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WESTERN BALKANS
REGULAR ECONOMIC REPORT

№11

FASTER GROWTH, MORE JOBS

SPRING 2017

Highlights of the Western Balkans RER 11

- The Western Balkan's region grew faster in 2016 than in 2015: the strengthening of growth in Serbia and Albania, and steady growth in Bosnia and Herzegovina, compensated for weaker expansion in Montenegro and FYR Macedonia and the slight slowdown in growth in Kosovo.

- Faster economic growth created more jobs: while unemployment levels remain high, all Western Balkan countries except Montenegro reduced unemployment. Job growth was high Serbia, at 7.2 percent during 2016.

- The external deficit narrowed in Serbia, thanks to recent private sector-friendly reforms that spurred broad-based exports. In contrast, external deficits widened in Montenegro and Albania. There, large infrastructure projects supported growth, but the related expansion in capital-goods imports combined with low commodity prices exacerbated external imbalances.

- For the first time since the global financial crisis, the average public debt to GDP ratio in the Western Balkans stabilized. Public revenues grew in most countries. Serbia and Albania continued consolidating expenditures. In some countries, revenue gains in 2016 were partially offset by discretionary increases in wages and social benefits.

- The medium-term economic outlook for the Western Balkans is positive, but it is subject to downside external and domestic (including political) risks. Sustaining and supporting growth will require a continued commitment to lower fiscal and external imbalances, and bold implementation of structural reforms.

Western Balkans Regular Economic Report No.11

Faster Growth, More Jobs

Spring 2017

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Acknowledgements

This Regular Economic Report (RER) covers economic developments, prospects, and economic policies in six South Eastern European countries of the Western Balkans: Albania, Bosnia and Herzegovina, Kosovo, FYR Macedonia, Montenegro, and Serbia. The Western Balkans RER succeeds the South East Europe (SEE) RER.

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

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1. Overview

Strong recovery of output in Serbia and Albania drove the expansion of the Western Balkans region's economy in 2016. Economic growth among the Western Balkan countries (WB6)[1] reflects two distinct growth patterns. On the one hand, the economies of Serbia and Albania, which account for over half of the region's GDP, experienced steady acceleration as sustained fiscal consolidation efforts and structural reforms facilitated a rebound in private consumption and investment, and helped to boost Serbian exports. On the other hand, growth slowed in Kosovo, FYR Macedonia, and Montenegro, as private investment softened due to political uncertainty in FYR Macedonia, and external imbalances widened in Montenegro. Meanwhile, with relatively slower progress on structural reforms, Bosnia and Herzegovina (BiH), the region's second-largest economy, is growing steadily, with low import prices supporting consumption growth.

More jobs and low prices are helping to reduce poverty, although unemployment is still high. It is estimated that between 2013 and 2016, the average poverty rates for Albania, FYR Macedonia, Montenegro, and Serbia declined by close to 2 percentage points.[2] This lifted approximately 240,000 people out of poverty. It is also estimated that in 2016 poverty declined in all WB6 countries except for Bosnia and Herzegovina where it is thought to have stagnated. Growth helped to create more jobs and reduce unemployment in all countries except Montenegro, where unemployment worsened once the country introduced the lifetime mother's benefit, which incentivized women to leave employment. Job growth was high in Serbia and Albania, at 7.2 and 5.8 percent during 2016, respectively. Albania has been working to reduce informality, and employment was boosted in Serbia by a manufacturing revival and a good agriculture season. Employment in Kosovo also grew. Somewhat smaller employment gains were also recorded in FYR Macedonia and Montenegro.

Table 1.1. A Positive Growth Outlook

Real GDP growth, percent	2015	2016[e]	2017[f]	2018[f]
Albania	2.6	3.2	3.5	3.5
Bosnia and Herzegovina	3.0	2.8	3.2	3.7
Kosovo	4.1	3.6	3.9	4.2
FYR Macedonia	3.8	2.4	2.8	3.3
Montenegro	3.4	2.1	3.3	3.0
Serbia	0.8	2.8	3.0	3.5
Western Balkans	**2.2**	**2.8**	**3.2**	**3.6**

Sources: Data from central banks and national statistical offices; World Bank staff estimates and projections.

In 2016, external deficits narrowed in the manufacturing exporters that have been undertaking business-friendly reforms. Serbia is enjoying strong broad-based export growth, spurred by a recent inflow of foreign direct investment (FDI) in manufacturing. Similarly, Bosnia and Herzegovina and FYR Macedonia continue to benefit from low oil prices and rising external demand, although in FYR Macedonia sizable import content

1 Albania, Bosnia and Herzegovina, Kosovo, FYR Macedonia, Montenegro, and Serbia.

2 Measured between 2013 and 2016. Poverty is measured as percent of a population living on less than US$5 per day in 2005 purchasing power parity terms, which is the standardized regional benchmark.

diminished the positive effect of rising exports. These countries had the lowest external deficits in the region in 2016—less than 4 percent of GDP. In contrast, a rise in investment-related imports combined with weak commodity prices widened external deficits among WB6 commodity exporters. Despite a gradual recovery in EU demand for Western Balkan exports, low commodity prices reduced export earnings in Albania, Kosovo, and Montenegro, and major infrastructure investments continue to require large capital-goods imports. This has pushed current account deficits above 12 percent of GDP in these three countries. The widening of Montenegro's external deficit to nearly 20 percent of GDP has exacerbated its vulnerability.

Albania and Serbia firmed up their fiscal positions by consolidating spending and improving the management of state-owned enterprises; meanwhile, lax current spending in Montenegro, Kosovo, and FYR Macedonia partly offset recent revenue gains. In 2016 fiscal deficits fell in all Western Balkan countries except in Bosnia and Herzegovina where it is low. However, the way in which fiscal deficits fell varied by country, with some shifting away from growth-enhancing capital spending. In Albania and Serbia both revenue gains and a reduction of current spending supported the narrowing of the fiscal deficit. Revenues also rose in Kosovo and Montenegro, but recent amendments to regulations have steeply increased the cost of their untargeted entitlement programs. Moreover, capital investment budgets were under-executed and the share of current spending increased. FYR Macedonia's revenues dropped as a share of GDP and its overall spending fell as the economy felt the effects of a severe political crisis. Hence, although fiscal deficits narrowed in 2016 in FYR Macedonia (to 2.6 percent) and Montenegro (to 3.9 percent), and remained low in Kosovo (1.3 percent), the composition of their spending shifted to less productive and equitable areas.

