—including with digital, investment, innovation, and industrial policy—could boost investment and trade prospects, the regulatory environment, competition, and productivity.[40] The EU investments over the remainder of the decade also include sizable funding for the green and digital transition in the Western Balkans—a key priority given these economies are among those in ECA farthest from the green transition frontier.[41] Increasing R&D spending—which ranged from 0.2 to 0.9 percent of GDP in 2020 across the Western Balkans compared to 2.3 percent of GDP in the EU—could provide additional support to the digital and green agendas, further encouraging the acceleration of technological development and TFP.

38 World Bank Regular Economic Report for the Western Balkans, Spring 2022.
39 https://blogs.worldbank.org/psd/western-balkans-should-leverage-foreign-direct-investment-integrate-global-value-chains.
40 https://ec.europa.eu/info/sites/default/files/economy-finance/ip180_en_0.pdf.
41 EBRD 2021. https://www.ebrd.com/news/publications/annual-report/annual-review-2021.html.

*(Box 9.2 continued)*

**Figure 9.10.** Structural reforms are needed to boost potential growth in the Western Balkans.




*Sources:* Penn World Tables; UN Population Prospects; World Bank; World Bank, WDI.
*Note:* ECA = Europe and Central Asia; EMDEs = emerging market and developing economies; WBK = Western Balkans. Shaded area indicates forecasts. GDP weights are calculated using average real U.S. dollar GDP (at average 2010-19 prices and market exchange rates) for the period 2011–19.
*A.* Bars show period averages of annual GDP-weighted averages. Markers denote medians, vertical lines denote min-max ranges.
*B.* Bars show period averages of annual GDP-weighted averages. Vertical lines denote min-max ranges. Sample includes 14 ECA economies, including Türkiye, the Russian Federation, and Ukraine.
*C.* Figure shows proportion of the population ages 15 and older that is economically active. Aggregates are calculated as simple averages. Sample includes Sample includes 145 EMDEs, 23 ECA economies, and 6 WBK including Albania, Bosnia and Herzegovina, Kosovo, Montenegro, North Macedonia, and Serbia.
*D.* Period averages of annual GDP-weighted averages. Estimates based on production function approach. Sample includes 4 Western Balkans economies (Albania, Bosnia and Herzegovina, Montenegro, and Serbia).

# 10. *Spotlight:* Greening the Western Balkan Financial Sector

**The energy crisis is accelerating decisions on green transition polices across the European Union countries.** The external environment is going through a major structural change, and fundamental environmental pressures are changing the foundations of economic activity, consumer choices, and investor behavior everywhere. Yet, the Western Balkans have so far been slow in moving away from legacy "brown" industries, skills and jobs, and established value chains and market infrastructure. And furthermore, while leapfrogging to a "green" growth pathway is far from easy, especially in the short term,[42] the green transition offers opportunities for the Western Balkans, and for the financial sector in particular.

## *The financial sector has an important role to play in addressing climate change*

**Transition towards a low-carbon, environmentally sustainable economy requires significant global investments to deal with adaptation and mitigation costs, and address other aspects of environmental degradation.** High-level estimations suggest that supporting a green economic recovery after COVID-19 will generate more than $10 trillion in investment opportunities.[43] The global transition away from fossil fuels has been estimated as a $50 trillion investment and financing opportunity.[44] However, despite large financing gaps, greening the financial sector and green finance have fallen short of the required scale and scope that is required to address these challenges.

**Climate change and environmental concerns expose the financial sector to physical and transition risks which impact financial stability.** Physical risks are risks in terms of natural disasters/hazards related to climate change—floods, droughts, landslides, earthquakes, hurricanes and/or climate change induced extreme events. Other potential climate-related extreme events may be deforestation, heatwaves, water scarcity and wildfires which are becoming more frequent and intense with climate change. Such physical risks translate to financial exposure through the banking and insurance segments related to agriculture, industry, services, energy, and mining sectors, nearly all sectors. Transition risks are risks related to sudden and unanticipated climate policy, technology, and consumer preference changes. Transition risks could also emerge when other countries implement climate border adjustment measures (e.g. EU imposing tariffs on imports of carbon intensive products to avoid carbon leakage and encourage partner countries to introduce carbon pricing). A rapid and unmanaged transition to a low carbon economy could translate into significant transition risks for the financial sector, especially if there is a need for a rapid transition toward green investments to meet climate goals; and/or to mitigate large exposures of financial sector to carbon-intensive

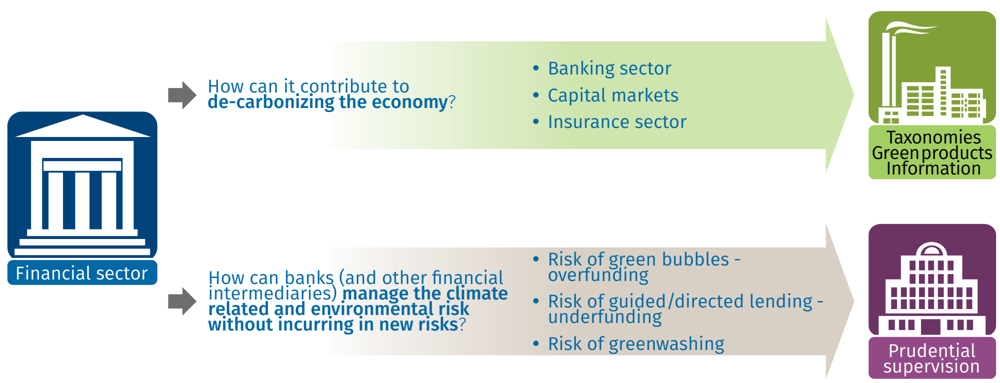
42 World Bank Western Balkan Regular Economic Report #20, Fall 2021.
43 World Bank (2021): Toolkit for Policymakers to green the financial system.
44 World Bank (2021): Toolkit for Policymakers to green the financial system.

and other transition-sensitive sectors. Both types of risks may impact financial stability.

**To support financial stability, mitigating climate change and environmental risks can be achieved by "greening" the financial system, including through the development of green finance instruments.** Greening the financing system refers to increasing financing flows into sectors that contribute to climate and environmental objectives.[45] It can be supported by (i) enhancing prudential measures to maintain the quality of financial sector portfolios that may be subject to climatic shock (direct or indirect), and (ii) developing green finance instruments and services which support households, firms and government in meeting adaptation and mitigation actions (Figure 10.1). Green finance is a narrower term and refers to all lending and investment towards climate mitigation, climate adaptation and resilience, and other environmental objectives—including biodiversity management and nature-based solutions.[46]

**The nexus of climate change and the financial sector has prompted a growing body of international cooperation and policy guidance.** Volunteer networks have been developed between central banks and supervisors to share best practices and contribute to the development of environment and climate risk management in the financial sector and to mobilize finance to support transition towards a sustainable economy.[47] Likewise, a voluntary coalition of fiscal and economic policy makers of over 70 countries have formed "the Coalition of Finance Ministers for Climate Action" utilizing the Helsinki Principles to guide the coalition's commitment to combat climate change.[48] International financial standard setting bodies, including the Financial Stability Board[49] and the Basel Committee on Banking Supervision[50] have published guidelines related to combating climate change within the financial sectors—Task Force on Climate-Related Financial Disclosures and the Principles for the effective management and supervision of climate-related

**Figure 10.1.** Green Finance and the Role of the Financial Sector.




*Source:* World Bank FinSAC.

45 World Bank (2021): Toolkit for Policymakers to green the financial system.
46 World Bank (2021): Toolkit for Policymakers to green the financial system.
47 NGFS: Central Bank and Supervisors: Network for Greening the Financial System. https://www.ngfs.net/en.
48 https://www.financeministersforclimate.org/.
49 https://www.fsb-tcfd.org/.
50 https://www.bis.org/bcbs/publ/d532.pdf.

financial risks, respectively. The Principles seek to improve banks' risk management and supervisors' practices related to climate-related financial risks. Lastly, the International Capital Market Association (ICMA) also published guidelines regarding the voluntary process for issuing green bonds.

**From a regional perspective, the European Commission (EC) has issued several guidelines and policy measures to combat climate change within the European financial sector.** It also adopted a set of policies to reduce greenhouse gas emissions to net-zero through the European Green Deal[51] and adopted an Action Plan to finance sustainable growth.[52] Market guidance has been developed and issued in the areas of: (i) European Corporate Sustainability Report that requires certain large companies to disclose information on how they operate and manage social and environmental challenges;[53] (ii) Green Bond Standards,[54] which are voluntary standards to help scale up and raise the environmental ambitions of the green bond market; and (iii) Sustainable Finance Taxonomy,[55] the EU taxonomy that is a classification system that establishes a list of environmentally sustainable economic activities. From the prudential regulatory aspects, the European Banking Agency provided a comprehensive proposal on how ESG factors and ESG risks should be included in the regulatory and supervisory frameworks for credit institutions and investment firms.[56] The European Central Bank published guidelines on climate-related and environmental risks for banks.[57]

**Specific implementation guidance for emerging markets, including the Western Balkan economies, have also emerged.** From a regional perspective, a working group on climate change was created under the Vienna Initiative with a task to come up with practical recommendations for the Western Balkan countries to address the topics of climate risk-related data gaps, banking supervision issues, and transitional strategies. Furthermore, Guidelines for the Implementation of the Green Agenda for the Western Balkans (Sofia Deceleration)[58] and an Action Plan for the Western Balkan economies[59] for 2021–2030 providing implementation guidelines and concrete actions of implementing the European Green Deal have been issued.[60]

### The Western Balkan economies still have some way to go when it comes to greening the financial sector

**Most of the Western Balkan economies are at the initial stage of greening their financial sectors.** While the carbon intensity of their growth is on decline, it is still several

51 https://ec.europa.eu/info/strategy/priorities-2019-2024/european-green-deal_en.

52 https://www.greenfinanceplatform.org/policies-and-regulations/european-commissions-action-plan-financing-sustainable-growth#:~:text=The%20Action%20Plan%20on%20Sustainable,3)%20To%20foster%20transparency%20and.

53 https://ec.europa.eu/info/business-economy-euro/company-reporting-and-auditing/company-reporting/corporate-sustainability-reporting_en.

54 https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/european-green-bond-standard_en.

55 https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities_en.

56 https://www.eba.europa.eu/eba-publishes-its-report-management-and-supervision-esg-risks-credit-institutions-and-investment.

57 https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr201127~5642b6e68d.en.html.

58 https://ec.europa.eu/neighbourhood-enlargement/system/files/2020-10/green_agenda_for_the_western_balkans_en.pdf.

59 https://www.rcc.int/docs/596/action-plan-for-the-implementation-of-the-sofia-declaration-on-the-green-agenda-for-the-western-balkans-2021-2030.

60 For emerging economies, in general, the World Bank published: (i) the Toolkit for Policymakers to Green the Financial System—a practical, high-level guidance for public authorities that are exploring opportunities to green their financial sector; and (ii) Developing a National Green Taxonomy—the guide includes recommendations for drafting of national green taxonomies, as well as a comparison of several existing taxonomies, in order to support countries in their efforts to clarify to market participants the types of activities that are deemed environmentally sustainable.

times above the EU levels.[61] Collectively, the Western Balkan countries are vulnerable to several physical risks: floods, earthquakes, landslides, wildfires, droughts, blizzards. Climate change will exacerbate the frequency and intensity of such occurrences and associated vulnerabilities (e.g. energy production vulnerabilities associated to droughts which effected hydropower-reliant countries, food security associated to agriculture production reliant upon climate stability) (Table 10.1). In terms of transitory risks, the countries face substantial challenges in transitioning towards less carbon-intensive economic activities. These transition risks are likely to affect the banking, insurance, and pension sectors, particularly, as this is the case for the financing of construction, transportation, energy, manufacturing, and agriculture sector credits and investments within their respective portfolios. The real sector is trailing in terms of adjusting their industries to meet the pending European market standards—part of the European Green Deal—and will ultimately need to be funded to ensure their decarbonization is in line with the Paris Agreement.

**Despite the presence of these risks and the proximity and economic linkages to the European market, there is an absence of country-specific, comprehensive strategies and roadmaps to tackle climate and environmental risks.** In many Western Balkan economies, an initial taxonomy of their economic activities has yet to be undertaken. Transparency and disclosure standards and statements for sustainability for large corporate and financial institutions have not yet been developed. Prudential supervision and oversight guidelines have yet to be drafted and enforced by financial regulators.

**Despite growing public awareness of the role that the financial sector could play in reaching countries' climate and environmental goals, the Western Balkan economies are still far from implementation of the actual interventions required to greening their respective financial sectors nor do they offer a broad array of green finance products due to several reasons.** This delay could be associated to the misalignment of fiscal, economic, and environmental policies. For example, public subsidies are still being offered to sectors that are not low-carbon and there is low effective carbon taxation. There could also be uncertainty regarding long-term government policy which in turn inhibits the development

**Table 10.1.** Selected Indicators from the INFORM Risk 2022 Index for Climate Risk Management.

| Country | Inform Risk | Flood | Drought | Vulnerability | Economic Dependency | Lack of Coping Capacity |
|---|---|---|---|---|---|---|
| Bosnia and Herzegovina | 3.5 | 7.1 | 2.8 | 3.8 | 2.6 | 4.9 |
| Albania | 3.1 | 4.7 | 6.6 | 1.7 | 2.3 | 4.4 |
| Serbia | 2.8 | 8.9 | 2.9 | 2.4 | 1.4 | 3.7 |
| Montenegro | 2.7 | 4.4 | 1.9 | 2.6 | 2.5 | 3.2 |
| North Macedonia | 2.5 | 4.2 | 3.6 | 2.1 | 1.4 | 3.6 |
| EU Average | 1.9 | 4.4 | 1.8 | 2.6 | 0.3 | 2.0 |

*Source:* European Commission INFORM Risk Index 2022.

61 https://openknowledge.worldbank.org/bitstream/handle/10986/36402/Greening-the-Recovery.pdf?sequence=1&isAllowed=y.

of a project pipeline; or there could be limited motivation or capacity of financial institutions to identify and originate green assets and manage climate-related and environmental risks. Furthermore, the high upfront financing costs, transactions costs, lack of track-record of new technologies, and long payback periods for some green projects could increase the real and perceived riskiness of green projects overall.[62] Overall, these delays can indirectly influence the perceived level of risk which has a direct impact on investment decisions. Rather, managing climate and environmental risks through financial supervision and increasing awareness can play an important role in changing financial behavior and driving capital towards green goals.

**One positive development is Serbia's issuance of its first sovereign green bond in 2021 of EUR1 billion.** The sovereign green bond is envisaged to be used for Serbia's financing and refinancing in the areas of renewable energy, energy efficiency, sustainable water management, pollution prevention and control, protection of the environment and biodiversity and sustainable agriculture. The seven-year bond, three times oversubscribed, has a 1 percent interest rate, and the yield rate is 1.26 percent. The interest rate was well below the rate for regular bonds and drew in a new and wider class of investors. Serbia's sovereign green bond issuance offers useful lessons for other countries in the region.

**Fortunately, there is a strong presence of predominantly European-owned banks as well as international institutions which are supporting the Western Balkans to take the initial steps towards greening their financial sectors.** The presence of these institutions has supported initial efforts towards raising awareness of ESG and Sustainable Finance within the financial sector. Several banks operating across the Western Balkan region[63] are subsidiaries of EU-based banks (Austria, Germany, Italy and Slovenia). These banking groups are typically more familiar with the relevant European legislations and guidelines and have already faced consolidated prudential and risk management requirements by the ECB. These banks effectively work as a key channel for cross-border knowledge and the transferring of best practices. Likewise, the financial sector is currently supported by IFIs—EBRD, IFC, IBRD, KfW, USAiD—which have designed and implemented programs to support the development of sustainable lending markets in the Western Balkans. They regularly offer concessional funding to partner banks in the region linked to sustainable lending products.

**To ensure financial stability, central banks and banking supervisors in the region are in the process of building their capacity, as they take their first steps towards the preparation and approval of Green Finance Strategies.** These strategies are being developed by the central banks in Albania, Kosovo, Montenegro and North Macedonia, and the Banking Agencies of the Federation of BiH and the Republika Srpska. Most authorities are also actively participating in international and regional fora, regularly engaging with international organizations to have a clear understanding of what their role should be in greening the financial sector and what initiatives they may adopt within a credible timeline.

62 World Bank (2021): Toolkit for Policymakers to Green the Financial System.
63 Such as RBI, OTP Bank, Unicredit Group, Intesa SanPaolo, ProCredit, and NLB Group, among others.

Furthermore, Western Balkans central banks and supervisory authorities coordinate with the relevant competent government ministries (Finance, Environment, Industry, etc.) to seek synergies across domestic policies.

### *The development of Green Finance Strategies is a key priority*

**As a first step, each Western Balkan country can develop a national strategy and a roadmap on green finance to prioritize actions.** To coordinate initiatives and activities across different stakeholders such as policy makers, regulators, supervisors, and financial market participants, establishment of a national task force on green finance would be beneficial not only for advancing green finance but also for further assessing and understanding climate and environmental risks. Such a task force could build on and reinforce an inter-institutional working group on the broader green agenda established under the oversight of the Cabinet. This may require legal mandates and responsibilities by different authorities to fulfill the objectives. Nonetheless the agile and efficient coordination between institutions, avoiding gaps, overlaps and inconsistencies in the process needs to be assured.

**The ministries of finance would be responsible for creating the conditions for the development of the green financial market by adopting a "green taxonomy."** This would identify the criteria upon which the economic activities can be identified as sustainable or green, and therefore their funding or investment can also be earmarked as such. The taxonomy should be interoperable with the EU's taxonomy practices; as well as, aligned with climate-related national strategies, laws, and action plans of each country. Albania and Montenegro's national green taxonomy could also cover blue economy considerations such as sustainable fisheries given their access to the Adriatic Sea. This would help with the development of green and blue financial products and the avoidance of greenwashing. Using this national green taxonomy, financial sector regulators could develop climate-related reporting and disclosure requirements, enforceable for financial institutions and corporates.

**Subsequently, ministries of finance can consider issuing mandatory sustainability disclosure requirements applicable to the largest corporates.**[64] Disclosing regulated, audited information on the sustainable credentials of corporates will be essential for banks and investors when assessing different elements of corporate sustainability. Furthermore, market regulators can be engaged to support the ministry of finance define the framework for Green Bonds. A Green Bond Framework would enable both the state and private sector agents to issue green or social bonds.[65]

**Climate and Environment Risk and Opportunity Assessments (Green Finance Diagnostics) are useful tools to understand the climate risks and opportunities** (Figure 10.2). In 2021–22, the World Bank worked

64 Corporate sustainability plans may involve how corporates will align business plans to the Paris agreement, exposure to transition and physical risks from climate change, ESG management practices, own GHG emissions, etc.