Further fiscal consolidation and structural reforms are necessary to stabilize debt dynamics in all Western Balkan countries. Though recently several countries have managed to stabilize and even reduce their debt burdens, spending on wages, pensions, and social benefits continue to burden budgets in the Western Balkans. In particular, recent regulatory changes in Montenegro have elevated annual spending on such budget items by 3.8 percent of GDP. In Kosovo, it is estimated that a new veterans' benefits program will cost about 0.7 percent of GDP annually. In FYR Macedonia, pensions, which have been rising for the last five years, reached 9 percent of GDP in 2016. Restructuring public utilities is also essential to limit fiscal liabilities and improve competitiveness. More attention is needed to creating an efficient and effective public administration, reinforcing governance and the rule of law, and improving the quality and equity of such public services as education and health.

Though the regional growth outlook is positive, it remains vulnerable to risks, and success hinges on whether countries can rebalance toward a more sustainable growth model. Regional growth is forecast to accelerate from 2.8 percent in 2016 to 3.2 percent in 2017 as domestic demand continues to recover. While it is expected that fiscal management in Serbia, Albania, and Bosnia and Herzegovina continues to be prudent, it is projected that expansionary fiscal policies in Kosovo, FYR Macedonia, and Montenegro will drive an

increase in the regional deficit. External deficits would also grow in the latter three countries, thus exacerbating already high external vulnerabilities in Montenegro and Kosovo. Growing uncertainty suggests that external risks will continue to complicate growth prospects, among them faster normalization of U.S. monetary policy and possible appreciation of the U.S. dollar exchange rate, higher protectionism, a possible slowdown in EU economies, and variability in commodity price dynamics. Meanwhile, political tensions, upcoming elections, and resistance from vested interests in several Western Balkan countries could slow progress on fiscal consolidation and structural reforms, which would undermine investor confidence.

Continuing structural reforms have helped Serbia to increase exports, particularly in manufacturing. Sustained reform efforts in Serbia, and also in Albania, have helped to attract private investment and—in Serbia—reap the benefits from a recovery in export demand. Public debt is stabilizing in both countries for the first time since the global financial crisis and with job creation and a broad-based increase in household incomes, consumption growth is less dependent on public transfers.

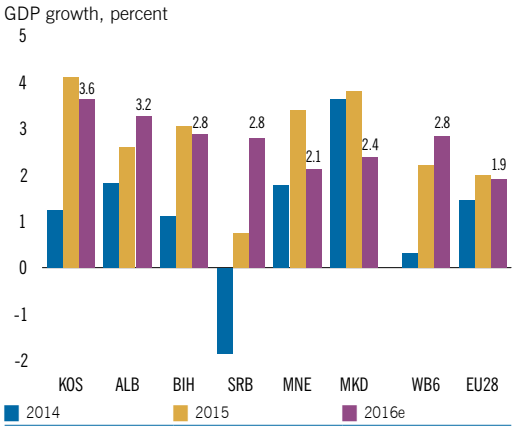
The rebalancing of growth is proceeding more slowly in other Western Balkan countries, highlighting the need for them to accelerate the pace of structural reforms to promote private investment and exports. With financing conditions tighter, these countries are struggling to build their policy credibility—a problem illustrated by recent downgrades in the sovereign credit outlooks for FYR Macedonia and Montenegro. Thus, for all countries, heightened risks underscore the urgency of structural reforms to reinforce the nascent rebalancing from domestic to external sources of growth and greater reliance on investment. If the cycle of slow growth and massive youth emigration is to be broken, the benefits of job-creating growth need to be consolidated.

2. Growth with differing dynamics across the Western Balkans

Economic growth in the Western Balkans region strengthened, with a notable acceleration in Serbia compensating for slower growth in FYR Macedonia and Montenegro.[3] Stronger growth in output in Serbia, the largest economy in the six-country region (the WB6) comprising about 41 percent of WB6 GDP, was the main contributor to regional growth (Figure 2.1). Following recession in 2014 and lackluster growth of 0.8 percent in 2015, Serbia's economy expanded by 2.8 percent in 2016—the highest growth since 2008. Recovery was also solid in Albania, with growth increasing from 2.6 percent in 2015 to 3.2 percent in 2016. In the other Western Balkan countries, growth softened in 2016, but mildly and from a high base in Kosovo, to 3.6 percent, and in Bosnia and Herzegovina (BiH), to 2.8 percent. By contrast, political uncertainty put the brakes on growth in FYR Macedonia, which slowed from 3.8 percent in 2015 to 2.4 percent. In Montenegro, growth also slowed, from 3.4 percent to 2.1 percent, as leveling off tourism receipts could not compensate for steep declines in manufacturing and mining production, as the aluminum and bauxite industries continued to struggle.

Robust consumption underpinned the positive growth performance in 2016 (Figure 2.2). Household consumption benefited from higher employment, low prices for consumer goods, and in some countries relaxation of wage- and hiring-related constraints brought about by continuing fiscal consolidation. This was particularly true of Serbia, where after three years of negative or negligible impact, consumption contributed 36 percent to 2016 GDP growth.

Figure 2.1. Though growth in the region was impressive, country differences were marked



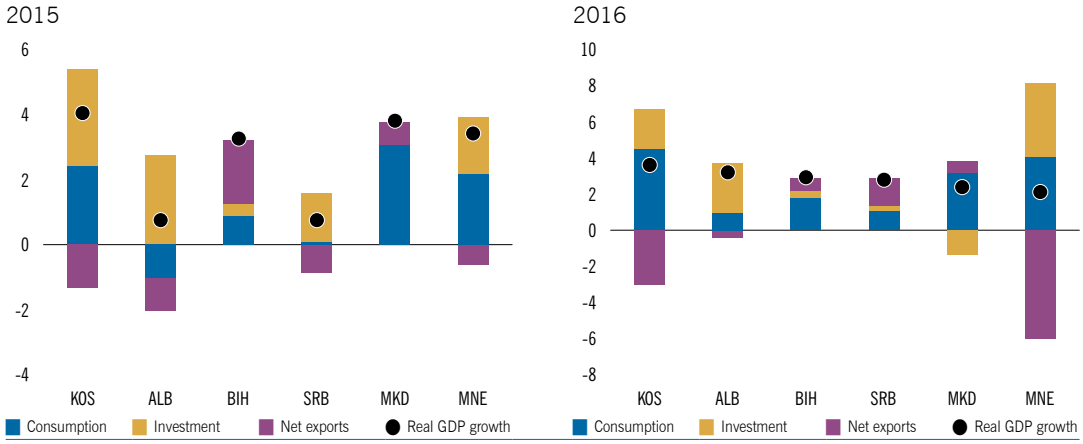
Source: Central bank and national statistical offices data; World Bank staff estimates for 2016.

Investment continued to support growth (except in FYR Macedonia), but its contribution moderated. In Albania, investment was the primary source of growth in 2016, generated mainly by construction of the Trans-Adriatic Pipeline and the Devoll hydropower plant. In Montenegro, investment continued to play a strong role, notably in the energy sector, notwithstanding delays in obtaining construction permits for the Bar-Boljare highway. In Kosovo, investment growth declined from 2015 but remained robust because of both public and growing domestic private investment. In Bosnia and Herzegovina, delays in public infrastructure projects decreased investments' contribution to growth. In Serbia, both public and private investment,

3 2016 figures are World Bank staff estimates.

Figure 2.2. The contribution of investment to growth moderated in 2016

Decomposition of real GDP growth, percent



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

including foreign direct investment (FDI) in manufacturing and construction, supported robust growth in overall investment. In FYR Macedonia, investment fell, subtracting from growth despite significant public investment in roads, reflecting the effect of the prolonged political crisis.[4]

Minimal net exports exerted a drag on regional growth as deteriorating trade deficits in Montenegro and Kosovo almost negated the positive export performance of Serbia, and Bosnia and Herzegovina. Net exports contributed negatively to growth in 2016 in all Western Balkan countries except Bosnia and Herzegovina, and Serbia. In Serbia buoyant manufacturing exports again pushed up growth. In Albania, Montenegro, and Kosovo, imports of equipment and materials for infrastructure works shot up while exports grew weakly.

4 In FYR Macedonia, early parliamentary elections originally scheduled to take place in April 2016 and then in June finally occurred in December. After the December elections, there was an attempt to form a coalition government, but when this report was issued, a coalition had not yet been formed.

3. More jobs and low prices are helping to reduce poverty

Growth has brought jobs to the Western Balkans, although the labor market situation is still challenging. Employment growth accelerated in most countries, driving up the year-on-year regional job growth rate from 2 percent in June 2015 to 4.5 percent in June 2016 (Figure 3.1). Employment grew fastest in Serbia, at 7.2 percent in 2016, amounting to an almost 6 percent average employment gain for the Western Balkans. Albania has been working to reduce informality, and Serbia enjoyed a revival of manufacturing and a good agriculture season, which generated an expansion in informal jobs. FYR Macedonia and Montenegro also recorded job growth but to a much smaller extent. In Bosnia and Herzegovina, recent and continuing labor market reforms are yet to translate meaningfully into higher employment, which fell by 2.6 percent year-on-year in June 2016.

Whether unemployment was reduced depended on each country's recent reform efforts and on presence of active labor market policies. Unemployment declined in nearly all countries: Serbia, FYR Macedonia, Bosnia and Herzegovina, and Albania, reduced unemployment by more than 2 percentage points.[5] This was despite an expansion in labor force participation in Serbia and Albania. In FYR Macedonia, lower unemployment was aided by fiscally-supported active labor market policies and some gains in private sector employment, particularly in construction. Kosovo also saw considerable job creation in 2016.[6] Montenegro is the only country where unemployment worsened, after introduction of a lifetime benefit for mothers incentivized women to leave the labor force.

Despite recent positive developments in the region, unemployment remains high. It averages about 20 percent in 2016 and ranges from 13 percent of the labor force in Serbia to almost 33 percent in Kosovo.[7] More than 70 percent of those unemployed have been jobless for prolonged periods (Figure 3.2). The youth unemployment rate is about double that of the working-age population, which has implications for future income generation.

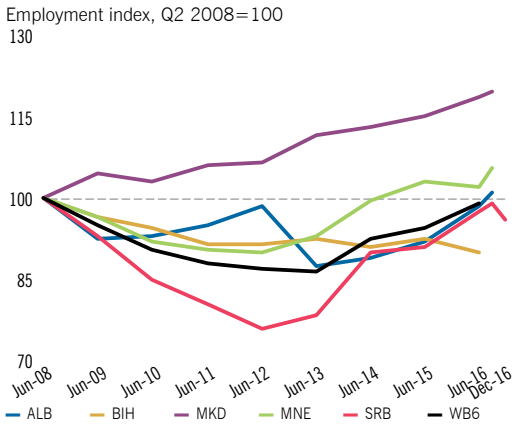
Despite the pick-up in growth and employment, inflation remained low or negative—a real benefit for household budgets. Low import prices, especially for commodities, restrained price pressures, though there was some upward momentum as the year was ending. Despite the pick-up in average regional growth, inflation in the Western Balkans is estimated to have slowed from 0.6 percent in 2015 to 0.1 percent in 2016. In Albania and Serbia inflation was also low at just above 1 percent. Meanwhile, deflation persisted in Bosnia and Herzegovina, FYR Macedonia, and Montenegro, despite impressive growth in private consumption, while in Kosovo it only recently moved into positive territory. Weak

5 Based on the latest available year-on-year data for 2016: December for Serbia and Albania, September for FYR Macedonia and Montenegro, and June for Bosnia and Herzegovina.

6 Quarterly data were made available for the first time in 2016. The lack of such data for 2015 makes direct comparisons impossible, but this information does suggest that in 2016 there was a healthy increase in employment.

7 2015 number is used for Kosovo.

Figure 3.1. Employment gains varied by country



Source: National statistics offices and World Bank staff estimates.

Figure 3.2. Unemployment remains high generally

Source: National statistics offices and World Bank staff estimates.

or declining international prices benefited households, especially the poor. In Bosnia and Herzegovina, for example, declining consumer prices provided a small boost to real incomes—in November the net nominal monthly salary rose by 2.5 percent compared to a year earlier. In late 2016, inflation began to head upward in several countries, for example reaching 0.5 percent in Montenegro in the last quarter of 2016 and continuing into early 2017.