65 The WB has issued guidance for public financial sector authorities in developing appropriate key performance indicators for sustainability linked bonds (https://documents1.worldbank.org/curated/en/935681641463424672/pdf/Striking-the-Right-Note-Key-Performance-Indicators-for-Sovereign-Sustainability-Linked-Bonds.pdf and https://documents1.worldbank.org/curated/en/099615001312229019/pdf/P170336065a94c04d0a6d00f3a2a6414cef.pdf).

**Figure 10.2.** Scope and example of CERO Assessments: An illustrative example.

A. Climate Change and Environmental Context

| B. Vulnerabilities to Climate and Environmental Risks | C. Supervisory Response | D. Deepening Markets for Green Growth | E. Deepening Markets for Climate Risk Resilience |
|---|---|---|---|

Impact of typhoons and pandemic on bank capital

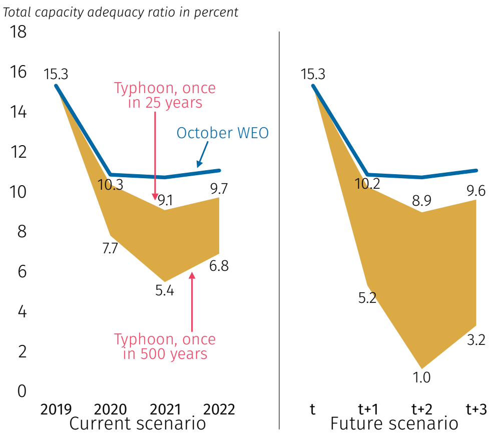



Table of Key Recommendations

| | Recommendations (references to main text) | Responsible authorities | Time |
|---|---|---|---|
| *Supervisory response (140-61)* | | | |
| 1 | Perform in-depth environmental risk assessments of the impact of climate and environmental risks on banks and insurers. | BSP, IC | NT |
| 2 | Improve information collection and monitoring of relevant climate and environmental risk metrics. | BSP, IC | NT |
| 3 | Develop capacity to stress test prudential impacts of climate change. | BSP | MT |
| 4 | Issue guidelines for banks on environmental risk management, governance and disclosures taking account of FSB TCFD recommendations. | BSP | NT |
| 5 | Integrate climate and environmental risks in off-site monitoring, on-site supervision and supervisory ratings. | BSP | MT |
| 6 | Consider applying for membership of the Central Banks and Regulators Network for Greening the Financial System. | BSP | MT |
| 7 | Build capacity to monitor and supervise uptake of the Sustainability Reporting Guidelines for PLCs and evaluate whether a mandatory approach is needed. | SEC | MT |
| 8 | Conduct a study on how investors are integrating sustainability factors into investment decisions and risk management. | SEC | MT |
| 9 | Develop risk-based regulation and supervision methodologies that address insurers' catastrophe risk accumulation and transfer practices. | IC | MT |
| 10 | Introduce disclosure guidelines on reporting of environmental and climate risks for insurance companies, taking account of FSB TCFD recommendations. | IC | NT |
| *Deepening Markets for Green Inclusive Growth (162-81)* | | | |
| 11 | Develop a strategy on green or sustainable finance. | DOF, BSP | NT |
| 12 | Set up a national platform for green or sustainable finance. | BSP | NT |
| 13 | Introduce a green finance taxonomy based on global best practices. | DOF, BSP | MT |
| 14 | Consider a mandatory labeling system for energy efficiency of buildings. | DoE | MT |
| 15 | Explore the opportunity for further reprioritizing development banks for green growth. | DOF, BSP | MT |
| 16 | Consider issuing sovereign green bonds, performing a readiness and opportunity study as a first step. | DOF | NT |
| 17 | Explore the potential for blended finance instruments to stimulate green investments. | DOF | NT |
| 18 | Introduce a catastrophe insurance pool. | DOF | NT |
| 19 | Launch an NDC implementation roadmap providing clarity on pathways and investments needed for climate adaptation and mitigation. | CCC, Congress | NT |
| 20 | Consider incentives to further price externalities, including a carbon tax. | DOF | MT |

*Short Term (ST) = within one year; Near Term (NT) = 1–3 years; Medium Term (MT) = 3–5 years.*

*Source:* World Bank FinSAC.

with the authorities in Albania, North Macedonia, and Serbia to help draft Green Finance Diagnostics; high-level observations are noted below. The diagnostics follows the FSAP Climate and Environment Risk and Opportunity Methodology. The framework looks at vulnerabilities in the climate and environment within the macro-financial context. It includes analysis regarding the supervisory response, deepening green finance markets, and deepening markets for climate risk resilience by covering ways authorities can promote the development, access, and use of climate-resilient instruments.

- **Albania**'s greatest climate-related hazard risk is flooding, as the country has multiple rivers and stream systems with significant downstream flooding potential. Other potential climate-related extreme events are droughts, heatwaves, water scarcity, and wildfires. A recent report on Albania by the Global Facility for Disaster Reduction and Recovery (World Bank Group 2020) estimates average future damage from earthquakes and flooding alone at US$147 million per year, while catastrophic and more unlikely events could cause considerably higher damage. Albania shows slow but steady greenhouse gas (GHG) emission growth, of which transportation, industrial and agricultural processes are the most influential drivers. The largest shares of current GHG emissions stem from agriculture, which has put a strong focus on livestock that accounts for over 50 percent of agricultural production value. Unlike many other countries in the region, Albania's electricity generation contributes only minor GHG emissions because its power sector is almost 100 percent fueled by hydropower. The portfolio of Albanian banks consists of multiple sectors that could be directly or indirectly exposed to physical risks such as droughts. Manufacturing, construction, electricity, accommodation, mining, transportation, real estate, agriculture, and water sectors are identified as directly or indirectly exposed to climate physical risks. In addition, credit exposure and economic activity in Albania show high levels of geographical concentration. Over 74 percent of loans are granted to the Tiranë district. About one-third of the outstanding loans on the balance sheets of Albanian banks are linked to transition-sensitive sectors. Exposures are highest in the manufacturing sector (15 percent of total credit exposure), followed by construction (13 percent), mining (3 percent), transportation (2 percent), and agriculture (1.5 percent). The investment portfolios of Albanian insurers are very conservative and transition risks appear to be manageable. Institutional investors, mainly consisting of investment funds, could also be affected by climate-related risks if recurring climate-related impacts affect fiscal sustainability and thus put pressure on domestic sovereign bond holdings.

- **North Macedonia** is characterized by a variable climate and is vulnerable to floods, extreme temperatures, wildfires, droughts, and landslides. Previous disasters in North Macedonia highlight its historical vulnerability to floods and extreme temperatures which are representing 46 and 25 percent of all disasters registered between 1950–2021, respectively. Over the recent years, North Macedonia has shown relatively persistent levels of GHG emission, with energy being the largest driver accounting for about 75 percent of the emissions. Total emissions in 2019 were estimated at 12.9 million metric tons, which is a 15 percent increase on the average emissions in 1990–2018. The region of Skopje represents 53 percent of all loans to non-financial firms in North Macedonia. This concentrated exposure makes banks more vulnerable to physical risks of that region, particularly flooding. Agriculture is another key transmission channel for physical risks to the North Macedonia's financial sector. In terms of transition risks, in total, about 51 percent of bank loans to non-financial firms (USD 1.6 billion) are exposed to Climate Policy-Related Sectors. Banks' direct exposure to fossil fuels and utilities appears limited, although transition risk exposures could differ strongly amongst individual banks, depending on their specialization. Pension funds and other institutional investors as well as insurance sector face limited exposure to physical and transition risks currently, while risk of insurers from agriculture, property damage and business interruption has been growing.

- **Serbia** is particularly exposed to droughts and floods. Physical risks can materialize through the banking sector's exposure to the agriculture, hydropower, and energy and mining sectors, among others. According to high-level estimates, more than significant of non-life insurers' underwriting portfolios could be exposed to physical risks through insurance products to cover natural disasters. Transition risks could materialize for the banking sector through exposure to activities related to building, transportation, energy, or agriculture. Although only assessed at high-level, these so-called climate-policy-relevant sectors make up the equivalent of nearly half of Serbia's GDP. In the nonbanking sector, larger voluntary pension funds seem to be more exposed to transition risks through equity exposure to climate policy-relevant sectors such as oil and gas compared to insurance companies and investment funds.

## *Prudential management of climate and environment risks is essential*

**To support prudential management of climate-related and environment risks, Western Balkan financial sector public authorities—central banks, ministries of finance, financial sector supervisors and regulators—should develop an approach to climate and environment risk assessment and management of the financial sector.** First, a qualitative climate risk assessment of the financial institutions should be completed. The qualitative assessment should be supplemented with a granular quantitative assessment. The authorities should have a comprehensive understanding of the situation of the banking sector's climate and environmental risks. To this end, authorities can prepare surveys addressed to the banking sector and organize climate risks conferences with the participation of financial institutions. Albania, Bosnia and Herzegovina, Kosovo and North Macedonia are in the initial stages of issuing these surveys/questionnaires to the commercial banks; BiH and North Macedonia have begun drafting a Strategy for Green Finance. General conclusions of the surveys and questionnaires are referenced below and are applicable to the majority of the Western Balkan financial sectors (Table 10.2). Moreover, authorities can improve their understanding[66] of the banking sector exposure to the transition and physical risks from climate change. This can be done by engaging in simple, static exercises that maximize the available data sources and methodologies (i.e. sensitivity analysis).

**Based on the assessment, high-level supervisory guidance and more technical guidelines could benefit Western Balkan financial institutions.** Based on the results of these assessments and better knowledge of the exposures of the financial sector to the risks, supervisory recommendations[67] and/or requirements on managing climate-related risks can be drafted.[68] Supervisors should also integrate climate and environmental risk considerations into their supervisory review process and other regular supervisory activities. Ongoing developments of regulatory and supervisory frameworks by the European financial sector authorities—European Central Bank and the European Banking Authority could guide the Western Balkan authorities.[69]

**Once supervisory recommendations are issued, requesting banks to conduct a self-assessment against them and define remediation plans would be the next step.[70]** The outcome from this process should be a clear commitment from the banking sector to fully meet the recommendations. WB6 Supervisors

66 For example, by assessing the transition risk by breaking down the corporate loan portfolio of the banking sector by NACE, identifying the credit exposures for the most sensitive economic sectors. Furthermore, the geographical location of the exposures of the banking sector can be linked to the physical risks (hazards) that affect those locations.

67 Many European and worldwide authorities have issued a comprehensive set of principles that banks are expected to follow when managing the climate-related risks that they are exposed to. In most cases, the regulatory acts are soft instruments, instrumented as recommendations (such as the 2020 ECB Expectations of Climate-related and environmental risks or the 2020 MNB's Recommendations on Sustainability, updated in July, 2022). Importantly, the Basel Committee on Banking Supervision have issued a similar document, outlining the key principles that banks should follow in managing these risks.

68 The documents can outline several key principles on (i) business model and strategy, (ii) governance framework, (iii) risk strategy and risk appetite, (iv) the role of the internal control functions, (v) principles for credit, operational, market and liquidity risks triggered by climate-related risks, (vi) scenario analysis and stress testing and (vii) data issues.

69 European supervisors are actively working towards ensuring the integration of the risks towards the ordinary supervisory framework. For example, supervisors should work on the integration of the assessment of climate risks into the supervisory rating. For example, supervisors are complementing the assessment of banks' internal governance and risk management, credit risk, or business model by introducing in their methodologies questions and dimensions that are directly related to sustainability. Moreover, supervisors should identify in their supervisory planning process the climate-related issues as an emerging priority and define specific actions to fully ensure the focus on them.

70 For example, after being published in a draft version (2019), the ECB Expectations were approved in the last quarter of 2020. In 2021, banks were requested to engage in self-assessments and to submit credible remediation plans.

**Table 10.2.** Western Balkan commercial banks: Conclusions of the questionnaire/survey to the commercial banks regarding climate and environment risks.

| | |
|---|---|
| 1 | Banks exhibit an uneven level of progress in the management of climate risks |
| 2 | The first contact by banks with green finance has been broadly provided by the engagement with International Financial Institutions |
| 3 | Foreign-owned banks, especially those included in EU banking groups, are benefitting from the group expertise by starting the implementation of the group corporate policies |
| 4 | Some banks have been making progress towards the development of green products, both for corporates and individuals. Typically, these green loans are provided to improve the energy efficiency of buildings |
| 5 | The implementation of sustainability into the bank's risk culture is uneven, with some banks already starting to promote mandatory training programs, updating their codes of conduct to consider aspects related to sustainability. Some banks have also identified their own targets for addressing their own footprint |
| 6 | Banks are making very preliminary steps to integrate climate-related risks into credit risk appetite. Typically, banks define "exclusion lists" by enumerating the economic activities that are considered unsustainable by the bank and therefore banks are unwilling to fund. Banks mostly identify coal-related activities |
| 7 | Some banks have started to allocate the roles and responsibilities on sustainability and, more concretely, on the management of climate related risks throughout the organization, although the practices are still at a nascent stage. Some banks have explicitly allocated responsibilities in one specific area and provide the supervisory board and management with specific information on climate risks |
| 8 | In some banks, the risk management function is actively involved in assessing climate risks, particularly for the corporate clients. Some banks are planning to have their internal audit units involved in assessing climate-related risks. No banks report any involvement by the compliance monitoring units in sustainability. |
| 9 | A small proportion of banks have already begun to integrate sustainability into their credit risk underwriting decisions, by requesting from their borrowers specific information on their sustainability when assessing the solvency of their corporate clients when making their credit risk underwriting decisions. Most banks are not ready to start embedding climate risks into their credit risk management framework |
| 10 | Banks do not have a process for systematically collecting client data for assessing their carbon footprint (i.e., GHG emissions, alignment plans with the NDC and the Paris Agreement, etc.) |
| 11 | Most banks have made progress in integrating the climate risks into the operational risk management framework, mainly to the consideration and, where applicable, insurance coverage of the most relevant physical risks that they are exposed to |
| 12 | No banks have made any relevant progress on integrating climate-related risks in market and liquidity risks. No banks have reported to have conducted any stress test or scenario analysis |
| 13 | No bank has reported the issuance of any green bond to the market. |

*Source:* World Bank FinSAC.

should also be aware of the limitation faced by banks when addressing the recommendations, such as data availability, lack of developed methodologies or the country's legal gaps (i.e., lack of green taxonomy, of disclosures on sustainability, labelling system for building energy efficiency, etc.).

**After banks have made significant advances on the management of climate risks, further supervisory steps can be taken to ensure risks are transparent and mitigated.** Authorities may consider the possibility of including rule-based requirements like the forced implementation of Pillar 3 prudential disclosures related to sustainability[71] or credit risk underwriting rules to force banks to assess the sustainability of the activities of a client before any lending decision.

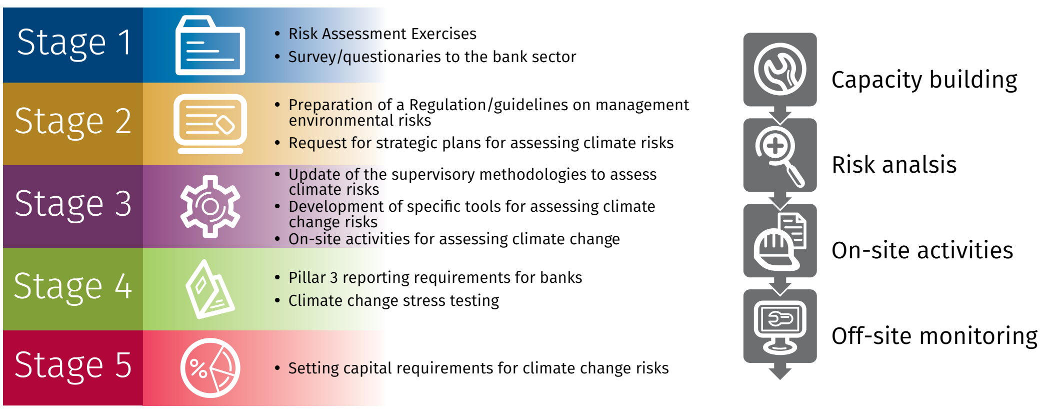
71 For example, by introducing the new European requirements on prudential sustainability disclosures, that involve specific rules on publishing data on ESG risk management practices, on the exposure to transition risks, on the physical risks that the bank is exposed to, etc.

**Supervisory bottom-up stress testing should only come once banks and authorities have made significant progress in addressing climate risks.** These exercises require significant data gathering capabilities, and the development of sophisticated methodologies to project long-term climate scenarios. As they are likely to demand significant efforts by both the banking sector and the authorities, they should only come as the climate risk management practices have been properly anchored in the country's banking system[72], especially for micro-prudential bottom-up exercises.

**Decisions such as setting up climate-sensitive capital requirements can be made at a later stage.** The current international debate over the imposition of capital requirements is currently at its inception. Supervisors and policymakers are debating the possibility of introducing green supporting factors that can reduce the capital requirements for green loans and investments. Regulatory authorities are reluctant to introduce such factors in the absence of evidence of "green risk differentials," according to which green assets are assessed to be less risky than non-green assets. Therefore, the inclusion of capital requirements should only happen at a very late stage (Figure 10.3).

**Authorities, and especially central banks, can complement their approach with other activities.** Central banks should steer their research and macro analysis departments to prepare risk assessments on sustainability, such as the assessment of climate data sources or the analysis of the "green factor", or the existence of a certain risk differential[73] across different portfolios. Finally, authorities can lead with their own example by creating a sustainability culture across their organization by setting specific targets for emission reductions, actions that promote the circular economy, etc.[74]

**Figure 10.3.** Overview of specific actions for regulating and supervising climate-related and environmental risks.




*Source:* World Bank FinSAC.

72 Although some top-down macroeconomic climate stress testing can be undertaken by the central bank without the intervention of banks. In this regard, and considering other relevant supervisory experience, performing bottom-up micro-prudential exercise is a much more challenging and complex exercise with requires substantial preparations and to which banks will need to undertake significant steps.

73 The green factor or the risk differential seeks to identify the impact on the sustainability of an asset in its risk profile. Many comprehensive studies have been trying to identify the existence of such differential and quantify it.

74 World Bank's Financial Sector Advisory Center (FinSAC), based in Vienna, Austria, offers tailored expertise for the overall objective financial stability and via macroprudential frameworks and microprudential supervision and regulations. For example, FinSAC has commenced work with the Bosnia and Herzegovina financial sector authorities on designing a green finance strategy, roadmap and taxonomy regarding the management and supervision of climate-related financial risks in the financial sector for 2022-2025 and is also engaged with the Central Bank of Albania, the National Bank of the Republic of North Macedonia and, more recently, with the Central Bank of Kosovo.