Recent job creation, falling unemployment, and low prices have helped reduce poverty. The average poverty rate for Albania, FYR Macedonia, Montenegro, and Serbia is estimated to have dropped by close to 2 percentage points between 2013 and 2016.[8] An estimated 240,000 people were thus lifted out of poverty, measured against the regional standardized benchmark of living on less than US$5/day in 2005 purchasing power parity terms (PPP). It is estimated that in 2016 poverty was alleviated in all Western Balkan countries, except Bosnia and Herzegovina where it is estimated to have stagnated. If the welfare improvements are to be sustained, greater employment opportunities and a higher share of income coming from labor earnings will be necessary for citizens of Western Balkan countries, as is true of other middle-income countries. Poverty in the region is expected to continue falling, though the pace will vary by country; it will be slower in Bosnia and Herzegovina, Kosovo, and FYR Macedonia. How fast poverty is reduced depends on national patterns of economic growth, labor market improvements, and how many people are close to the poverty line. Downside risks to growth, challenges with fiscal consolidation, high rates of unemployment and inactivity, and exposure to natural disasters will continue to heighten vulnerability.

8 Regional average excludes Kosovo and Bosnia and Herzegovina due to issues in calculating PPP welfare aggregates.

4. Reforms helped boost exports

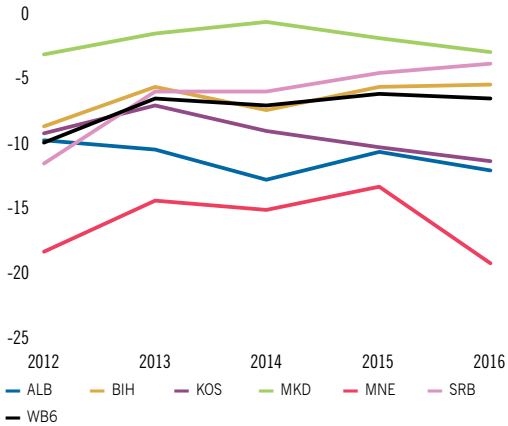
The widening current account deficits (CADs) expose WB6's economies to vulnerabilities (Figures 4.1 and 4.2). The CAD for the region went up from 6.2 percent of GDP in 2015 to an estimated 6.6 percent in 2016 and a projected 7 percent in 2017. For Albania, the main problems are a larger trade deficit and weaker remittances. In FYR Macedonia, although the trade deficit narrowed, the decline in private transfers and significant repatriation of profits widened the CAD. Lower income inflows explain the growing external deficit in Kosovo. In Montenegro, surging construction-related imports dwarfed exports, resulting in a trade deficit of 44.9 percent of GDP and an external deficit of 19.2 percent. In contrast, strong manufacturing exports and a better balance of trade in services in Serbia, and strong services exports in Kosovo and Albania helped to counterbalance the widening of the regional CAD.

Export growth continued to narrow Serbia's external balance but, in Montenegro and Albania especially, trade deficits deteriorated. In Albania and Kosovo the deterioration was driven primarily by commodities, with an additional drag from a rise in imports as domestic demand and investment firmed up. For Montenegro both manufacturing and commodity exports have declined, and the leveling-off of tourism receipts has not been able to fully compensate. In Kosovo, the diaspora continues to relieve external balances through services exports, remittances, and FDI, but the goods trade balance put it in deficit in 2016. On the other hand, manufacturing exporters continue to benefit from low commodity prices and better than expected growth in the EU. Serbia is also benefiting from private-sector-oriented reforms in recent years that have supported broad-based growth in manufacturing exports (largely financed by FDI), including streamlined construction permits, improved cadaster, simplified tax administration, and reform of its public administration and SOEs. Bosnia and Herzegovina's exports of both goods and services also benefited from rising external demand. Although still riding on its past reforms, in FYR Macedonia, high import content lowered the positive effect of rising manufacturing exports, which could not compensate for the negative effects of prolonged political uncertainty.

Although regional FDI edged down in 2016 from a particularly strong performance in 2015, it remains the main source of external financing to the region. At an average of 3.7 percent of GDP in 2016, FDI was down from its peak of 4.2 percent in 2015 and more in line with past aggregate performance (Figure 4.3). In Kosovo the decline was the result of saturation in diaspora demand for direct investment, primarily in real estate, and an increase in portfolio investment. In Montenegro, net FDI plunged from 17 percent of GDP in 2015 to 10 percent in 2016, mainly due to a large dividend outflow from the telecom industry; it now finances only half of the large and growing CAD. Net FDI continues to be more than sufficient to finance the entire external deficits of FYR Macedonia and Serbia and 25 to 60 percent for the rest of the region. In FYR Macedonia, even though investment as a whole fell in 2016, FDI grew

Figure 4.1: As Serbia, and Bosnia and Herzegovina narrow external deficits, their neighbors' imbalances widen…

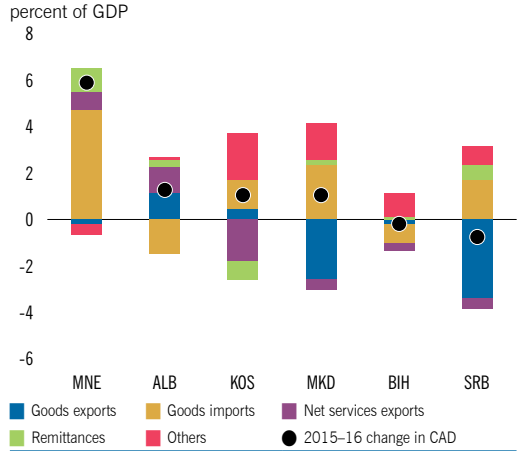
Current account balance, percent of GDP



Source: Data from central banks and national statistical offices; World Bank staff estimates.

Figure 4.2: …driven primarily by trade deficits

Contribution to changes in current account deficit, 2016, percent of GDP



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

Figure 4.3: FDI edged down from a particularly successful 2015

Four-quarter rolling sum, € millions

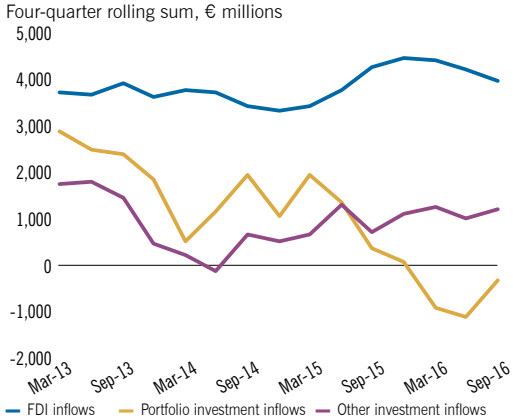
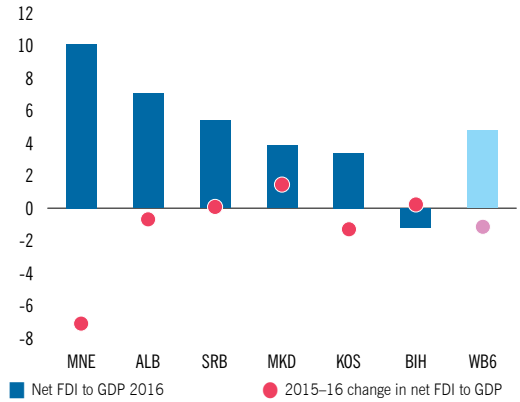


Figure 4.4: FDI inflows plunged in Montenegro, but simply moderated in the rest of the region

Percent



Source: Data from central banks and national statistical offices; World Bank staff estimates.

despite the difficult political situation because it is concentrated in the free economic zones and driven by non-debt creating flows (Figure 4.4). The falling portfolio investment (Figure 4.3) reflects mainly debt restructuring and repayment in Serbia and Albania, part of their fiscal consolidation strategies.

5. Fiscal policy paths diverge

Figure 5.1. Montenegro's fiscal deficit remains high, while continued consolidation efforts further narrowed fiscal deficits in Albania and Serbia

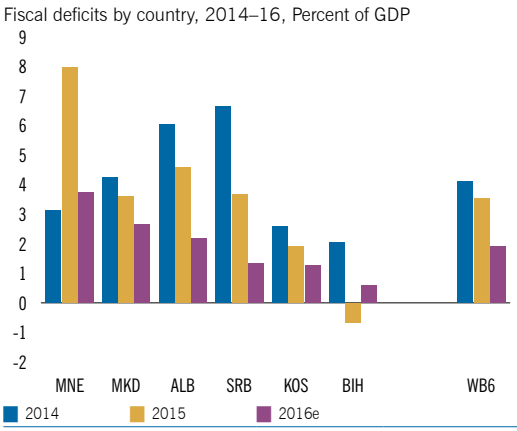
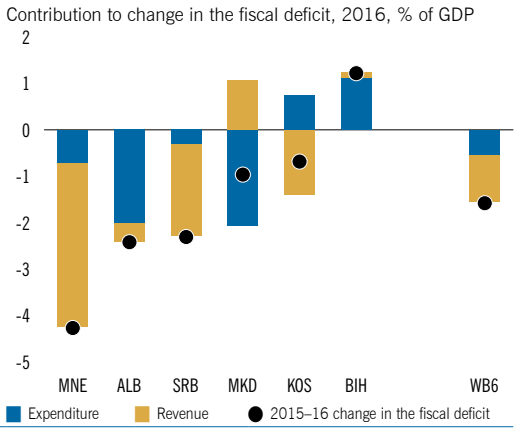


Figure 5.2. In most countries, revenue gains and spending reductions supported the fall in fiscal deficits



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

Most countries narrowed their fiscal deficits in 2016; but this common trend masked the divergent policy paths. The region's average fiscal deficit narrowed from 3.5 percent of GDP in 2015 to 2 percent in 2016 (Figure 5.1). Serbia's deficit fell from 3.7 percent of GDP to 1.4 percent and Albania's from 4.6 percent to 2.2 percent. The deficit also narrowed in FYR Macedonia, from 3.5 percent of GDP to 2.6 percent, and in Kosovo to 1.3 percent. It remained low in Bosnia and Herzegovina, where it was estimated at less than 1 percent of GDP. Even though it temporarily fell from 7.9 percent of GDP to 3.9 percent in 2016 due to delays in the construction of the Bar-Boljare highway, Montenegro's deficit still jeopardizes medium-term fiscal sustainability.

Revenue growth supported fiscal balance across the region. The average revenue-to-GDP ratio for the Western Balkans went up from 34.8 percent of regional GDP in 2015 to 35.8 percent in 2016, with the largest increases recorded in Montenegro (3.5 percentage points of GDP) and Serbia (2 percentage points), see Figure 5.2. Indirect taxes contributed as rebounding consumption and rising imports boosted revenues from value-added tax (VAT). Excise reforms also helped because taxes were raised on alcohol, tobacco, fuel, sugary drinks, and electricity, as governments continued pushing these prices closer to EU standards. Montenegro and Serbia enjoyed significant one-off gains in nontax revenue in 2016 from 4G network licenses. Reforms of state-owned enterprises (SOEs) have brought long-term fiscal gains in Albania and Serbia (see Box 5.1 for the Albania example).[9] Efforts to improve tax

9 The authorities are accelerating Serbia's SOE-restructuring process, reinforcing the regulatory and institutional framework for SOEs, and adopting new monitoring and transparency arrangements,

Box 5.1. Albania: Addressing Contingent Liabilities in the Energy Sector

Albania's electricity sector has long been a major source of fiscal imbalances. Because distribution losses are high and electricity tariffs are below the cost of production, the national electric utility (*KESh: Korporata Elektroenergjitike Shqiptare*) has required repeated budgetary support in the form of power-import guarantees and liquidity injections. By 2013, KESh had a guaranteed overdraft of US$274 million, or about 2.5 percent of GDP.* Low rates of collection from households, businesses, and public institutions exacerbated the financial distress of the state-owned distribution company (*OShEE: Operatori i Shpërndarjes së Energjisë Elektrike*); its unfunded deficit widened to US$550 million in 2014.

The large financial imbalances of energy SOEs threaten Albania's fiscal stability and absorb an increasing share of its resources. Since 2014, the government has pursued a program to (a) invest in new small-scale generating plants; (b) reduce distribution losses; (c) raise tariffs to cost-recovery levels; and (d) open the Albanian electricity market to regional competition. An inter-ministerial task force was appointed to disconnect illegal connections, and enforcement of criminal penalties for electricity theft was intensified. In 2014–15 the government also cleared a substantial amount of its own arrears to the energy sector. These efforts increased the general collection rate from 78 percent in 2013 to 86 percent in 2016 and reduced OShEE's distribution losses from 45 to 28 percent per kWh. The collection of debt from electricity consumption also improved by 10 percent over the same period. While further efforts are needed to bring down distribution losses, Albania is taking important steps in the right direction.