### *The development of green finance instruments presents an opportunity for the region*

**Aside from Serbia's sovereign green bond, other Western Balkan governments could explore opportunities to issue sovereign green and/or blue bonds.** The development of green finance instruments presents an opportunity for the region in the future; however, credit to private sector is currently very low and non-bank financial sector is almost non-existent beyond sovereign bond markets. To this end, the government might want to form an interdepartmental working group on green bonds comprising stakeholders from multiple ministries tasked with establishing a governance and green bond framework and facilitating coordination and consultation among stakeholders in both government and financial markets. A sovereign green and blue bond issuance could also create momentum for corporate entities, including commercial banks, to consider issuing corporate green and blue bonds.

**To further mobilize private capital toward climate mitigation and adaptation, additional policy actions should be explored.** Public financial authorities could cooperate with financial institutions, large companies, and market participants to develop green finance principles, standards, and guidelines for both green and blue corporate bonds and loans. With green finance expanding toward sustainability-linked instruments, robust key performance indicators for these instruments need to be developed. Financial sector regulators could also consider disclosure requirements for large corporates, establishing minimum entry requirements for private entities that provide green assessments, ratings, or verification services to ensure quality external reviews and enhance comparability. Because the corporate bond market is very nascent amongst the Western Balkan financial sector, the governments might want to consider introducing incentive mechanisms to reduce transaction costs such as external reviews on a green and blue bond/loan framework to stimulate green finance in the private sector.

**Western Balkan Ministries of Finance may want to explore options to introduce industry-level risk pooling mechanisms for natural disaster insurance.** A risk pooling mechanism for natural disasters (e.g. earthquake, flood, agriculture insurance) can be introduced. Financial incentives could also be an option to promote natural disaster insurance (e.g. agriculture insurance). For overall capacity building and knowledge exchange purposes beyond risk pooling mechanisms, the Coalition of Finance Ministers for Climate Action could be a useful initiative for the Ministry of Finance and Economy to join in order to learn about other countries' experience and knowledge.

# Country Notes

# Albania

- Following robust growth in early 2022, GDP is likely to decelerate in the remaining part of the year, as rising inflation affects real disposable income, and a slowdown in the global economy translates into tighter financing conditions and lower foreign demand.
- High food and energy inflation have prompted additional government support to households and SMEs, which are already benefitting from regulated electricity prices. This adds to the fiscal pressures.
- Medium-term prospects hinge on the global recovery and structural reforms, and on the launch of fiscal consolidation.
- Poverty is expected to continue declining but the continuation of inflationary pressures will decelerate the recent gains.

## *Recent Economic Developments*

**Following a strong rebound in 2021, Albania's economy expanded by 6 percent in Q1 2022.** Albania's GDP growth rebounded to 8.5 percent in 2021, reflecting economic resilience following two exceptionally large shocks: the 2019 earthquake and the COVID-19 pandemic. Growth continued to be strong in Q1 2022; private consumption, exports and investment expanded, as business and consumer confidence remained strong despite increasing energy and food prices. Household consumption rose by 8.6 percent,[1] outpacing growth of the previous quarter. Net foreign demand contributed positively to growth as exports surged by 25.3 percent while imports increased by 17.6. After driving growth in 2021, gross fixed capital formation slowed to 15.5 percent (versus 16.9 percent in Q4 2021) as government capital expenditures declined. On the supply side, trade and construction led growth in Q1 2022. Business surveys indicate continued growth in the following trimesters on account of tourism, although business confidence indicators started to decline in the second half of the year.

**Labor market conditions improved in early 2022.** Annual employment growth accelerated to 3.4 percent in Q1 2022, from 2.7 percent in the previous quarter. At the same time, unemployment fell to 11.3 percent, while labor force participation increased. Business Surveys indicators suggest firms were expecting sustained employment growth from April to July,[2] with indicators being above historical averages. However, expected employment growth started to slow down in August for businesses operating in industry and services. Given the strong growth in GDP per capita in 2021, poverty is estimated to have dropped from 33 percent in 2020 to 23.1 percent in 2021.

**Following the war in Ukraine, inflation pressures that started in H2 2021 intensified.** The war in Ukraine and the sanctions imposed on Russia disrupted supply chains and were reflected in surging prices of food, energy, and key minerals used in various industries. These developments gradually affected Albania's inflation: the annual inflation rate rose to 7.5 percent in July 2022, the highest since March 2002. Food price inflation

1 All comparisons are year-on-year, unless otherwise stated.
2 The question refers to business employment expectations for the three upcoming months.

and transport inflation for the same month increased at 13.2 percent and 19.7 percent, respectively. Such increases are adversely impacting the poorest citizens given the higher weights these items have in the consumption basket of the poor. The exchange rate against the euro appreciated by 3.7 percent in July, which restrained the transmission of imported inflation into the domestic economy. In addition, regulated prices of energy for business and consumers as well as temporary controlled prices for transport fuels and key food items have redistributed the burden of global price increases and prevented a full transmission to domestic inflation. Yet, these also had a negative fiscal impact.

**Persistent supply-side shocks have created second round effects, raising prices of all items in the consumption basket.** In July 2022, core inflation stood at 7.3 percent against its long-term average of 0.8 percent during 2015-2021. Inflation expectations also have started to reflect these trends: expected inflation for the 12 months ahead reached 9.6 percent for businesses and 10.6 percent for consumers, the highest value recorded since 2016. Longer term inflation expectations are still anchored at below 4 percent.

**The increase in inflation expectations prompted a faster monetary policy normalization.** The central bank raised its key policy rate by 50 basis points to 1.75 percent in August, marking the third hike since the start of the war in Ukraine. As a result, government securities yields' have followed an upward trend since March, also reflecting expectations for a faster normalization of monetary policy.

**Credit to the private sector continued its strong positive trend from 2021 for both enterprises and households.** Outstanding credit to the private sector increased by 13.8 percent in Q2 2022. Non-performing loans stood at 5.3 percent, reflecting sound asset quality. However, the lending survey conducted by the central bank indicates that banks have started to follow more prudent policies for lending to enterprises in the Q2 2022. For the same period, total deposits grew by 10.2 percent, decelerating by 0.4 percentage points from Q1 2022. The growth of foreign currency deposits reflected higher service export inflows and a good performance of remittances in Q2 2022.

**The current account deficit narrowed by 21.8 percent in Q1 2022** as compared to the same quarter in 2021, mainly driven by an increase in exports (by 58 percent) in particular tourism inflows (by 70 percent). Merchandise exports (especially minerals, metals, construction materials, energy, and crude oil), also recorded a high growth of 82.9 percent, largely explained by increased international prices. Imports grew by 32.1 percent, largely driven by the increase in imports of goods, of minerals, energy, refined fuels, and food. Remittances increased by 9.2 percent. Total direct investment inflows increased by 16 percent in Q1 and a double-digit increase was observed in real estate, extractive industries, energy, the financial and insurance sectors, and manufacturing. The foreign exchange reserve stock remained robust at the end of Q1 2022, covering 8.2 months of imports of goods and services, or 394 percent of short-term gross external debt.

**The budget balance was positive in H1, at about 1.5 percent of GDP, reflecting, higher revenues, and cautionary spending given the uncertainties ahead.** Fiscal revenues increased by 19.2 percent in H1 2022 on account of robust growth, increased inflation, formalization efforts, and higher profit tax revenues. VAT revenues contributed 10 percentage points to total growth. Revenues from profit tax generated the second highest contribution to total growth. Investment spending declined by 16.4 percent. In response to higher food prices stemming from the war in Ukraine the government increased budget allocations for support to vulnerable groups and increased subsidies to the energy SOEs, while keeping the tariffs for households and SMEs unchanged. Support for the energy sector since January to June reached 7.9 billion Albanian leks, out of the 28 billion Albanian leks planned for the year.

## *Outlook and Risks*

**Growth for the current year is expected to decelerate towards the fourth quarter of the year, despite the strong performance in the first quarter.** Sustained price increases are likely to lead to a decline in domestic private demand while the government contribution is expected to be affected through the post-earthquake reconstruction program winding down. Foreign demand is likely to decelerate affecting net exports contributions.

**The baseline scenario projects economic activity to expand at an average of 2.7 percent over 2024 following global conditions and persistent supply side shocks.** This is below the pre-earthquake historical rate. Enduring geopolitical tensions could further increase inflation, disrupt supply chains, and disturb financial markets; all of which could further dim Albania's growth prospects. In turn, a sluggish labor market combined with diminished purchasing power could dampen progress on poverty reduction.

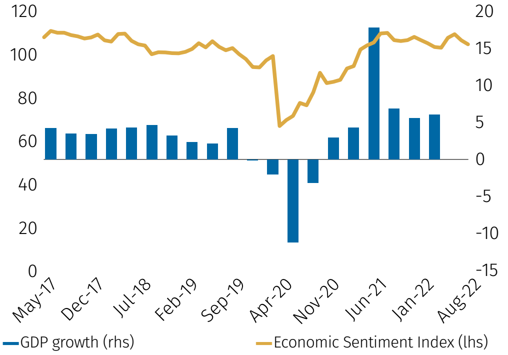
**While the government plans to contain spending in line with fiscal consolidation plans, higher costs of public service provision create additional pressures on growth.** Higher spending may be needed to guarantee the energy supply through more costly energy imports and support to the fragile energy SOEs. Public debt is expected to decline to 68.9 percent of GDP in 2022 from 74 percent in 2021, and more significantly over the medium term. However, the fiscal balance could further deteriorate in a worsening international context, forcing the government to cut public spending to prevent a hike in the debt-to-GDP ratio. Given Albania's growing reliance on external financing, interest rate and refinancing risks remain elevated. Contingent liabilities in the form of guarantees to cover energy purchases also represent a significant risk.

**Regarding the external account, services exports, including tourism and fast-expanding business-process operations, should gradually recover.** Following a reduction of the trade deficit on the first quarter, the current account deficit is expected to slightly expand for the year 2022 reaching 7.9 percent of GDP on account of lower remittances and incomes. The current account deficit is expected to reach 7.7 percent of GDP in 2024, reflecting high demand for infrastructure-related imports.

**In the medium term, private consumption is projected to return as a key driver of growth.** Private investment could provide further support to growth if business climate reforms are implemented. After a significant reduction in 2021, poverty is expected to continue declining in 2022, but persistent inflationary pressures could lead to smaller declines in the future or to reversals of past gains.

## Growth continued to expand in early 2022, and surveys signal a slowing down in Q2 and Q3.

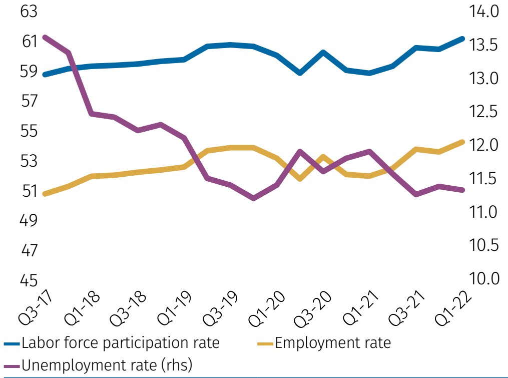
Economic Sentiment Index (lhs) and GDP growth (rhs)




*Source:* INSTAT and Bank of Albania.

## Labor markets improved.

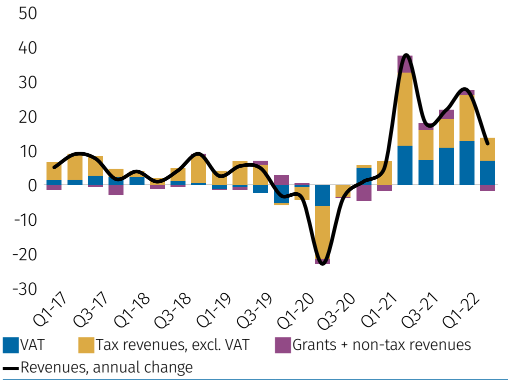
Percent




*Sources:* INSTAT.

## Fiscal revenues grew strongly largely reflecting high transaction prices and formalization efforts.

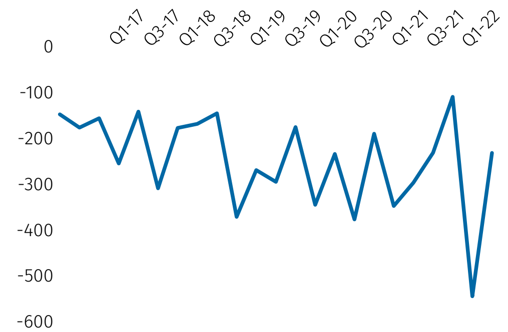
Contribution in total annual revenue growth




*Source:* Ministry of Finance.

## The current account deficit narrowed in Q1 2022.

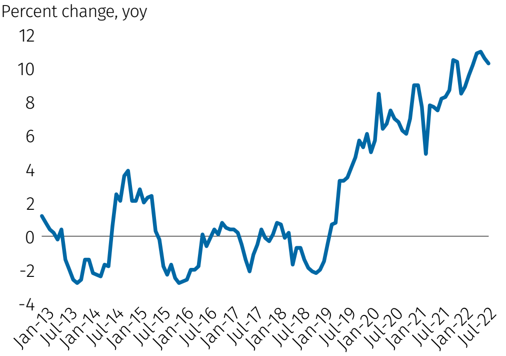
EUR million




*Source:* Bank of Albania.

## Credit to the economy has supported growth.

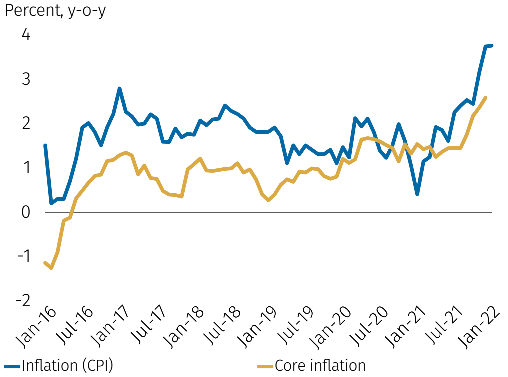
Percent change, yoy




*Source:* Bank of Albania.

## Headline and core inflation have accelerated since April.

Percent, y-o-y




*Source:* Bank of Albania.

| **ALBANIA** Selected Economic Indicators | 2019 | 2020 | 2021 | 2022e | 2023f | 2024f |
|---|---|---|---|---|---|---|
| Real GDP growth (percent) | 2.2 | -3.5 | 8.5 | 3.2 | 2.3 | 2.5 |
| Composition (percentage points): | | | | | | |
| Consumption | 2.5 | -2.6 | 4.5 | 1.6 | 1.6 | 1.9 |
| Investment | -0.9 | -0.9 | 4.8 | 1.0 | 0.0 | 0.0 |
| Net exports | 0.6 | 0.0 | -0.9 | 0.5 | 0.7 | 0.6 |
| Exports | 2.0 | -9.4 | 11.5 | 2.2 | 2.0 | 2.0 |
| Imports (-) | 1.4 | -9.3 | 12.4 | 1.7 | 1.3 | 1.4 |
| Consumer price inflation (percent, period average) | 1.4 | 1.6 | 2.6 | 6.7 | 4.0 | 3.5 |
| Public revenues (percent of GDP) | 27.2 | 25.9 | 27.0 | 26.8 | 27.4 | 27.6 |
| Public expenditures (percent of GDP) | 29.2 | 32.6 | 31.6 | 30.7 | 32.1 | 31.4 |
| Of which: | | | | | | |
| Wage bill (percent of GDP) | 4.6 | 4.7 | 4.4 | 4.1 | 4.4 | 4.4 |
| Social benefits (percent of GDP) | 11.9 | 12.7 | 11.8 | 10.4 | 10.8 | 10.8 |
| Capital expenditures (percent of GDP) | 4.5 | 6.2 | 6.8 | 5.1 | 4.7 | 4.0 |
| Fiscal balance (percent of GDP) | -1.9 | -6.7 | -4.5 | -3.8 | -4.6 | -3.8 |
| Primary fiscal balance (percent of GDP) | 0.1 | -4.6 | -2.6 | -1.3 | -1.1 | 0.0 |
| Public debt (percent of GDP) | 63.7 | 74.0 | 72.1 | 67.0 | 65.5 | 65.0 |
| Public and publicly guaranteed debt (percent of GDP) | 67.4 | 75.9 | 74.0 | 68.9 | 67.4 | 66.9 |
| Of which: External (percent of GDP) | 29.1 | 35.3 | 36.1 | 31.8 | 30.6 | 29.7 |
| Goods exports (percent of GDP) | 6.6 | 6.0 | 8.2 | 10.2 | 9.8 | 9.7 |
| Goods imports (percent of GDP) | 29.7 | 28.4 | 33.0 | 36.6 | 35.1 | 34.5 |
| Net services exports (percent of GDP) | 9.3 | 8.1 | 11.5 | 14.8 | 14.0 | 13.8 |
| Trade balance (percent of GDP) | -13.8 | -14.3 | -13.3 | -11.6 | -11.3 | -11.0 |
| Net remittance inflows (percent of GDP) | 5.2 | 5.1 | 4.9 | 4.7 | 4.4 | 4.4 |
| Current account balance (percent of GDP) | -8.0 | -8.5 | -7.7 | -7.9 | -8.1 | -7.7 |
| Net foreign direct investment inflows (percent of GDP) | 7.6 | 6.7 | 6.4 | 6.3 | 6.4 | 6.4 |
| External debt (percent of GDP) | 60.0 | 60.5 | 62.7 | 55.5 | 51.6 | 49.3 |
| Real private credit growth (percent, period average) | 1.5 | 5.2 | 5.5 | — | — | — |
| Nonperforming loans (percent of gross loans, end of period) | 8.4 | 8.1 | 5.7 | — | — | — |
| Unemployment rate (percent, period average) | 11.5 | 11.7 | 11.5 | — | — | — |
| Youth unemployment rate (percent, period average) | 21.5 | 20.9 | 20.9 | — | — | — |
| Labor force participation rate (percent, period average) | 60.4 | 59.5 | 59.8 | — | — | — |
| GDP per capita, PPP (current international $) | 15,393 | 14,888 | 16,183 | 16,733 | 17,118 | 17,546 |
| Poverty rate (percent of population) | 29.6 | 33.0 | 23.1 | 20.4 | 17.8 | 15.5 |

*Sources:* Country authorities, World Bank staff 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. e= estimate; f = forecast; — = not available.

# Bosnia and Herzegovina

- Robust economic activity continued in the first half of 2022. Nevertheless, employment improved only marginally; unemployment remains elevated and is especially high among youths.
- Headline inflation accelerated fueled by food and transport prices, raising inflation to 12 percent by July 2022. Fiscal revenues benefited from strong growth and inflation, with the deficit expected to reach 1 percent of GDP in 2022, on election year.
- Real output growth is expected to decelerate in the second half of 2022 as private consumption slows due to the erosion of real disposable income caused by high inflation, and a deterioration in net exports.
- Elections took place on October 2, 2022, potentially setting the scene for a return to much-needed and delayed structural reforms to boost potential growth in the medium term.