The authorities built on these efforts by adopting a Power Sector Financial Recovery Plan, passing a New Power Sector Law, reforming KESh and OShEE management, and revising sectoral investment priorities. The New Power Sector Law (April 2015) restricted below-cost tariffs to low-voltage consumers and replaced the wholesale public supplier with a market-based mechanism for small independent power plants and eligible consumers, including private concessions. Eight large customers are now authorized to buy electricity on the open market, and OShEE is no longer obliged to supply them with subsidized power. KESh's role as both a wholesale public supplier and supplier of last resort ended in July 2016, and OShEE became fully responsible for providing a consistent supply of energy to consumers eligible for below-cost tariffs.

These reforms are gradually restoring the financial stability of the energy sector and reducing contingent liabilities. Public guarantees fell from 0.5 percent of GDP in 2014 to zero in 2016. KESh is undergoing a major restructuring program in order to comply with the EU's Third Energy Package. Access to international financial institutions has enabled KESh to replace expensive short-term commercial loans with longer-term concessional loans.** In July 2016 the authorities adopted both a new model for regulating the electricity market and a plan to phase-out price regulation and enable all market participants to trade power freely. However, to complete the reform and liberalization required 56 new or amended acts addressing virtually all segments of the electricity sector, progress on which has been slow. It would be important to accelerate the establishment of an organized electricity and power-exchange market, advance reforms to deregulate prices, and strengthen corporate governance in the sector.

* Additional contingent liabilities arising from the disputed takeover of the private operator were estimated at 2–2.5 percent of GDP.
** The interest rate on KESh's debt fell from 6.6 percent in 2013 to 3.9 percent in 2016.

Source: World Bank.

Figure 5.3. Under-execution of capital budgets drove lower expenditures…

Contribution to change in public spending, 2016, percent of GDP

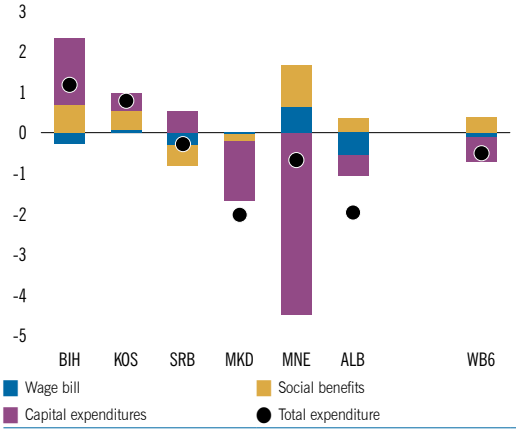
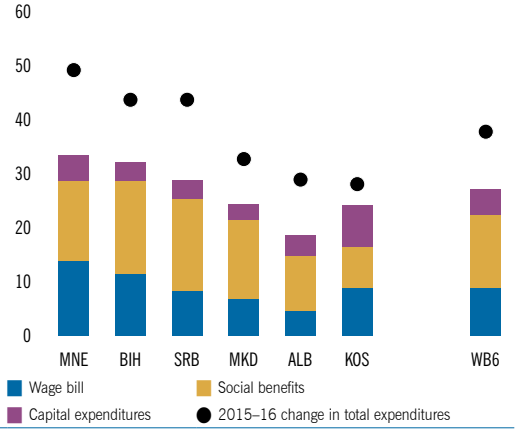


Figure 5.4. …but spending on public-sector wages and social programs remains high

Estimated public spending, 2016, percent of GDP



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

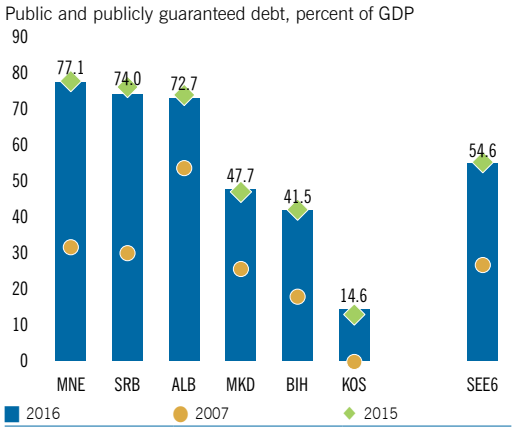
collection also advanced. In 2016, Montenegro collected about €20mn (0.5 percent of GDP) in tax arrears and adopted a one-off restructuring program that allows viable companies to pay their tax arrears without accrued interest. Albania conducted more tax audits and imposed tougher penalties on informal firms. Despite better revenue mobilization, the inefficiency of tax collection and widespread tax concessions and exemptions for foreigners continue to pose major policy challenges. Reductions in tax exemptions would bring foregone revenues back into budgets in most Western Balkan countries.

Most countries reduced growth in spending, but spending cuts tended to focus on capital investment. The largest reductions in spending were in Montenegro (3.7 percentage points of GDP), Albania (2 percentage points), FYR Macedonia (1.7 percentage points), and Serbia (0.3 percentage points). In Albania, FYR Macedonia, and Montenegro, under-execution of the capital budget drove the consolidation, as policymakers delayed infrastructure and other investments (Figure 5.3). In Montenegro, although deferred infrastructure plans temporarily reduced capital spending by 3.7 percent of GDP, given the country's commitments to execute large infrastructure projects in transport and energy, their eventual resumption will expand the fiscal deficit. In FYR Macedonia, delays in project execution due to the prolonged electoral cycle pushed capital spending down to its lowest level since 2006. Similarly, in Kosovo the capital budget reached only about 87 percent of what was planned, which helped to reduce the deficit.

Two distinct trends in current spending underpin the differences in policy paths. Albania, Bosnia and Herzegovina, and Serbia have been rationalizing current spending over the past three years by reducing public-sector wages and pensions and inefficient

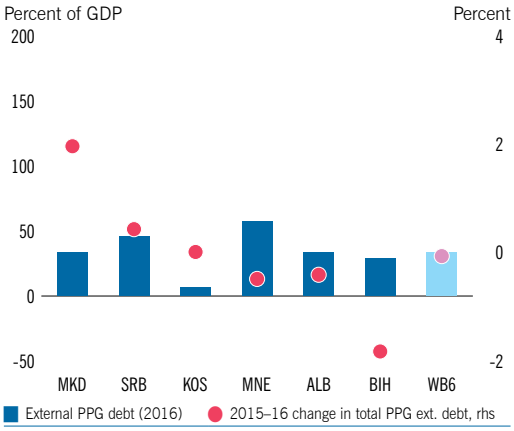
notably the new Law on Public Enterprises adopted in February 2016. As SOEs are a significant source of employment in Serbia, the government is also moving to mitigate the social and labor-market impact of the reform program.