## *Recent Economic Developments*

**Growth in the first half of 2022 remained robust at 5.9 percent and was buoyed by strong investment and higher private consumption.** Domestic demand grew at a rate of 5.5 percent, while negative net exports decelerated somewhat compared to the first half of the previous year. Domestic demand surged on the back of a boost in investment supported by infrastructure works and higher private consumption. The latter was driven by rising nominal net wages totaling 10.7 percent in the first half of 2022[1] (or a decline of 0.7 percent in real terms) and higher remittances, which expanded by 2.6 percent, in real terms. On the production side, industrial production slowed to 3.1 percent during the period January to July 2022, from 11.6 percent the year before. Meanwhile exports grew a remarkable 20.5 percent in H1 2022, outpacing imports, which grew 18.5 percent. This resulted in a compression of the net foreign deficit by 1.2 percentage points of GDP to 2.1 percent of GDP in H1 2022.

**Price increases accelerated in the first half of 2022, with a disproportionate impact on the poor.** In July 2022, headline inflation surged to 16.7 percent, which elevated inflation to over 12 percent during January–July 2022 due to soaring food and transport prices. Food prices continued rising to 25.5 percent in July, resulting in a food inflation rate of 19.3 percent during January–July 2022. In parallel, transport prices accelerated to over 26 percent during the same period as, for example, the price of diesel fuel grew 52 percent between January and July, with spillover effects to other products, bolstering inflationary pressures during the first half of 2022. The sharp increase in food and transport prices places disproportionate stress on lower-income groups and generates risks for poverty reduction in 2022.

**Labor market conditions improved, especially for women, but the unemployment rate remains elevated.** The labor market tightened somewhat, with the employment rate increasing to 40.1 percent in Q1 2022 from 38.4 percent a year ago, despite the concomitant rise in the labor force participation rate. This means that 42,000 individuals found work in

1 All comparisons are year-on-year, unless otherwise stated.

Q1 2022, more than two-thirds of whom were women. High unemployment, nevertheless, persists at 16.7 percent.[2]

**Fiscal data were revised, substantially increasing the consolidated fiscal deficit in 2020.** The latest consolidated data suggest a consolidated fiscal deficit of 5.3 percent of GDP in 2020 and only 0.3 percent in 2021, up from the previously published deficit of 1.8 percent of GDP and a surplus of 0.5 percent in 2021. In 2022, stronger tax revenues supported by high inflation were more than offset by higher spending, which is expected to result in a fiscal deficit of 0.9 percent of GDP in 2022.[3] Expenditures in 2022 are mainly driven by social measures softening the inflationary impact on households, which are estimated to result in social benefits expanding 3.4 percentage points to 18.7 percent of GDP in 2022. Higher expenditures also reflect pre-election spending, including wage hikes and sizable growth in capital expenditures. Public debt hovers around 35 percent of GDP.

**Despite the deceleration in merchandise imports, the current account deficit widened sharply to 4.8 percent of GDP in the first half of 2022, from 2.8 percent of GDP in H1 2021.** Adjusted for the capital account inflows of 0.7 percent of GDP, the external financing requirement amounted to 4.1 percent of GDP in the first half of 2022, two times larger than a year ago. Adverse terms of trade developments, among others, caused the sharp increase in the merchandise deficit by 48 percent in H1 2022 in nominal terms, or a widening of 4.6 percentage points, in GDP terms. Nevertheless, the deficit in goods and services narrowed to 14.3 percent of GDP, which is 2.2 percent of GDP less than in the same period a year ago, in part due to an increase in net travel receipts of 1.1 percent of GDP in 2022. The primary and secondary income accounts remained broadly unchanged in H1 2022 at around 9.5 percent of GDP, helping keep the external balance in check, with remittance inflows just below 8 percent of GDP. Net FDI inflows covered roughly one-third of the external deficit in the H1 2022, nominally the smallest amount since 2016. 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 borrowing requirement.

**In 2022, the external deficit is projected to widen to 3.1 percent of GDP from 2.6 percent the year before.** It is expected that the merchandise trade deficit will increase to 25.1 percent of GDP for the year as a whole. Meanwhile, services inflows should improve significantly to 12.5 percent of GDP, in part based on the doubling of overnight stays during January–July this year. At the same time, remittances are set to disappoint somewhat as net inflows are set to remain below 8 percent of GDP in 2022. The resulting net borrowing requirement is largely going to be financed by net FDI inflows of about 69 percent of CAD, which are expected to pick up during the remainder of the year, and external borrowing by the government and private sector, supporting a mild buildup in foreign exchange reserves by the end of 2022.

**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

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

period, with nonperforming loans to total loans declining to 5.2 percent at the end of Q2 2022 from 5.7 percent in same period last year and 8 percent in 2019. Capital adequacy, meanwhile, remains robust compared to last year as the Tier 1 capital ratio is steady at around 18.6 percent. The profitability of the banking sector has improved given the rise in the net interest income to gross income to 56.6 percent in Q3 2022 from 53 percent last year, and a modestly higher return on equity by 1.6 percentage points to 11.8 percent compared to last year. Lastly, foreign currency risk exposure has been reduced, with the share of indexed and foreign currency loans declining 6.9 percentage points to 45.7 percent compare to last year's outcomes.

## *Outlook and Risks*

**Real output growth is expected to decelerate to 4 percent in 2022 as private consumption slows due to the erosion of disposable income because of high inflation, and a deterioration in net exports significantly softening the rise in aggregate demand.** By 2024, real output growth is projected to reach 3.2 percent driven largely by a pickup in private consumption supported by remittances and a tightening labor market. Investment in energy and infrastructure (such as windmills and Corridor Vc[4]) will add to the growth stimulus over the medium term, although not to the same extent as in 2021 and 2022.

**Strong exports are likely to be offset by higher imports in part for infrastructure projects, keeping the trade balance to around 25 percent of GDP over the next two years.** This, in turn, is likely to widen the current account deficit to over 5.3 percent of GDP in 2023 and just below 4.5 percent of GDP in 2024, despite a shift to fiscal surpluses over the medium term. As general elections are completed, fiscal policy is expected to result in a balanced budget in 2023 and a fiscal surplus of close to 1 percent in 2024. Public debt is, nevertheless, expected to hover around 35 percent of GDP due to the rollover of amortization payments coming due. Following the elections, the attention of policy makers could turn to the structural reform agenda for EU accession.

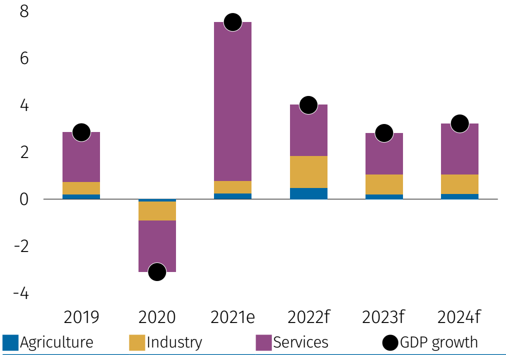
**Considering energy market disruptions from the war in Ukraine, inflationary pressures are now assumed to last longer than initially expected.** Hence, inflation is projected at 11 percent in 2022, stabilizing in 2023–24 at rates seen prior to the pandemic, at around 2 percent and lower. Phased out pre-election spending and one-off expenditures in response to the price shock will be in part offset by higher interest payments. However, a return to fiscal surpluses is expected by 2024.

**Downside risks dominate the outlook.** Protracted effects of the war in Ukraine could have a negative impact on aggregate demand through depressed consumer and business confidence. Furthermore, war-related uncertainties and sanctions can dampen the recovery in the EU, adversely impacting demand for BiH exports, except for energy. Adverse labor market developments across the EU could also limit remittance inflows, which support private consumption. Finally, geopolitical risks could further aggravate domestic political frictions, with adverse consequences for the much-needed structural reform push.

4 Corridor Vc is a major north-south transit road between the countries of the region through Bosnia and Herzegovina.

## GDP growth slowed in 2022.

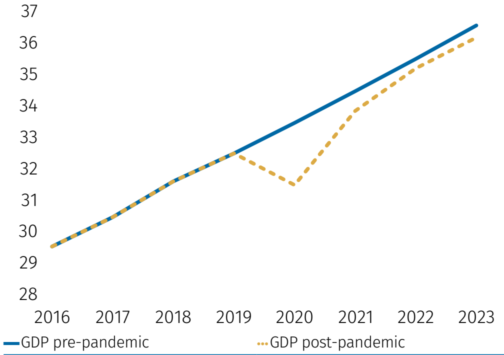
Contributions to growth, percentage points of GDP




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

## Yet, postcrisis growth trajectory is unlikely to close the gap with respect to the precrisis growth path.

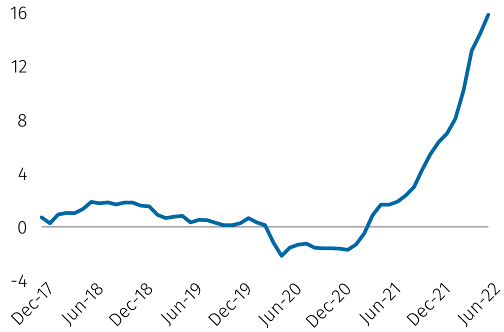
In 2015, thousand KM




*Source:* World Bank staff estimates.

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

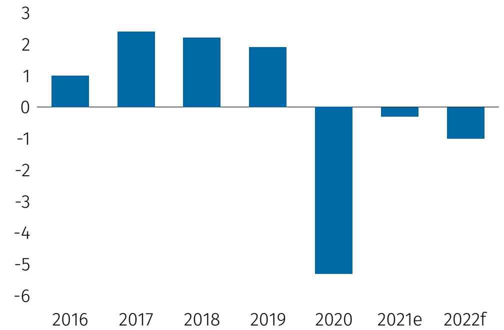
Percent y-o-y




*Sources:* BiH Agency for Statistics; World Bank.

## ...and despite higher revenues due to inflation, the fiscal deficit widened in 2022, an election year.

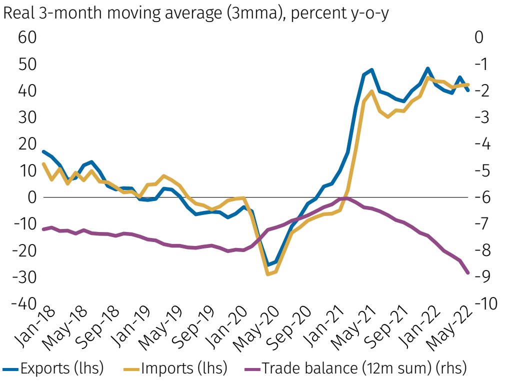
General government fiscal balance, percent of GDP




*Sources:* BiH fiscal authorities; World Bank staff estimates.

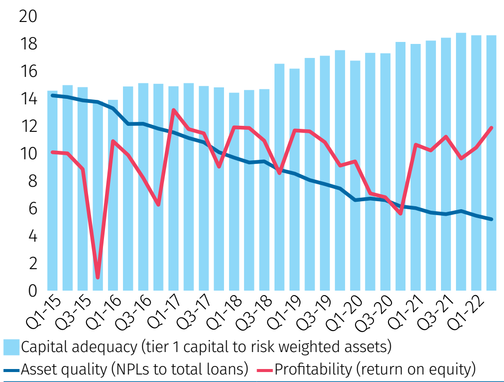
## The merchandise trade deficit widened.

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




*Sources:* BiH Indirect Tax Office; World Bank.

## Nonperforming loans in commercial bank portfolios declined steadily.




*Sources:* BiH Central Bank; World Bank calculations.

| BOSNIA AND HERZEGOVINA Selected Economic Indicators | 2019 | 2020 | 2021 | 2022e | 2023f | 2024f |
|---|---|---|---|---|---|---|
| Real GDP growth (percent) | 2.8 | -3.1 | 7.5 | 4.0 | 2.8 | 3.2 |
| Composition (percentage points): | | | | | | |
| Consumption | — | — | 4.2 | 2.0 | 1.9 | 1.7 |
| Investment | — | — | 5.4 | 4.3 | 0.9 | 0.5 |
| Net exports | — | — | -2.0 | -2.3 | 0.0 | 0.9 |
| Exports | — | — | 1.8 | 3.5 | 2.7 | 2.8 |
| Imports (-) | — | — | 3.8 | 5.8 | 2.7 | 1.9 |
| Consumer price inflation (percent, period average) | 0.6 | -1.1 | 2.0 | 11.0 | 2.0 | 0.5 |
| | | | | | | |
| Public revenues (percent of GDP) | 42.5 | 42.1 | 43.0 | 41.4 | 41.9 | 41.9 |
| Public expenditures (percent of GDP) | 40.6 | 47.4 | 43.3 | 42.3 | 41.8 | 41.1 |
| Of which: | | | | | | |
| Wage bill (percent of GDP) | 10.6 | 11.4 | 10.8 | 10.8 | 11.1 | 10.8 |
| Social benefits (percent of GDP) | 14.8 | 16.1 | 15.3 | 18.7 | 18.5 | 18.6 |
| Capital expenditures (percent of GDP) | 2.9 | 5.2 | 3.7 | 4.1 | 3.4 | 3.0 |
| Fiscal balance (percent of GDP) | 1.9 | -5.3 | -0.3 | -0.9 | 0.1 | 0.8 |
| Primary fiscal balance (percent of GDP) | 2.6 | -4.5 | 0.3 | -0.2 | 1.0 | 1.7 |
| Public debt (percent of GDP) | 32.8 | 36.6 | 35.4 | 31.9 | 32.7 | 33.8 |
| Public and publicly guaranteed debt (percent of GDP) | 34.5 | 38.8 | 37.6 | 33.0 | 34.0 | 35.5 |
| Of which: External (percent of GDP) | 28.4 | 30.8 | 30.8 | 27.4 | 27.8 | 28.3 |
| | | | | | | |
| Goods exports (percent of GDP) | 28.8 | 27.5 | 34.1 | 40.2 | 41.6 | 42.1 |
| Goods imports (percent of GDP) | 51.4 | 45.9 | 53.3 | 65.3 | 66.7 | 67.2 |
| Net services exports (percent of GDP) | 7.9 | 4.4 | 6.9 | 12.4 | 10.3 | 11.1 |
| Trade balance (percent of GDP) | -14.7 | -14.0 | -12.3 | -12.7 | -14.8 | -14.0 |
| Net remittance inflows (percent of GDP) | 8.5 | 7.4 | 8.2 | 7.3 | 7.1 | 7.0 |
| Current account balance (percent of GDP) | -2.9 | -3.9 | -2.3 | -3.1 | -5.3 | -4.4 |
| Net foreign direct investment inflows (percent of GDP) | 1.5 | 1.7 | 2.1 | 2.2 | 2.1 | 2.1 |
| External debt (percent of GDP) | 65.6 | 70.7 | 65.4 | 57.2 | 55.9 | 54.8 |
| | | | | | | |
| Real private credit growth (percent, period average) | 5.2 | 1.3 | -0.3 | — | — | — |
| Nonperforming loans (percent of gross loans, end of period) | 7.4 | 6.1 | 5.8 | — | — | — |
| | | | | | | |
| Unemployment rate (percent, period average) | 15.7 | 15.9 | 17.4 | — | — | — |
| Youth unemployment rate (percent, period average) | 33.8 | 36.6 | 38.2 | — | — | — |
| Labor force participation rate (percent, period average) | 42.1 | 47.7 | 48.0 | — | — | — |
| GDP per capita, PPP (current international $) | 13,775 | 13,424 | 14,110 | 14,710 | 15,260 | 15,800 |

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

# Kosovo

- Kosovo's economic growth moderated in early 2022, with activity affected by broad-based price increases. Risks to the outlook remain high as the country continues to grapple with rising inflation pressures.
- The price shock will inevitably continue affecting demand and economic activity in 2022, and growth is expected to moderate to 3.1 percent, mainly on account of higher real exports.
- Strong tax revenue collection continues to favor the fiscal position, supported by higher inflation and tax compliance measures. The fiscal deficit is expected to reach 0.8 percent of GDP in 2022, amid significant capital underspending.
- In a context of high uncertainty, maintaining buffers to respond to the changing macroeconomic environment, particularly in the context of an ongoing energy crisis, is vital. Over the medium term, it is imperative to advance structural reforms to enhance competitiveness and private sector development in support of the current export growth momentum.

## *Recent Economic Developments*

**After experiencing a stronger-than-expected recovery in 2021, Kosovo's economic growth moderated in early 2022.** Real output grew at a record high of 10.5 percent in 2021, supported by a rebound in domestic demand and strong export growth. During the first months of 2022, economic growth lost momentum, as the spike in inflation and the energy shock weighed significantly on economic activity. As a net importer of food and energy, Kosovo is particularly vulnerable to imported inflation, which in the current context started eroding consumer purchasing power and private sector competitiveness.

**Growth in H1 2022 reached 3.2 percent, driven by domestic demand and exports.** Consumption, which rose 5.2 percent, was the main contributor to growth, supported by credit growth, remittances inflows, and crisis-related fiscal support. Exports growth—particularly of manufactured, plastic, and mineral goods—continues to record a positive performance, and key seasonal indicators on border crossings and flight travel suggest a positive trend of services exports. However, imports surged led by a rise in commodity prices, substracting from growth. Capital execution stood at 17 percent of the original plan by August, leading to a lower contribution of investment to growth. The supply side was marked by continued support from the services sector, whereas the contribution of agriculture and industry was modest, due among other factors to the negative impact of a double-digit rise of input prices.

**The labor market continues to reflect chronic weaknesses.** Low labor force participation and employment, especially among women, is one of the key binding constraints to growth and poverty reduction. Although information on labor markets remains limited to 2021, administrative data for H1 2022 show an acceleration in formal employment and a decreasing trend in registered unemployment, reflected in a decrease of 32 percent[1] of the number of job-seekers registered at employment

1 All comparisons are year-on-year, unless otherwise stated. All comparisons are year-on-year, unless otherwise stated.

centers. Moreover, the labor market continues to be characterized by significant gender imbalances (a 44 percent employment rate for males and 16 percent for females) and skills mismatches and labor outmigration, as firms increasingly report difficulties filling vacancies.

**Crisis-induced commodity price increases led to a persistent increase in consumer inflation in 2022.** The Harmonized Index of Consumer Prices reached a historic high of 13 percent in August 2022, a rise from 7.1 percent in January 2022, fueled by increases in the price of food (21 percent), energy (16.7 percent), and transport (25 percent) and disproportionally impacting the poor and most vulnerable. Import prices increased by an average of 21.8 percent between Q1 2021 and Q1 2022. Similarly, data from the agriculture sector show that in Q2 2022, the price of goods and services consumed in agriculture increased by 45 percent. Core inflation reached 4.5 percent in August, from 2.6 percent in January, signaling a gradual increase in inflation expectations.

**Despite a sizable increase in exports, the current account deficit (CAD) deteriorated in 2022.** Growth of merchandise exports reached 29.4 percent in July. In the meantime, the value of merchandise imports grew by 26 percent until July, whereas import volumes, particularly for fuel, followed a declining trend during Q2 2022, signaling weakened demand against the spike in prices. Remittances inflows have slightly declined (-0.3 percent), moderating their pace of growth after a record peak in 2021. In terms of financing sources, the CAD was financed primarily by FDI inflows, concentrated predominantly toward real estate and banking, and loans and trade credit to the private sector.

**Tax revenue growth and capital underspending outpaced increases in current transfers by the summer of 2022.** By August 2022, higher social transfers and expenditure associated with crisis-response measures and energy subsidies fueled a 17.6 percent increase in current expenditure. However, for the same period, total tax revenue—particularly VAT collected at the border—increased by 15.4 percent and, together with a considerable underexecution of public investment, kept the budget balance positive to date. Yet, a new package of inflation mitigation measures—worth 1.7 percent of GDP—announced in early September, and half of committed energy subsidies, remain to be implemented by year end.

**Total public and publicly guaranteed (PPG) debt remains moderate.** PPG debt stood at 20.7 percent of GDP in June 2022, on a decreasing trend from 21.9 percent of GDP at end-2021. The total stock of public and publicly guaranteed debt consists mostly of domestic debt (65 percent of total PPG debt), and is held predominantly by the Kosovo Pension Savings Trust, commercial banks, and the Central Bank of Kosovo.

**The financial sector continues to be resilient.** In July 2022, the annual change in loans was 18 percent, supporting consumption and investment activity. During the same period, deposits recorded double-digit growth (10.6 percent). Bank capital buffers and asset quality remain adequate, with the ratio of regulatory capital on risk-weighted assets standing at 15.8 percent and non-performing loans remaining stable at 2.1 percent in July 2022.

### *Outlook and Risks*

**Growth is expected to slow to 3.1 percent in 2022, affected by reduced purchasing power and higher input costs for households and firms.** Real exports and government consumption are expected to be the main drivers of economic activity. On the production side, services—supported by higher diaspora demand, credit growth, and public transfers—are expected to be the main driver of growth. Reflecting broad-based inflationary pressures, private consumption and investment are expected to provide a modest contribution to economic growth. Investment activity, particularly in the construction sector, could be impacted by the postponement of investment projects due to rising input prices. In the meantime, public investment, impaired by among others factors, the inability to adjust for higher input costs in multi year contracts, is expected to subtract from growth.

**Over the medium term, the outlook remains highly uncertain and risks are skewed to the downside.** Real GDP growth is expected to pick up and reach 4.2 percent by 2024, assuming inflationary pressures and associated uncertainties subside, but the outlook could deteriorate further as a result of the continuation of the energy crisis and rising inflationary pressures. Higher energy consumption during the winter months and rising energy costs could add further pressure to both the import bill, as the outdated domestic capacity is unable to cover the country's needs, and the fiscal balance. Rising inflation in the European Union could also erode the income of the diaspora residing abroad, with a detrimental impact on remittances inflows and construction-related investment.

**High import dependency exposes Kosovo to significant inflation risk, in a context of rising international food and energy prices.** Consumer price inflation is expected to reach a record 12.1 percent in 2022, as impaired supply chains and rising international prices of food and energy continue to add pressures domestically. Upward wage pressures could also lead to further increase in prices. Moreover, high import dependence on several agricultural products such as vegetable oils and cereals, also exposes Kosovo to significant risks. As a result of the significant rise in the import bill, the trade deficit is expected to deteriorate and, coupled with stalling diaspora remittances, could lead to a temporary deterioration of the current account balance. In the medium term, the current account deficit is expected to be financed primarily by non-debt creating FDI and external private and public lending.

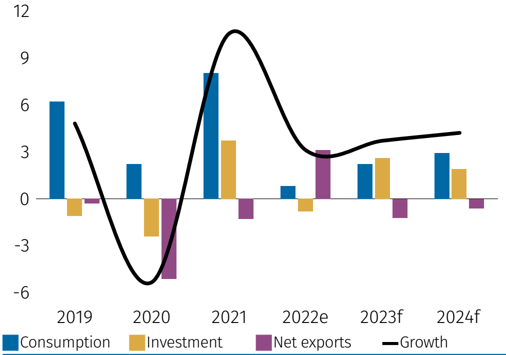
**Over the medium term, the fiscal deficit is expected to increase and surpass 2 percent of GDP by 2024, but stay within the fiscal rule limit.** After a low deficit in 2022 due to improved tax revenues and controlled spending, the increase in the deficit over the medium term will be driven by spending associated with compensation of employees amid new legislation on public wages, a rise in transfers and a gradual pick up in capital investment. Public debt is expected to reach 23 percent of GDP over the medium term, remaining below the 40 percent legal debt ceiling.

**While financial sector deepening continues, financing costs are expected to rise in light of tighter financial conditions in Europe and rising inflation.** This is increasing the vulnerability of sectors that have been highly exposed, such as construction, which may lead to a rise in nonperforming loans. Credit growth is expected to continue over the medium term, supporting consumption and investment.

**The post-pandemic recovery has stressed the need to address key structural bottlenecks to enhance competitiveness and sustain inclusive growth over the medium term.** Moreover, in the current context of high uncertainty maintaining adequate fiscal buffers to respond to the changing macroeconomic environment is key. Over the medium-term, advancing structural reforms is essential. Priority reforms should focus on increasing productivity growth and boosting competition; enhancing human capital development and closing the infrastructure gap.

## Growth in 2022 will moderate.

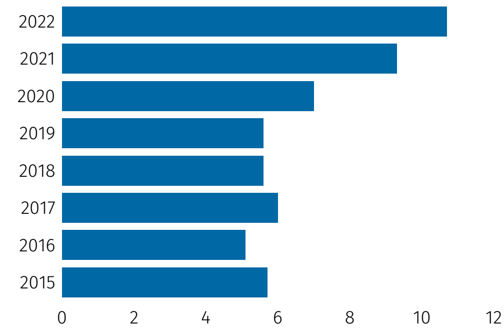
Contributions to growth, percentage points




*Sources:* Kosovo Statistics Agency; World Bank staff calculations.

## Export growth momentum continues.

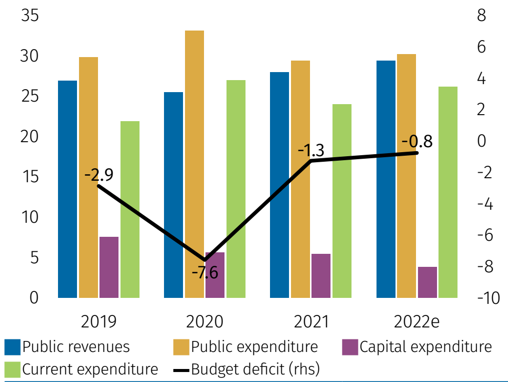
Exports of goods as a percent of GDP




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

## Higher revenue collection and capital underspending will offset a continued increase in current spending.

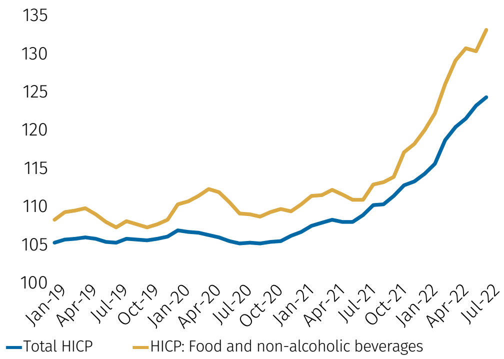
Percent of GDP




*Sources:* Ministry of Finance; World Bank staff calculations.

## Inflationary pressures increased in 2022.

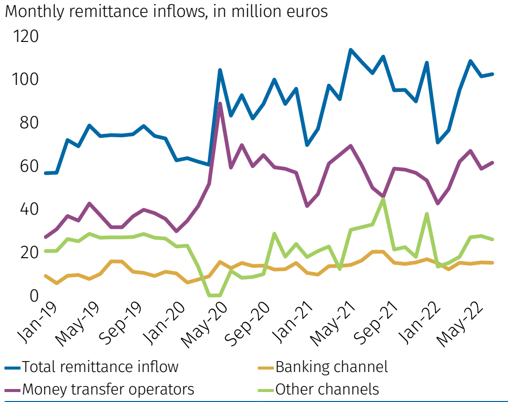
2015=100




*Source:* Kosovo Statistics Agency.

## After their 2021 peak, remittances have plateaued.

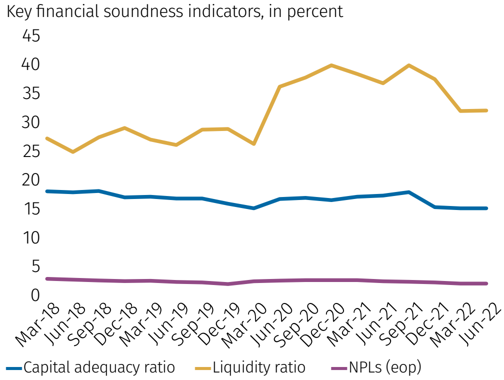
Monthly remittance inflows, in million euros




*Source:* Central Bank of Kosovo.

## Financial sector performance remains sound.

Key financial soundness indicators, in percent




*Source:* Central Bank of Kosovo.

| **KOSOVO** Selected Economic Indicators | 2019 | 2020 | 2021 | 2022e | 2023f | 2024f |
|---|---|---|---|---|---|---|
| Real GDP growth (percent) | 4.8 | -5.3 | 10.5 | 3.1 | 3.7 | 4.2 |
| Composition (percentage points): | | | | | | |
| Consumption | 6.2 | 2.2 | 8.0 | 0.8 | 2.2 | 2.9 |
| Investment | -1.1 | -2.4 | 3.7 | -0.8 | 2.6 | 1.9 |
| Net exports | -0.3 | -5.1 | -1.3 | 3.1 | -1.2 | -0.6 |
| Exports | 2.2 | -8.4 | 16.9 | 4.0 | 2.3 | 3.1 |
| Imports (-) | 2.5 | -3.3 | 18.1 | 0.9 | 3.4 | 3.7 |
| Consumer price inflation (percent, period average) | 2.7 | 0.2 | 3.4 | 12.1 | 4.0 | 3.0 |
| Public revenues (percent of GDP) | 26.8 | 25.4 | 27.9 | 29.3 | 28.9 | 29.0 |
| Public expenditures (percent of GDP) | 29.7 | 33.0 | 29.3 | 30.1 | 30.6 | 31.2 |
| Of which: | | | | | | |
| Wage bill (percent of GDP) | 8.7 | 9.8 | 8.5 | 8.0 | 8.6 | 8.4 |
| Social benefits (percent of GDP) | 6.3 | 7.7 | 7.4 | 7.2 | 6.5 | 6.2 |
| Capital expenditures (percent of GDP) | 7.5 | 5.6 | 5.4 | 3.8 | 5.6 | 6.3 |
| Fiscal balance (percent of GDP) | -2.9 | -7.6 | -1.3 | -0.8 | -1.6 | -2.1 |
| Primary fiscal balance (percent of GDP) | -2.6 | -7.2 | -0.9 | -0.4 | -1.1 | -1.6 |
| Public debt (percent of GDP) | 17.0 | 22.0 | 21.5 | 20.9 | 21.9 | 23.2 |
| Public and publicly guaranteed debt (percent of GDP) | 17.6 | 22.4 | 21.9 | 21.2 | 22.1 | 23.4 |
| Of which: External (percent of GDP) | 5.8 | 7.8 | 7.4 | 7.1 | 7.2 | 7.7 |
| Goods exports (percent of GDP) | 5.6 | 7.0 | 9.3 | 10.7 | 11.3 | 11.4 |
| Goods imports (percent of GDP) | 45.8 | 45.1 | 53.4 | 58.9 | 58.3 | 57.8 |
| Net services exports (percent of GDP) | 13.1 | 5.8 | 13.4 | 15.5 | 11.8 | 11.2 |
| Trade balance (percent of GDP) | -27.1 | -32.3 | -30.7 | -32.7 | -35.2 | -35.2 |
| Net remittance inflows (percent of GDP) | 11.6 | 13.8 | 13.9 | 12.9 | 13.4 | 13.6 |
| Current account balance (percent of GDP) | -5.6 | -7.0 | -8.3 | -11.3 | -13.1 | -12.3 |
| Net foreign direct investment inflows (percent of GDP) | 2.7 | 4.2 | 3.9 | 3.7 | 4.9 | 5.0 |
| External debt (percent of GDP) | 31.2 | 37.2 | 37.3 | — | — | — |
| Real private credit growth (percent, period average) | 7.8 | 7.6 | 7.5 | — | — | — |
| Nonperforming loans (percent of gross loans, end of period) | 1.9 | 2.5 | 2.3 | — | — | — |
| Unemployment rate (percent, period average) | 25.7 | 25.9 | — | — | — | — |
| Youth unemployment rate (percent, period average) | 49.4 | 49.4 | — | — | — | — |
| Labor force participation rate (percent, period average) | 40.5 | 38.3 | — | — | — | — |
| GDP per capita (US$) | 4,433 | 4,295 | 5,209 | 5,212 | 5,381 | 5,706 |
| Poverty rate (percent of population) | 28.9 | 32.4 | 26.4 | 25.0 | 23.3 | 21.6 |

*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; — = not available.

# Montenegro

- While still recovering from the pandemic, the economy is facing renewed headwinds.
- Growth remains very strong, estimated at 6.9 percent in 2022, led by private consumption and a tourism recovery.
- Inflation surged to new highs, but its adverse impact on the cost of living was largely mitigated by an increase in real disposable income.
- The fiscal deficit is estimated to widen to 4.9 percent of GDP in 2022, due to the forgone revenues of the recent tax reform and increased social spending.
- High public debt and the deteriorating global environment require near-term fiscal consolidation.

## Recent Economic Developments

**Private consumption is driving growth.** GDP growth was remarkably strong in the first half of 2022 at 10.3 percent,[1] driven by surging private consumption, underpinned by increases in real disposable income, household credit, employment, and remittances. Private consumption, further supported by a stronger-than-expected tourism season, is expected to lead growth in 2022, which is estimated to reach 6.9 percent. Despite a decline in the number of Russian and Ukrainian tourists, tourism continued recovering in 2022, boosting exports. However, an increase in imports alongside stronger domestic demand is expected to turn net exports negative for the year. Government consumption is projected to support growth, while investment is estimated to grow only marginally, still affected by higher costs of materials, supply-chain disruptions, and completion of a first section of highway.

**Reviving tourism is stimulating economic activity.** In the first seven months of the year, the number of international tourist overnight stays in accommodation facilities[2] reached 93 percent of the 2019 level, with the number of stays in July alone reaching their 2019 level. Tourism in turn supported retail trade, which expanded by 16 percent in real terms through July. However, in the same period, industrial production declined by 3.6 percent, as unfavorable hydrological conditions affected electricity generation. Similarly, construction declined by 3 percent,[3] but an increase in the number of building permits issued points to a likely resumption of construction activity in the near term.

**The labor market shows continuous improvement.** Labor Force Survey data reveal a 30 percent increase in employment in Q2 2022, which equally benefited male and female employees. The activity rate rose to 59.5 percent in Q2 from 46.8 percent a year ago, while in the same period the unemployment rate fell to 14.6 percent from 17.1 percent in Q2 2022. The administrative data show record-high employment in July of 235,343 employees, exceeding the July 2019 employment by 9.4 percent, with all sectors but public administration registering double-digit growth rates. The registered unemployment rate fell to 16 percent in July 2022 from 22 percent in July 2021. In the first seven months, the average net

1 All comparisons are year-on-year, unless otherwise stated.

2 Accommodation facilities include hotels, holiday facilities, boarding houses, tourist resorts, hostels, and motels. High-frequency private accommodation data are not available.

3 Measured as the number of effective hours worked on construction sites.

monthly wage increased by 21 percent in real terms, due to the reduction in labor taxes and an increase in the minimum wage.

**Inflation has been galloping in 2022.** Global inflationary pressures and higher wages have been driving a surge in prices. In the first eight months, inflation averaged 11 percent, peaking in August at 15 percent. Most of the inflation is explained by increases in the price of food and non-alcoholic beverages (19.4 percent) and fuel (30.5 percent). The cost-of-living crisis has been largely mitigated so far by an increase in real disposable income through the tax reform, which resulted in an increase in the net average monthly wage of 21 percent in real terms in the first seven months. The tax reform reduced labor taxes from a flat 39 percent of total labor cost to an average of 22 percent.[4]

**The financial sector is well capitalized and liquid.** In July 2022, outstanding loans were up by 4.4 percent, driven by lending to the private sector and households. At the same time, deposits were up by 20.4 percent, similarly led by increases in the private sector and households, but also nonresidents. As a result, the loan-to-deposits ratio declined to 77 percent, its lowest level ever. In the first seven months of 2022, new loans surged by 37 percent, outpacing new lending in the same period in 2019. The June average capital adequacy ratio was a healthy 18.9 percent, well above the regulatory minimum, while nonperforming loans increased to 6.9 percent of total loans from 6.3 percent in June last year. Overall, the financial sector seems to be in a good position, though at a time of high economic uncertainty and vulnerabilities to global shocks, added vigilance on the side of bank supervision is warranted.

**External imbalances are expected to widen from their 18-year low in 2021.** In the first half of 2022, exports of goods and services grew by 72 percent, based on equally strong performance on both goods and services. Transport and tourism services led service export growth, while exports of electricity and metals, benefiting from higher prices, supported merchandise exports. In the first seven months of 2022, Montenegro exported 62 percent more in value of electricity and metals than in all of last year. Owing to higher demand, import growth was also strong, expanding by 52 percent by June. Net primary and secondary incomes strengthened, primarily due to strong net remittances, which increased by 23 percent. Net FDI increased by 73 percent in the same period and financed more than half of the current account deficit. In July 2022, international reserves stood at €1.7 billion, covering seven months of merchandise imports.