Figure 5.5. Public debt-to-GDP ratios have begun to stabilize in Serbia, Albania, and Bosnia and Herzegovina…



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

Figure 5.6: …and external PPG debt declined in countries pursuing fiscal consolidations



Source: Haver.

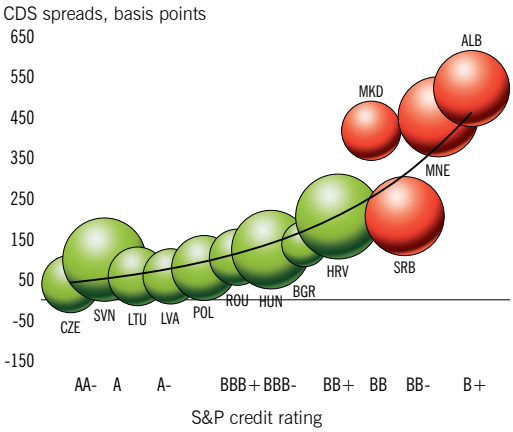
social benefits and subsidies to state-owned enterprises. On the other hand, untargeted current spending has risen in Montenegro, Kosovo, and FYR Macedonia. In Montenegro, new regulations raised annual spending on social benefits by about 2 percent of GDP, on wages by about 1.4 percent, and on pensions by about 0.4 percent. In Kosovo, it is estimated that a new veteran's benefits program will raise spending by about 0.7 percent of GDP annually. In FYR Macedonia, pensions have been rising for the last five years, reaching 30 percent of the overall central government spending in 2016.

Although deficits were reduced in 2016, fiscal consolidation remains a priority, with emphasis on shifting towards pro-growth public spending. At 22.8 percent of regional GDP, spending on public-sector wages and social benefits is still sizeable in the Western Balkans, leaving little space for public investment (Figure 5.4). Speeding up growth will depend on a better balance between capital and current spending: tightening controls over the wage bill and better targeting social benefits would free up resources to invest in priority infrastructure, expand labor-market opportunities for targeted groups, build human capital, provide quality public services, and protect poor and vulnerable households from the impact of fiscal consolidation.

Faster growth and smaller deficits in Serbia, Albania, and Bosnia and Herzegovina have helped stabilize the stock of public and publicly guaranteed (PPG) debt for the first time since the global financial crisis. In these three countries, PPG debt fell by 0.4–1.9 percentage points of GDP in 2016, reversing the rising trend that began in 2009 (Figure 5.5). Growth and fiscal discipline are helping Serbia and Albania to deal with historically high levels of debt. External PPG debt also declined in countries that set out to reduce debt payments and improve structure during fiscal consolidation (Figure 5.6). Overall, the region's average PPG debt stabilized at 54.6 percent of GDP in 2016, double the 2008 level.

The financial market response: sovereign credit outlooks are improving in Serbia and Albania and worsening in FYR Macedonia and Montenegro. Financial-market volatility is a special concern for these countries because they have access to international capital markets and are subject to regular credit-rating assessments.[10] Montenegro's 2016 decision to increase current spending and implement a large public investment program, despite the country's substantial public and external debt burden, prompted Standard and Poor's (S&P) to downgrade its credit outlook from stable to negative in May 2016. The higher costs of much-needed financing exacerbate the already high risks associated with unhedged currency exposure and a high percentage of commercial loans—Montenegro already spends 2.4 percent of its GDP on interest payments.[11] While FYR Macedonia's record of credible monetary and macro-prudential policies has enabled it to maintain its credit rating, in February 2017 the Fitch rating agency noted a negative outlook caused by political uncertainty. By contrast, credit ratings improved in Albania and Serbia, largely based on the success of fiscal consolidation. Albania's S&P's credit rating improved from B (negative) in 2013 to B+ (stable) in February 2017. Serbia's 2016 long-term issuer rating was upgraded by Moody's from "B1" to "Ba3", bringing it in line with the other agencies' ratings. Serbia now enjoys much lower spreads than its neighbors with similar ratings, making its bonds attractive for investors (Figure 5.7). In Bosnia and Herzegovina, credit ratings by Moody's and S&P remained unchanged in 2016 and early 2017, with stable outlook.

Figure 5.7. Serbia enjoys lower spreads than its neighbors with similar credit ratings



Source: S&P credit rating, Bloomberg, Ministries of Finance, and World Bank estimates.

Note: Bubble size represents public debt as percent of GDP. CDS spreads are the latest available. Credit-default swap spreads are not available for Montenegro and FYR Macedonia because their bonds are not regularly quoted. For Montenegro, the spreads given here show the yield from the 2016 placement.

10 No credit rating is available for Kosovo.

11 Montenegro relies on external borrowing from China to finance its large infrastructure program. While this shift to external financing has reduced average interest rates and lengthened average maturities, the rising share of US dollar-denominated loans in national debt profiles in the region has exacerbated exchange-rate and refinancing risks.

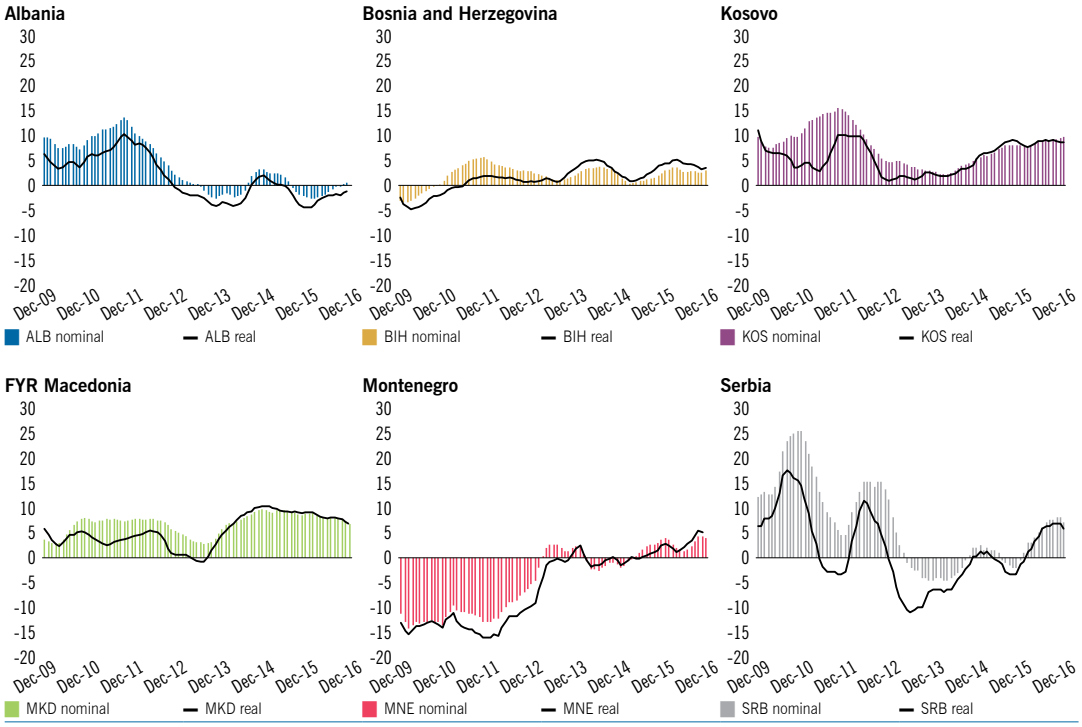
6. Better asset quality is helping drive credit growth