**Lower revenues as a share of GDP and higher social spending are estimated to widen the fiscal deficit to 4.9 percent of GDP.** Total revenues as a share of GDP are projected to drop from 44.4 percent of GDP in 2021 to 40 percent in 2022. There was a solid increase in VAT and excise collection in the first eight months of 2022 despite the reduced VAT rate of 7 percent for the hospitality industry and a 50 percent reduction of the excise on fuel as a cost-of-living mitigation measure. But revenues from social security contributions and the personal income tax declined as part of the government's tax reform that removed healthcare contributions, which was planned to be financed by progressive income taxation and higher excises. At the same time, expenditures increased, led by higher social and capital spending. In December 2021, the Parliament

4 The labor tax wedge starts at 20 percent for the minimum wage and slowly increases with the rise of income.

increased minimum pensions by 36 percent, followed by another increase of 10 percent to be implemented in September. These adjustments, without complementary reform measures, are significantly increasing the pension costs and threatening pension system sustainability and equity. The Ministry of Finance has prepared a revision of the 2022 budget to account for new expenditures, including pensions, higher-than-planned social spending, and clearance of health arrears.

**In August, there was a vote of no confidence in the government—the second government to collapse in 2022.** The complexity and fragility of the political landscape in Montenegro exacerbates already high uncertainties, slows the reform process, and diverts the focus from imminent economic challenges. Prudent fiscal policy based on continuous public debt reduction and policies to support growth are of critical importance in such an environment.

## *Outlook and Risks*

**The unfavorable global economic outlook and high uncertainty are weighing on Montenegro's recovery prospects.** Growth is expected to moderate to 3.4 percent in 2023 and further to 3.1 percent in 2024, as private consumption growth slows. The projections do not assume that the remaining sections of the highway will start by 2025, as fiscal space is limited. The projections do assume that investments will be recovering, driven by the energy and tourism sectors, but at a slower pace, as major public investments are finalized. Tourism is expected to continue improving in 2023, although deteriorating growth prospects in the EU and the region can slow its recovery.

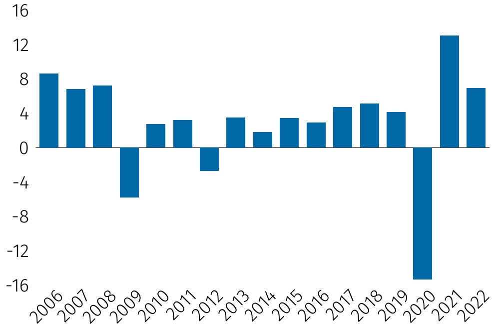
**The current account deficit is projected to decline gradually until 2024.** While higher energy prices are disproportionally affecting the poor, they are also supporting a reduction in the trade deficit as Montenegro's growing electricity capacity is used for energy exports. These, together with exports of tourism and transport services, are projected to support a reduction in the current account deficit to 9.7 percent of GDP in 2024. Inflation is projected to decelerate to 5.9 percent in 2023 and further to 2.6 percent in 2024 as global supply shortages ease.

**The fiscal balance is expected to moderate over the medium term but will remain elevated.** The fiscal deficit is projected at 4 percent of GDP in 2023 and 2.7 percent of GDP in 2024, unless additional measures compensate for the decline in revenues as a share of GDP. As a result, public debt is expected to stay high at 73 percent of GDP. Given the tightening of global financial conditions and Montenegro's sizable financing needs of around 9 percent of GDP per year in 2023–24, Montenegro will require careful debt management and stronger control over its expenditures.

**The outlook is clouded with multiple downside risks.** Prolongation of the war in Ukraine would further amplify geopolitical uncertainties and reduce growth prospects in Montenegro and its trading partners. Inflationary pressures are accelerating monetary tightening, which translates into more expensive external, but also domestic financing. Political instability and delays in government formation are major domestic risks. The severity of challenges ahead requires strong political commitment and actions to mitigate these risks.

## GDP growth remains strong at 6.9 percent...

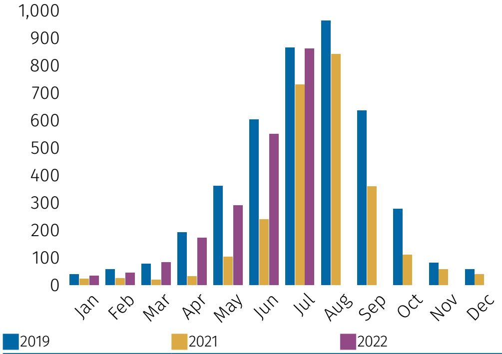
Real GDP growth, percent




*Sources:* MONSTAT data; World Bank staff calculations.

## ...supported by continuous tourism recovery.

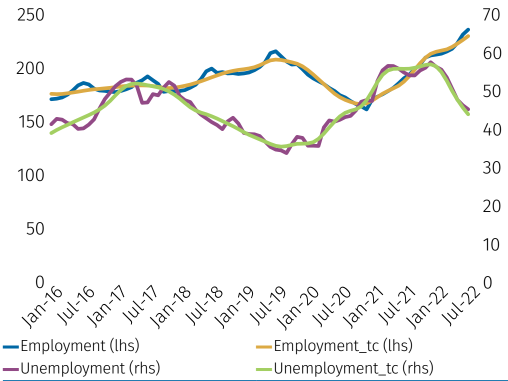
International tourist overnight stays, in thousands




*Sources:* MONSTAT; World Bank staff calculations.

## Employment reached a record high in July...

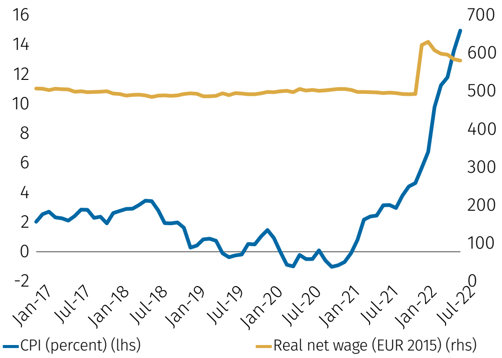
Administrative data, thousands, Jan 2016–Jul 2022




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

## ...as did inflation.

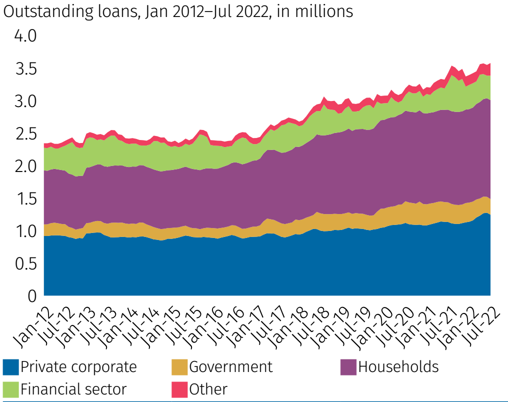
Administrative data, thousands, Jan 2017–Jul 2022




*Source:* MONSTAT data; World Bank staff calculations.

## Outstanding loans are also at a record high.

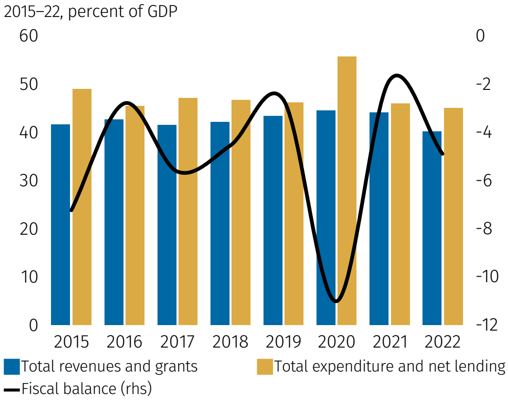
Outstanding loans, Jan 2012–Jul 2022, in millions




*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 | 2019 | 2020 | 2021 | 2022e | 2023f | 2024f |
|---|---|---|---|---|---|---|
| Real GDP growth (percent) | 4.1 | -15.3 | 13.0 | 6.9 | 3.4 | 3.1 |
| Composition (percentage points): | | | | | | |
| Consumption | 2.9 | -3.9 | 4.1 | 8.2 | 2.9 | 2.7 |
| Investment | 0.9 | -5.9 | -4.7 | 1.4 | 1.1 | 1.5 |
| Net exports | 0.3 | -5.5 | 13.7 | -2.7 | -0.6 | -1.1 |
| Exports | 2.9 | -24.2 | 25.7 | 13.7 | 3.1 | 2.5 |
| Imports (-) | 2.6 | -18.7 | 12.0 | 16.4 | 3.7 | 3.6 |
| Consumer price inflation (percent, period average) | 0.4 | -0.3 | 2.4 | 12.3 | 5.9 | 2.6 |
| | | | | | | |
| Public revenues (percent of GDP) | 43.3 | 44.4 | 44.0 | 40.0 | 39.0 | 38.8 |
| Public expenditures (percent of GDP) | 46.0 | 55.5 | 45.9 | 44.9 | 43.0 | 41.5 |
| Of which: | | | | | | |
| Wage bill (percent of GDP) | 11.0 | 13.5 | 12.2 | 11.1 | 10.7 | 10.1 |
| Social benefits (percent of GDP) | 11.2 | 13.4 | 11.5 | 12.0 | 12.1 | 11.7 |
| Capital expenditures (percent of GDP) | 8.7 | 7.5 | 5.7 | 6.2 | 5.6 | 5.8 |
| Fiscal balance (percent of GDP) | -2.7 | -11.0 | -1.9 | -4.9 | -4.0 | -2.7 |
| Primary fiscal balance (percent of GDP) | -0.5 | -8.3 | 0.5 | -3.3 | -2.2 | -0.6 |
| Public debt (percent of GDP) | 76.5 | 105.3 | 84.0 | 73.4 | 72.7 | 71.9 |
| Public and publicly guaranteed debt (percent of GDP) | 80.0 | 108.7 | 86.8 | 75.5 | 74.7 | 73.8 |
| Of which: External (percent of GDP) | 68.1 | 97.3 | 78.3 | 67.3 | 66.1 | 67.1 |
| | | | | | | |
| Goods exports (percent of GDP) | 9.4 | 9.8 | 10.6 | 13.0 | 12.6 | 12.0 |
| Goods imports (percent of GDP) | 51.1 | 49.0 | 49.3 | 57.6 | 57.1 | 57.1 |
| Net services exports (percent of GDP) | 20.6 | 4.2 | 19.3 | 25.7 | 26.8 | 28.1 |
| Trade and services balance (percent of GDP) | -21.1 | -35.0 | -19.4 | -18.9 | -17.7 | -17.0 |
| Net remittance inflows (percent of GDP) | 4.0 | 5.3 | 6.1 | 5.4 | 4.4 | 4.1 |
| Current account balance (percent of GDP) | -14.3 | -26.1 | -9.2 | -10.2 | -10.3 | -9.7 |
| Net foreign direct investment inflows (percent of GDP) | 6.2 | 11.2 | 11.7 | 10.3 | 9.0 | 7.9 |
| External debt (percent of GDP) | 169.0 | 224.1 | — | — | — | — |
| | | | | | | |
| Real private credit growth (percent, period average) | 5.5 | 6.4 | -0.2 | — | — | — |
| Nonperforming loans (percent of gross loans, end of period) | 5.1 | 5.9 | 6.8 | — | — | — |
| | | | | | | |
| Unemployment rate (percent, period average) | 15.1 | 17.9 | 16.6 | — | — | — |
| Youth unemployment rate (percent, period average) | 25.2 | 36.0 | 37.1 | — | — | — |
| Labor force participation rate (percent, period average) | 57.4 | 53.3 | 50.9 | — | — | — |
| GDP per capita, PPP (current international $) | 23,073 | 19,990 | 22,795 | 26,143 | 28,280 | 29,878 |

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

# North Macedonia

- As the war in Ukraine and the energy crisis dim growth prospects, inflation is racing toward an all-time high, disproportionately eroding real incomes of the poor.
- With limited fiscal space, elevated public debt, and increased cost of financing, fiscal support needs to target the most vulnerable households and firms. At the same time, monetary policy tightening needs to strike a balance between containing inflation and avoiding stifling economic activity.
- The output growth over the medium term is expected to moderate and downside risks remain elevated, dampening growth and lifting inflation at the same time. Disruptions related to the war in Ukraine, overstretched global supply chains, mounting inflationary and wage pressures, and the intensifying energy supply crisis continue to weigh on the outlook and the economic prospects of the country.

## *Recent Economic Developments*

**The beginning of 2022 saw output growth slow to below potential as the recovery momentum of the previous year waned and the energy crisis loomed.** After 4 percent GDP growth in 2021, output increased by 2.6 percent in H1 2022, driven by continued recovery in investment and robust consumption. At the same time, imports surged by 25 percent, leading net exports into negative territory. On the production side, growth in H1 was driven by services, as the industry struggled (owing in part to rising energy costs), and construction saw a further decline.

**Recent high-frequency indicators point to a further deceleration of growth during the summer.** Industrial production recorded a weak 0.2 percent growth in August 2022, as energy production dropped amidst a moderate increase in mining and manufacturing. At the same time, real retail trade growth increased by 3.1 percent in August 2022, following two months in a row of a real decline, something last observed during the Covid-19 pandemic. Tourism improved as travel demand surged, but tourist arrivals are still hovering below pre-pandemic levels.

**With soaring imports owing partly to higher energy prices, the merchandise trade deficit deteriorated, further widening external imbalances.** The current account deficit worsened to 6.3 percent of GDP (on a four-quarter rolling basis to June 2022), owing largely to a deterioration in the trade balance as import prices surged. The merchandise trade deficit widened to 22.8 percent of GDP, mainly because of the negative contribution of the energy balance, while the services surplus decreased to 3.7 percent of GDP, largely due to weaker travel and manufacturing services. Remittances declined very slightly, while net FDI stood strong at 3.4 percent of GDP. At the end of Q2 2022, gross external debt stood at 77.4 percent of GDP, down from 81.6 percent at end-2021, with the decline coming from higher nominal GDP in the denominator, lower public sector debt, amidst rising intercompany debt.

**The labor market recovery is slow and fragile despite government support.** After the release of the 2021 census data that revealed an approximately 9 percent decline in population and a smaller labor force, the participation rate settled at 55.3 percent in Q2 2022, drawn down by the low female participation rate that stood at 44.5 percent. At the same time, the employment rate remained below the pre-pandemic peak at 47.3 percent. The unemployment rate decreased to 14.5 percent,[1] but the youth unemployment rate remained high at 30.9 percent despite active labor market policies that target youth employment. Rising economic uncertainty lowered the share of fixed-term contracts to only 60 percent of all new employment contracts.

**Nominal net wage growth averaged 9 percent by June 2022, but domestic inflation outpaced wage gains, and the real net wage turned negative.** Nominal wage growth spread across all sectors. The growth for retail, accommodation, and entertainment services, in particular, was fueled by the 18.5 percent minimum wage hike agreed in February 2022. In addition, intensified pressures from labor unions prompted the government to agree on public sector pay increases (to align with the minimum wage increase) over the fall of 2022. Relatedly, the country agreed to open its labor market to the Open Balkan Initiative countries,[2] which might lead to further upward wage pressures as workers start exploiting opportunities across the border.

**Headline inflation surpassed a decades-long peak with food, energy, and core inflation all contributing to the rise.** Consumer price inflation reached a 25-year high at 16.8 percent in August 2022, as food and energy prices soared, with more than 20 percent annual growth, although the monthly increase decelerated. The cumulative inflation stood at 11.6 percent by August. The cost-of-living crisis unraveled, disproportionately eroding real incomes of the poor. Regulated heating and electricity prices were increased, but they remained below market prices. To respond to the rise in consumption and to widening electricity company losses, from July, the government introduced a block tariff system by progressively increasing the cost of electricity consumption across four consumption blocks for households and it increased the tariffs for small consumers that are supplied by the universal electricity provider.

**To tame inflationary expectations, the central bank further tightened monetary policy.** The policy rate was increased by 1.75 percentage points to 3 percent in five rounds to early September. The stability of the pegged exchange rate was preserved with regular FX interventions that led to a more than 20 percent loss of reserves since mid-2021, but signs of stabilization were visible by the end of the summer. The banking sector remained stable despite a decline in the liquidity ratio to 20.5 percent. The capital adequacy ratio increased to 17.3 percent in Q2 2022. Credit growth continued at 9.7 percent in July 2022, led by accelerated corporate and mortgage lending. To strengthen the resilience of the banking system, the central bank announced a countercyclical capital buffer rate of 0.5 percent to be applied from August 2023. In September 2022 the central bank increased the 7-day and overnight deposit rates to stimulate savings in domestic currency, and it reduced the RR base for new loans that secure financing for domestic renewable energy production.

1 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.
2 Albania, North Macedonia, and Serbia.

**A revised fiscal plan for 2022 left the fiscal deficit largely unchanged compared to 2021; deficit reduction is now postponed to 2023.** By June 2022, the general government deficit stood at 1.2 percent of GDP as revenues surged by 13.6 percent y-o-y, current spending decelerated to 8 percent y-o-y, and capital spending increased by 16 percent. Still, the capital spending realization rate is at one-third of the revised annual plan and will likely be rationed as the government needs resources to further support the energy sector. Continued calls for fiscal support by households and firms led the government to allocate an additional EUR76 million euros (0.6 percent of GDP) for anti-crisis measures within the 2022 budget revision in May. There is a plan to close the 2022 financing gap with short-term external borrowing, the IMF's Precautionary and Liquidity Line, and domestic financing. The issuance of a new Eurobond has been delayed due to the high interest rate.

**Public and publicly guaranteed and non-guaranteed debt dropped to 55.4 percent of GDP by the end of H1 2022.** Nominal public debt remained elevated compared to the pre-crisis period, but it stabilized close to the end-2021 level. Expenditure arrears were high at 3 percent of GDP on account of overdue payments of the health sector, state enterprises, and local governments, limiting fiscal space for crisis response going forward.

## *Outlook and Risks*

**The output growth over the medium term is expected to moderate and downside risks remain elevated.** The 2022 growth forecast is further adjusted down to 2.1 percent as the energy and Ukraine crises continue to take a toll on the domestic economy. Disruptions related to the war in Ukraine, overstretched global supply chains, mounting inflationary pressures, and the intensifying energy supply crisis continue to weigh on the outlook. As companies, including the electricity production company, build stocks to prevent production outages, imports are forecast to rise substantially, further deteriorating the current account balance. The baseline scenario is built on the assumption that the impact of the energy crisis and the war in Ukraine on the domestic economy will gradually subside while inflationary pressures tail off over the medium-term forecast horizon. However, underlying assumptions of the forecast are significantly tilted to the downside, simultaneously dampening growth and lifting inflation.

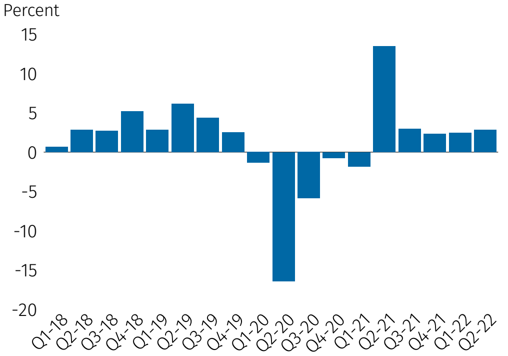
**With looming stagflation risks, the country needs to start delivering on reforms that can reinvigorate the potential growth momentum over the medium term.** Policy efforts need to be geared toward restoring fiscal sustainability while building social and climate resilience that will reduce the country's vulnerability to shocks and revamp the country's long-term growth prospects. Specifically, the focus of the country's reform agenda needs to be geared toward creating fiscal space to reduce debt (through boosting tax compliance, restructuring and reprioritizing spending), ensuring resilience of the financial sector, launching the green transition, and improving efficiency of public investment management.

**Given limited fiscal resources, widespread state aid through direct budget transfers, temporary subsidies, and broad tax exemptions should be revised and redirected toward long-term, growth-supportive**

**spending.** Efficient social protection will be critical in this transition. The draft Tax Reform Strategy is headed in the right direction in terms of keeping the tax system attractive while at the same time removing tax exemptions to increase progressivity. And while crisis support measures narrow, the launch of new highway construction from 2023 may stretch finances in the medium term and increase public debt.

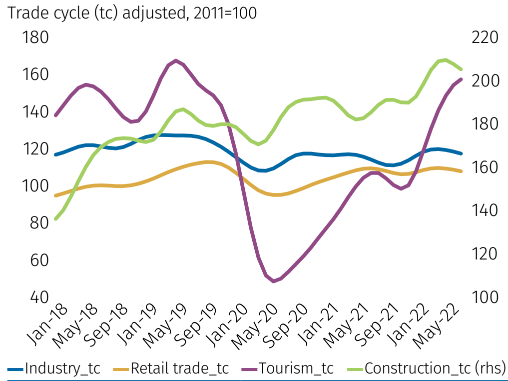
**At the current juncture, a rising political divide makes policy coordination and implementation increasingly difficult, including on energy, climate, and fiscal sustainability issues that are critical for economic growth.** Heightened political uncertainty and a parliamentary impasse following the results of the local elections, and a removal of obstacles for opening the EU accession negotiations, may lead to delays in reforms implementation needed to boost potential growth and consolidate public finances. Moreover, lower domestic and external demand, high input costs, and liquidity shortages could lead to layoffs and increase poverty, stretching already tight public finances. Finally, tightening financial conditions may affect financing options and costs going forward.

### Economic growth slowed as new crises emerged…



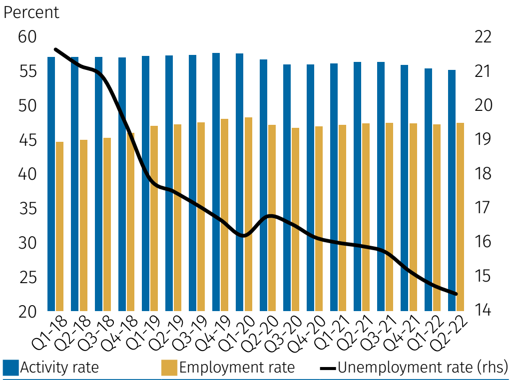

*Source:* State Statistics Office.

### …and high-frequency indicators point to a renewed slowdown ahead.



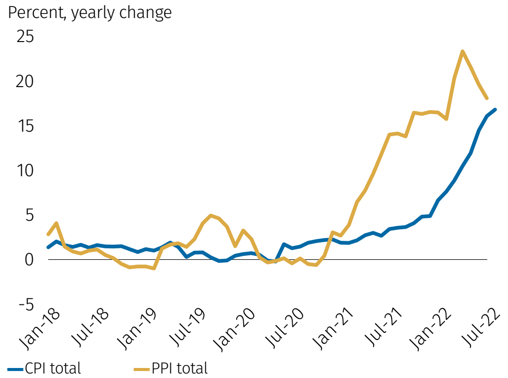

*Source:* State Statistics Office and World Bank staff calculations.

### The labor market recovery is still fragile as activity rate continues to decline.



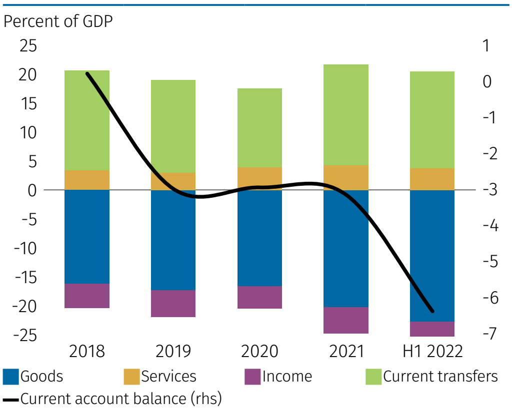

*Source:* State Statistics Office.
*Note:* LFS 2022 makes use of the 2021 census data, making a break in the series.

### Domestic inflation reached a 25-year high…



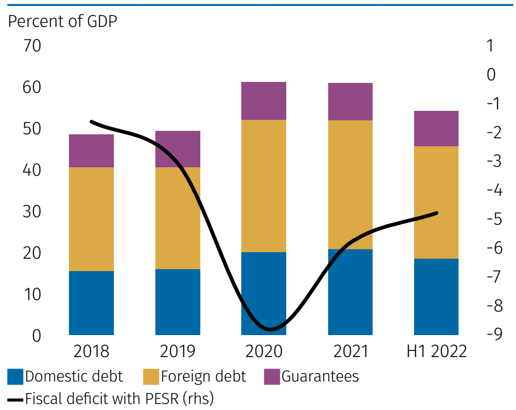

*Source:* State Statistics Office.

### …and external imbalances widened significantly led by energy and food imbalances.




*Source:* Central bank.
*Note:* H1 balance of payments is a rolling average.

### But public debt stabilized in early 2022 in response to tightened financing costs.




*Sources:* Ministry of Finance and World Bank estimates.
*Note:* *Deficit of the general government on a 12-month rolling basis.

| **NORTH MACEDONIA** Selected Economic Indicators | 2019 | 2020 | 2021 | 2022e | 2023f | 2024f |
|---|---|---|---|---|---|---|
| Real GDP growth (percent) | 3.9 | -6.1 | 4.0 | 2.1 | 2.7 | 2.9 |
| Composition (percentage points): | | | | | | |
| Consumption | 3.1 | -2.4 | 5.0 | 4.9 | 2.4 | 2.3 |
| Investment | 3.3 | -5.3 | 2.2 | 5.1 | 2.4 | 2.5 |
| Net exports | -2.4 | 1.7 | -3.3 | -7.9 | -2.1 | -1.9 |
| Exports | 5.8 | -7.4 | 7.9 | 7.7 | 5.5 | 4.8 |
| Imports (-) | 8.2 | -9.1 | 11.2 | 15.6 | 7.5 | 6.7 |
| Consumer price inflation (percent, period average) | 0.8 | 1.2 | 3.2 | 12.1 | 6.1 | 3.0 |
| Public revenues (percent of GDP) | 31.4 | 30.5 | 32.3 | 32.0 | 31.7 | 32.1 |
| Public expenditures (percent of GDP) | 33.5 | 38.9 | 37.7 | 37.2 | 35.8 | 35.7 |
| Of which: | | | | | | |
| Wage bill (percent of GDP) | 6.3 | 7.3 | 6.9 | 6.5 | 6.3 | 6.1 |
| Social benefits (percent of GDP) | 15.6 | 18.0 | 16.9 | 16.1 | 15.3 | 15.1 |
| Capital expenditures (percent of GDP) | 3.4 | 3.2 | 4.2 | 5.2 | 5.3 | 5.6 |
| Overall fiscal balance (percent of GDP) | -2.1 | -8.3 | -5.4 | -5.2 | -4.1 | -3.6 |
| Primary fiscal balance (percent of GDP) | -1.0 | -7.1 | -4.1 | -3.9 | -2.6 | -2.2 |
| Overall fiscal balance with the Public Enterprise for State Roads included | -3.1 | -8.8 | -5.8 | -6.2 | -5.0 | -4.5 |
| Public debt (percent of GDP) | 40.4 | 51.9 | 51.8 | 50.4 | 50.9 | 52.4 |
| Public and publicly guaranteed debt (percent of GDP)* | 49.2 | 61.0 | 60.8 | 59.4 | 59.9 | 61.4 |
| Of which: External (percent of GDP) | 32.7 | 40.7 | 39.8 | 39.0 | 38.5 | 37.8 |
| Goods exports (percent of GDP) | 47.5 | 44.4 | 51.3 | 55.7 | 57.0 | 57.9 |
| Goods imports (percent of GDP) | 64.8 | 61.0 | 71.6 | 81.5 | 78.4 | 77.5 |
| Net services exports (percent of GDP) | 3.0 | 3.9 | 4.2 | 4.2 | 4.7 | 5.1 |
| Trade balance (percent of GDP) | -14.3 | -12.7 | -16.0 | -21.6 | -16.7 | -14.5 |
| Net remittance inflows (percent of GDP) | 2.0 | 3.1 | 2.9 | 2.9 | 2.9 | 2.9 |
| Current account balance (percent of GDP) | -3.0 | -2.9 | -3.1 | -9.5 | -4.7 | -2.7 |
| Net foreign direct investment inflows (percent of GDP) | 3.2 | 1.4 | 3.3 | 3.0 | 3.0 | 3.1 |
| External debt (percent of GDP) | 72.4 | 78.7 | 81.9 | 79.2 | 82.4 | 84.9 |
| Real private credit growth (percent, period average) | 6.5 | 5.6 | 2.8 | — | — | — |
| Nonperforming loans (percent of gross loans, end of period) | 4.6 | 3.3 | 3.1 | — | — | — |
| Unemployment rate (percent, average)** | 17.3 | 16.4 | 15.7 | 14.4 | 13.7 | 13.6 |
| Youth unemployment rate (percent, period average) | 35.6 | 35.7 | 36.3 | — | — | — |
| Labor force participation rate (percent, period average) | 57.2 | 56.4 | 56.0 | — | — | — |
| GDP per capita, PPP (current international $) | 14,230 | 13,360 | 13,890 | 14,181 | 14,564 | 14,987 |

*Sources:* Country authorities; World Bank estimates and projections.
*Note:* *Includes non-guaranteed debt 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. f = forecast; — = not available.

# Serbia

- Growth continued to be strong in H1 2022, despite major domestic and external challenges.
- Inflation accelerated more rapidly than projected, and in line with developments in the region, reaching 13.2 percent y-o-y in August, driven by food and energy prices.
- The fiscal deficit turned lower than anticipated, thanks to a strong performance of revenues, while public debt plateaued at around 57 percent of GDP.
- While growth projections over the medium term (2022-2024) remain unchanged, risks to the outlook are clearly tilted to the downside.
- The most significant deterioration is expected on the external side, with the CAD widening to around 10 percent of GDP due to the major increase in imports.

## *Recent Economic Developments*

**The Serbian economy continued to grow at a solid pace in H1 2022.** At 4.1 percent y-o-y, economic growth was almost entirely driven by a surge in private consumption, with only a marginal contribution from investment. A substantial increase in salaries and in lending to households, as well as transfers from the budget, helped private consumption to grow 5.3 percent (y-o-y, in real terms). In the first half of the year, total investment increased by mere 1.4 percent (y-o-y) despite a significant increase in government investment.[1] Although the export performance was strong (up 19.9 percent in real terms), the increase in imports was even higher (up 22.3 percent in real terms, and from a higher level) primarily related to the import of energy (electricity, coal, oil, and gas). Thus, the net balance in goods and services made a negative contribution to growth of 3.8 percentage points. On the production side, agriculture output shrank again in H1 2022 due a major drought (the second summer in a row) and significantly higher input prices. Agriculture output was 5.3 percent lower in the first half of the year compared to the same period of 2021. Conversely, industry performed well over the first seven months of 2022. Industrial production increased output by 2.7 percent (y-o-y), driven by improvement is several sectors including pharmaceuticals, oil, tobacco, and electronics and paper industry—which all grew between 5 and 15 percent, y-o-y. Value added in services sectors increased by 5.7 percent (in real terms/y-o-y) in the first half of the year. Over the same period construction sector posted a decline of 6.6 percent in real terms.

**The labor market continued to improve in 2022.** As a result of a solid growth in H1, the employment rate reached a record high level of 50.9 percent, well above pre-COVID levels of 47 percent (average in 2019).[2] Meanwhile, unemployment gradually declined to 8.9 percent in Q2 2022. The activity rate increased from 55.2 percent in Q1 to 55.8 percent in Q2 2022.[3] Overall, wages continued to increase, by a further 13.5 percent in nominal terms in the first half of the year compared to the same period of 2021. Unlike

1 Up by 43.8 percent in nominal terms over the first seven months of 2022 compared to the same period of 2023.

2 This was to some extent supported by increase in informal employment (up by 54,200 person), which is typical for this part of the year when the construction and agriculture season start.

3 Activity rate was around 53 percent in years prior to COVID pandemic.

in previous years, private sector wages increased faster than public sector wages. The former went up by 16.3 percent in nominal terms, compared to a 7.9 percent increase in public sector wages.

**The consolidated budget shifted to a small surplus of 0.3 percent of GDP over the first seven months of 2022.** Revenues posted a strong performance (up 14.4 percent in nominal terms, over the first seven months, y-o-y), thanks to the major increases in value added tax (VAT), corporate income tax (CIT), and social contributions. High inflation and the surge in imports drove VAT revenues; while improved collection under CIT reflects the advances made during the previous fiscal year. Social contributions increased on the back of raising formal employment and wages. Expenditures have been kept under control (up by 12.7 percent over the same period) despite major pressures to provide financial support to energy companies. To date, the support provided to energy companies for importing gas, coal and electricity was not shown as direct budget expenditures, rather as below the line items. However, as the winter season approaches, energy companies might require additional direct budget support, which could lead to a significant increase in the fiscal deficit (it is currently projected at 4 percent of GDP for 2022). Public debt remained broadly stable throughout 2022 and stood at around 57 percent of GDP. The cost of financing debt increased significantly, and some of the recent T-bill auctions remain significantly undersubscribed. As a result, the government eventually opted to direct sale of bonds to qualified investors, thus bypassing the market.[4]

**Soaring imports, primarily related to energy, led to a significant deterioration in the current account deficit (CAD).** Imports of energy increased by 278 percent (or EUR 2.2 billion) over the first seven months of 2022, compared to the same period of 2021. This increase, equivalent to 3.7 percent of annual GDP, was driven by oil (up by EUR 1 billion), gas (up by EUR 0.9 billion), coal (up by EUR 0.2 billion) and electricity (up by EUR 0.1 billion). As a result, the trade deficit nearly doubled to reach 7.7 percent of annual GDP in the first half of the year, while the CAD reached 4.4 percent of GDP.[5] The CAD is now projected to increase to around 10 percent of GDP in 2022 (compared to 4.4 percent of GDP in 2021). Net foreign direct investment inflows declined by 9 percent of GDP in euro terms in the first half of 2022, compared to the same period of 2021, and stood at 2.4 percent of GDP, still covering a significant portion of the external shortfall.

**Inflation increased sharply, in line with developments in other CEE countries.** The consumer price index (CPI) peaked at 13.2 percent (y-o-y) in August, the highest level of inflation since January 2013. Food prices, notwithstanding the selective government price controls, drove this trend, increasing by 20.9 percent (y-o-y) in August 2022. In response to mounting inflation pressures, the National Bank of Serbia (NBS) increased the key policy rate several times, reaching 3.5 percent in September. The nominal dinar

4 Serbian government started using this option as of August by issuing three bonds: a 53-weeks bond worth EUR 350 million with fixed interest rate of 2.4 percent; a three-year bond worth EUR 250 million with interest rate of: 3.75 percent + 6-month Euribor, and a four-year bond worth EUR 90 million with interest rate of: 3.95 percent + 6-month Euribor. In September the government secured another loan from the UAE to serve as a budget support in the amount of 1 billion dollars with 3 percent interest.

5 The CAD reached EUR 2.7 billion in the first half of 2022, compared to EUR 0.6 billion in the same period of 2021.

exchange rate was stable throughout 2022, with only a minor depreciation in late February 2022.[6] NBS official foreign currency reserves declined by EUR 2.6 billion over the first five months of 2022, before recovering to close to EUR 15.9 billion by the end of August, which covers 4.9 months of imports.

**The performance of the banking sector continued to be robust.** Based on 2022 Q2 data, banks remained profitable and liquid. The share of liquid assets in total assets stood at 33.1 percent, while capital adequacy ratio stood at 19.8 percent at the end of June. Non-performing loans (NPLs) stood at 3.3 percent in June. Nevertheless, credit growth has slowed down in 2022. The total stock of loans in July was only 6.4 percent higher than a year earlier. The highest increase in credit growth relates to SOEs (up by over 50 percent, y-o-y) while loans to private companies increased by 8.3 percent (y-o-y) and to households by 9.1 percent.

## *Outlook and Risks*

**The growth outlook remains positive with risks tilted to the downside.** Before the outbreak of the war in Ukraine, the Serbian economy was expected to grow at around 4–4.5 percent annually. However, the war in Ukraine, increase in international prices and breakdowns in operations of EPS in winter 2021/22 brought projected growth downwards. Considering the impact of these shocks, growth for 2022 is projected at 3.2 percent. Further downward revision may be warranted depending on: (i) the performance of the energy sector and energy availability; and (ii) the impact of the poor agriculture season on the sectoral output, exports and food prices. Over the medium term, the economy is expected to grow steadily at around 3 percent annually.

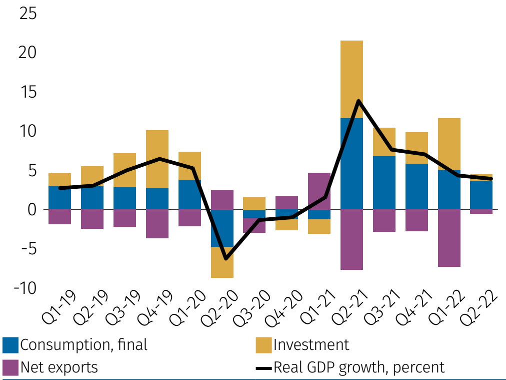
**The outlook also crucially depends on the domestic reform agenda and its implementation.** The ongoing crisis in the domestic energy sector has once again emphasized the urgency of improving the management of SOEs. In addition, contingent liabilities (currently covered by guarantees issued by the central government) could affect public finances, particularly those related to the deterioration in the performance of SOEs, as demonstrated recently by EPS and Srbijagas. As a remedy, the government should embark on a comprehensive and thorough reform of SOEs to make them financially viable while improving corporate governance. In addition to growth-oriented reforms, the government should reassess the effectiveness of the anti-inflationary measures used so far and to prepare the legal framework for assistance to energy vulnerable customers.

**The risks to the baseline macroeconomic outlook that could materialize in 2022 and 2023 are numerous.** First, although the peak of inflation is expected in Q3 2022, it could increase further depending on changes in international food and energy prices. Second, the 2022 fiscal deficit could be higher than the one projected under the base case scenario, notably if additional support to energy companies is provided. Consequently, public debt could start rising again as a share of GDP. Third, possible disruption in energy supply (electricity and gas in particular, e.g., power outages) could slow down growth. Finally, the CAD might deteriorate faster than projected if international prices of energy continue to rise, rendering its financing more expensive.

6 Since May the NBS is net-purchaser of FX, buying EUR 1.4 billion.

## Growth remained strong in H1 2022...

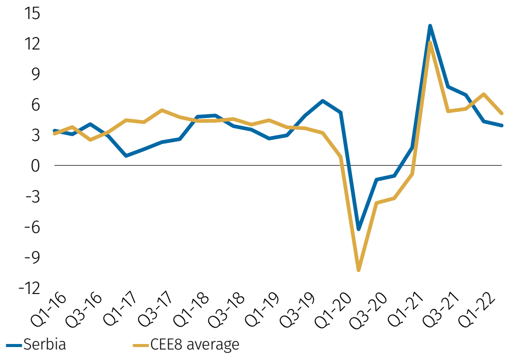
Contribution to growth, percentage points




*Source:* Statistics Office of the Republic of Serbia.

## ...but started to lag behind other CEE countries.

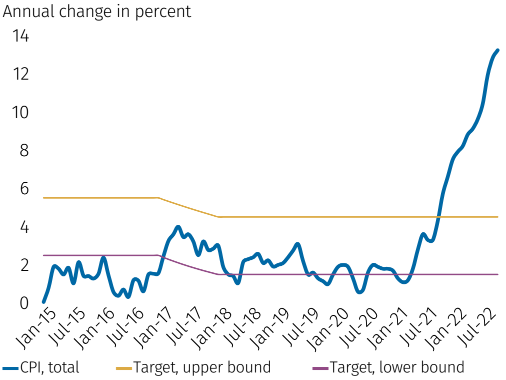
Growth rates, y-o-y




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

## Inflation is on rise...

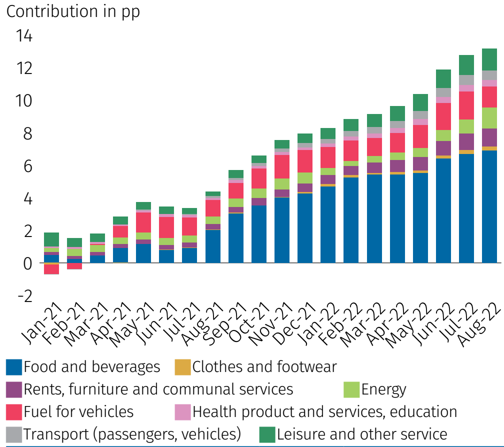
Annual change in percent




*Source:* Statistics Office.

## ...mainly because of food prices.

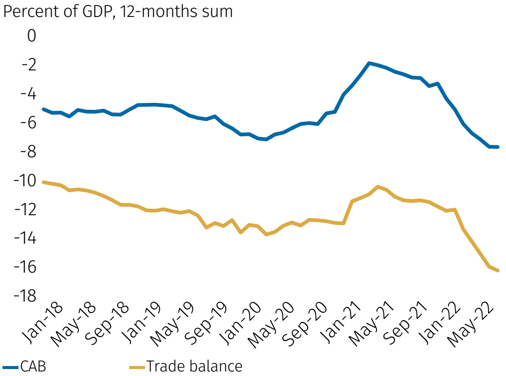
Contribution in pp




*Source:* Statistics Office.

## The CAD and trade deficit recently started to increase...

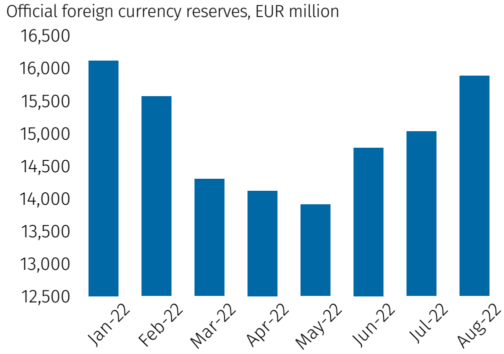
Percent of GDP, 12-months sum




*Source:* National Bank of Serbia.

## ...but reserves recovered as of June.

Official foreign currency reserves, EUR million




*Source:* National Bank of Serbia.

| **SERBIA** Selected Economic Indicators | 2019 | 2020 | 2021 | 2022e | 2023f | 2024f |
|---|---|---|---|---|---|---|
| Real GDP growth (percent) | 4.3 | -0.9 | 7.4 | 3.2 | 2.7 | 2.8 |
| Composition (percentage points): | | | | | | |
| Consumption | 2.9 | -0.9 | 5.7 | 3.5 | 3.2 | 3.1 |
| Investment | 4.0 | -0.1 | 3.8 | 1.5 | 0.9 | 0.9 |
| Net exports | -2.6 | 0.1 | -2.1 | -1.7 | -1.4 | -1.2 |
| Exports | 4.1 | -2.3 | 10.3 | 4.7 | 3.3 | 3.4 |
| Imports (-) | 6.7 | -2.4 | 12.4 | 6.4 | 4.7 | 4.6 |
| Consumer price inflation (percent, period average) | 1.9 | 1.6 | 4.0 | 11.5 | 9.2 | 3.7 |
| Public revenues (percent of GDP) | 42.0 | 41.0 | 43.3 | 43.1 | 43.0 | 42.9 |
| Public expenditures (percent of GDP) | 42.2 | 49.0 | 47.4 | 47.1 | 45.7 | 44.6 |
| Of which: | | | | | | |
| Wage bill (percent of GDP) | 9.5 | 10.5 | 10.0 | 10.0 | 10.2 | 10.3 |
| Social benefits (percent of GDP) | 14.4 | 14.7 | 13.6 | 14.0 | 14.0 | 14.2 |
| Capital expenditures (percent of GDP) | 4.9 | 5.3 | 7.4 | 7.2 | 6.7 | 6.6 |
| Fiscal balance (percent of GDP) | -0.2 | -8.0 | -4.1 | -4.0 | -2.7 | -1.7 |
| Primary fiscal balance (percent of GDP) | 1.8 | -6.0 | -2.4 | -2.2 | -0.7 | 0.2 |
| Public debt (percent of GDP) | 48.8 | 53.9 | 53.9 | 52.8 | 53.2 | 51.8 |
| Public and publicly guaranteed debt (percent of GDP) | 52.8 | 57.8 | 57.1 | 58.1 | 58.1 | 56.5 |
| Of which: External (percent of GDP) | 30.3 | 33.4 | 37.0 | 38.0 | 40.0 | 40.0 |
| Goods exports (percent of GDP) | 35.7 | 34.4 | 38.9 | 36.2 | 35.6 | 36.1 |
| Goods imports (percent of GDP) | 47.9 | 45.5 | 50.0 | 51.7 | 50.0 | 48.5 |
| Net services exports (percent of GDP) | 2.3 | 2.4 | 2.7 | 2.3 | 1.9 | 2.3 |
| Trade balance (percent of GDP) | -9.9 | -8.8 | -8.5 | -13.2 | -12.5 | -10.1 |
| Net remittance inflows (percent of GDP) | 5.6 | 4.5 | 4.7 | 4.3 | 4.0 | 3.8 |
| Current account balance (percent of GDP) | -6.9 | -4.1 | -4.4 | -10.2 | -9.4 | -7.9 |
| Net foreign direct investment inflows (percent of GDP) | 7.7 | 6.3 | 6.8 | 5.5 | 5.8 | 5.6 |
| External debt (percent of GDP) | 61.8 | 65.8 | 68.5 | 67.1 | 63.2 | 61.0 |
| Real private credit growth (percent, period average) | 6.9 | 9.2 | 3.7 | — | — | — |
| Nonperforming loans (percent of gross loans, end of period) | 4.1 | 3.7 | 3.6 | — | — | — |
| Unemployment rate (percent, period average) | 11.2 | 9.7 | 11.0 | 9.0 | 9.1 | 9.0 |
| Youth unemployment rate (percent, period average) | 28.6 | 27.3 | 26.6 | — | — | — |
| Labor force participation rate (percent, period average) | 52.9 | 52.2 | 54.7 | — | — | — |
| GDP per capita, PPP (current international $) | 19,025 | 19,168 | 21,243 | 22,901 | 24,599 | 26,271 |
| Poverty rate (percent of population) | 10.1 | 10.2 | 9.8 | 9.6 | 9.3 | 9.1 |

*Sources:* Country authorities, World Bank estimates and projections.

# Key Economic Indicators

| Key Economic Indicators | 2019 | 2020 | 2021 | 2022e | 2023f | 2024f |
|---|---|---|---|---|---|---|
| *Real GDP growth (percent)* | | | | | | |
| Albania | 2.2 | -3.5 | 8.5 | 3.2 | 2.3 | 2.5 |
| Bosnia and Herzegovina | 2.8 | -3.1 | 7.5 | 4.0 | 2.8 | 3.2 |
| Kosovo | 4.8 | -5.3 | 10.5 | 3.1 | 3.7 | 4.2 |
| North Macedonia | 3.9 | -6.1 | 4.0 | 2.1 | 2.7 | 2.9 |
| Montenegro | 4.1 | -15.3 | 13.0 | 6.9 | 3.4 | 3.1 |
| Serbia | 4.3 | -0.9 | 7.4 | 3.2 | 2.7 | 2.8 |
| *WB6* | *3.7* | *-3.2* | *7.6* | *3.4* | *2.8* | *3.0* |
| *Consumer price inflation (percent, period average)* | | | | | | |
| Albania | 1.4 | 1.6 | 2.6 | 6.7 | 4.0 | 3.5 |
| Bosnia and Herzegovina | 0.6 | -1.1 | 2.0 | 11.0 | 2.0 | 0.5 |
| Kosovo | 2.7 | 0.2 | 3.4 | 12.1 | 4.0 | 3.0 |
| North Macedonia | 0.8 | 1.2 | 3.2 | 12.1 | 6.1 | 3.0 |
| Montenegro | 0.4 | -0.3 | 2.4 | 12.3 | 5.9 | 2.6 |
| Serbia | 1.9 | 1.6 | 4.0 | 11.5 | 9.2 | 3.7 |
| *WB6* | *1.5* | *0.9* | *3.3* | *10.9* | *6.4* | *3.0* |
| *Public expenditures (percent of GDP)* | | | | | | |
| Albania | 29.2 | 32.6 | 31.6 | 30.7 | 32.1 | 31.4 |
| Bosnia and Herzegovina | 40.6 | 47.4 | 43.3 | 42.3 | 41.8 | 41.1 |
| Kosovo | 29.7 | 33.0 | 29.3 | 30.1 | 30.6 | 31.2 |
| North Macedonia | 33.5 | 38.9 | 37.7 | 37.2 | 35.8 | 35.7 |
| Montenegro | 46.0 | 55.5 | 45.9 | 44.9 | 43.0 | 41.5 |
| Serbia | 42.2 | 49.0 | 47.4 | 47.1 | 45.7 | 44.6 |
| *WB6* | *36.9* | *42.7* | *39.2* | *38.7* | *38.1* | *37.6* |
| *Public revenues (percent of GDP)* | | | | | | |
| Albania | 27.2 | 25.9 | 27.0 | 26.8 | 27.4 | 27.6 |
| Bosnia and Herzegovina | 42.5 | 42.1 | 43.0 | 41.4 | 41.9 | 41.9 |
| Kosovo | 26.8 | 25.4 | 27.9 | 29.3 | 28.9 | 29.0 |
| North Macedonia | 31.4 | 30.5 | 32.3 | 32.0 | 31.7 | 32.1 |
| Montenegro | 43.3 | 44.4 | 44.0 | 40.0 | 39.0 | 38.8 |
| Serbia | 42.0 | 41.0 | 43.3 | 43.1 | 43.0 | 42.9 |
| *WB6* | *35.5* | *34.9* | *36.3* | *35.4* | *35.3* | *35.4* |
| *Fiscal balance (percent of GDP)* | | | | | | |
| Albania | -1.9 | -6.7 | -4.5 | -3.8 | -4.6 | -3.8 |
| Bosnia and Herzegovina | 1.9 | -5.3 | -0.3 | -0.9 | 0.1 | 0.8 |
| Kosovo | -2.9 | -7.6 | -1.3 | -0.8 | -1.6 | -2.1 |
| North Macedonia | -2.1 | -8.3 | -5.4 | -5.2 | -4.1 | -3.6 |
| Montenegro | -2.7 | -11.0 | -1.9 | -4.9 | -4.0 | -2.7 |
| Serbia | -0.2 | -8.0 | -4.1 | -4.0 | -2.7 | -1.7 |
| *WB6* | *-1.3* | *-7.9* | *-2.9* | *-3.3* | *-2.8* | *-2.2* |

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

| Key Economic Indicators (continued) | 2019 | 2020 | 2021 | 2022e | 2023f | 2024f |
|---|---|---|---|---|---|---|
| *Public debt (percent of GDP)* | | | | | | |
| Albania | 63.7 | 74.0 | 72.1 | 67.0 | 65.5 | 65.0 |
| Bosnia and Herzegovina | 32.8 | 36.6 | 35.4 | 31.9 | 32.7 | 33.8 |
| Kosovo | 17.0 | 22.0 | 21.5 | 20.9 | 21.9 | 23.2 |
| North Macedonia | 40.4 | 51.9 | 51.8 | 50.4 | 50.9 | 52.4 |
| Montenegro | 76.5 | 105.3 | 84.0 | 73.4 | 72.7 | 71.9 |
| Serbia | 48.8 | 53.9 | 53.9 | 52.8 | 53.2 | 51.8 |
| *WB6* | *46.6* | *57.3* | *53.1* | *49.4* | *49.5* | *49.7* |
| *Public and publicly guaranteed debt (percent of GDP)* | | | | | | |
| Albania | 67.4 | 75.9 | 74.0 | 68.9 | 67.4 | 66.9 |
| Bosnia and Herzegovina | 34.5 | 38.8 | 37.6 | 33.0 | 34.0 | 35.5 |
| Kosovo | 17.6 | 22.4 | 21.9 | 21.2 | 22.1 | 23.4 |
| North Macedonia | 49.2 | 61.0 | 60.8 | 59.4 | 59.9 | 61.4 |
| Montenegro | 80.0 | 108.7 | 86.8 | 75.5 | 74.7 | 73.8 |
| Serbia | 52.8 | 57.8 | 57.1 | 58.1 | 58.1 | 56.5 |
| *WB6* | *50.3* | *60.8* | *56.4* | *52.7* | *52.7* | *52.9* |
| *Goods exports (percent of GDP)* | | | | | | |
| Albania | 6.6 | 6.0 | 8.2 | 10.2 | 9.8 | 9.7 |
| Bosnia and Herzegovina | 28.8 | 27.5 | 34.1 | 40.2 | 41.6 | 42.1 |
| Kosovo | 5.6 | 7.0 | 9.3 | 10.7 | 11.3 | 11.4 |
| North Macedonia | 47.5 | 45.3 | 51.1 | 55.5 | 56.7 | 57.7 |
| Montenegro | 9.4 | 9.8 | 10.6 | 13.0 | 12.6 | 12.0 |
| Serbia | 35.7 | 34.4 | 38.9 | 36.2 | 35.6 | 36.1 |
| *WB6* | *28.5* | *27.6* | *31.8* | *32.6* | *32.7* | *33.1* |
| *Trade balance (percent of GDP)* | | | | | | |
| Albania | -13.8 | -14.3 | -13.3 | -11.6 | -11.3 | -11.0 |
| Bosnia and Herzegovina | -14.7 | -13.9 | -12.3 | -12.7 | -14.8 | -14.0 |
| Kosovo | -27.1 | -32.3 | -30.7 | -32.7 | -35.2 | -35.2 |
| North Macedonia | -14.3 | -13.0 | -16.0 | -21.5 | -16.7 | -14.5 |
| Montenegro | -21.1 | -35.0 | -19.4 | -18.9 | -17.7 | -17.0 |
| Serbia | -9.9 | -8.8 | -8.5 | -13.2 | -12.5 | -10.1 |
| *WB6* | *-13.6* | *-13.6* | *-12.7* | *-15.5* | *-15.0* | *-13.5* |
| *Current account balance (percent of GDP)* | | | | | | |
| Albania | -8.0 | -8.5 | -7.7 | -7.9 | -8.1 | -7.7 |
| Bosnia and Herzegovina | -2.8 | -3.4 | -2.6 | -3.1 | -5.3 | -4.4 |
| Kosovo | -5.6 | -7.0 | -8.3 | -11.3 | -13.1 | -12.3 |
| North Macedonia | -3.3 | -3.4 | -3.5 | -9.8 | -5.0 | -3.0 |
| Montenegro | -14.3 | -26.1 | -9.2 | -10.2 | -10.3 | -9.7 |
| Serbia | -6.9 | -4.1 | -4.4 | -10.2 | -9.4 | -7.9 |
| *WB6* | *-6.1* | *-5.6* | *-4.9* | *-8.7* | *-8.3* | *-7.1* |

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

| Key Economic Indicators (continued) | 2019 | 2020 | 2021 | 2022e | 2023f | 2024f |
|---|---|---|---|---|---|---|
| *External debt (percent of GDP)* | | | | | | |
| Albania | 60.0 | 60.5 | 62.7 | 55.5 | 51.6 | 49.3 |
| Bosnia and Herzegovina | 65.6 | 70.7 | 65.4 | 57.2 | 55.9 | 54.8 |
| Kosovo | 31.2 | 37.2 | 37.3 | 40.3 | 42.1 | 41.3 |
| North Macedonia | 72.4 | 80.3 | 81.4 | 78.9 | 82.0 | 84.5 |
| Montenegro | 169.0 | 224.1 | 214.9 | 204.7 | 194.4 | 184.7 |
| Serbia | 61.8 | 65.8 | 68.5 | 67.1 | 63.2 | 61.0 |
| *WB6* | *76.7* | *89.8* | *88.4* | *83.9* | *81.5* | *79.3* |
| *Unemployment rate (period average, percent)* | | | | | | |
| Albania | 11.5 | 11.7 | 11.5 | - | - | - |
| Bosnia and Herzegovina | 15.7 | 15.9 | 17.4 | - | - | - |
| Kosovo | 25.7 | 25.9 | - | - | - | - |
| North Macedonia | 17.3 | 16.4 | 15.7 | 14.4 | 13.7 | 13.6 |
| Montenegro | 15.1 | 17.9 | 16.6 | - | - | - |
| Serbia | 11.2 | 9.7 | 11.0 | 9.0 | 9.1 | 9.0 |
| *WB6* | *16.1* | *16.3* | - | - | - | - |

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

**Western Balkans** Regular Economic Report
No.22 | Fall 2022

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