Low or negative inflation resulted in monetary policy adjustments, stimulating credit growth in Serbia and Albania. In Serbia, 1.2 percent inflation in 2016, persistently below the target band, and improved macroeconomic environment, caused the Central Bank to shave its target band from 4 ± 1.5 to 3 ± 1.5 percent. Inflation was also below the target band in Albania, but in 2016 with the target already at 3 ± 1 percent no changes were made as expectations are for higher growth and a gradual increase in capacity utilization. The Central Bank in FYR Macedonia lowered interest rates late in 2016 and early in 2017 back to 3.25 percent, as pressures on the exchange rate and deposit base that occurred in April and May 2016 dissipated during the second half of the year.

Though credit growth was positive in most WB6 countries, it moderated in the last six months (Figure 6.1). At over 10 percent in 2016, credit growth in Kosovo was the highest in the region as improved market conditions and lower interest rates continued to fuel private demand. In Serbia credit growth improved in all segments, also mainly driven by higher demand from households. Growth in credit to the private sector was strong in Albania, taking into account bad loans

Figure 6.1. Heightened economic activity drives private sector demand for credit

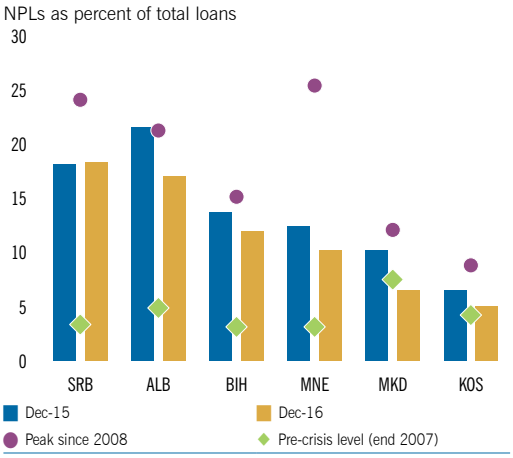
Credit growth, y-o-y 3-month moving average, Dec 2009–Dec 2016, percent



Source: Haver and National central banks.

write offs new lending growth was close to 3 percent. In FYR Macedonia, however, although household lending remained robust, the uncertain political climate depressed demand from the corporate sector, so that credit growth as a whole slowed significantly. A drop in demand from corporations was also responsible for a credit growth slowdown in Montenegro to about 1.3 percent, while in Bosnia and Herzegovina around 2 percent growth in credit at yearend reflected easing of credit supply in the small and medium enterprise (SME) and consumer credit segments.[12]

Figure 6.2. Nonperforming loans are declining

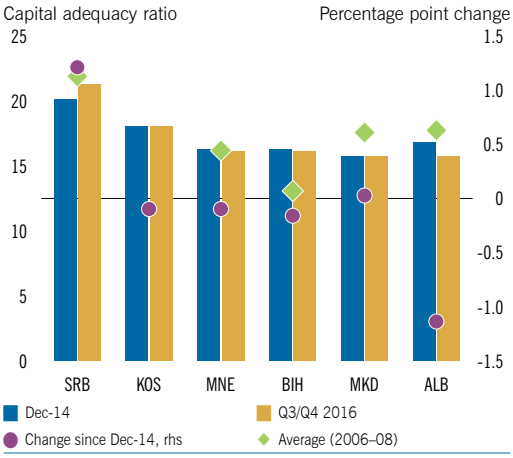


Source: National central banks.

An increase in lending in domestic currency helped manage currency risks in private sector portfolios. In Albania, lower interest rates and streamlined credit standards at commercial banks stimulated domestic currency lending, which as of December 2016 had grown by over 7 percent, up from 4 percent in 2015. In Albania and Serbia, foreign currency lending is 40–70 percent of total lending, which is risky for unhedged borrowers if there are nominal exchange rate movements.

Gradually improving asset quality is helping drive credit growth, but NPL levels remain high. NPLs burden bank balance sheets, undermine profits, and erode capital, thus making it harder for banks to support growth of the economy by making more credit available. Kosovo has the lowest NPL ratio in the region. At 11.5 percent, the high regional average for NPLs has been pushed up by Albania (18.3 percent) and Serbia (17 percent). However, recent reforms are helping to reduce the stock of NPLs considerably: including provisions to write off old NPLs in FYR Macedonia and Albania; Kosovo has a new system to enforce collateral recovery; Bosnia and Herzegovina's entity Republika Srpska has adopted a new insolvency law; and Montenegro now has a law on voluntary financial restructuring (Figure 6.2).

Figure 6.3. Capital adequacy ratios are sufficient



Source: National central banks.

12 European Investment Bank. CESEE Bank Lending Survey H2-2016, see at http://www.eib.org/attachments/efs/economics_cesee_bls_2016_h2_en.pdf.

In general, banks in the Western Balkans are well-capitalized and liquid. Recent failures of domestic banks renewed concerns about asset quality and the health of specific banks, in particular in Bosnia and Herzegovina, and Montenegro. The deleveraging of foreign banks has driven up domestic deposits and reduced average loan-to-deposit ratios. Deposits are the largest funding source for banks, ranging in 2016 from 69.4 percent of total liabilities (Albania) to almost 86 percent (Kosovo). The average loan-to-deposit ratio was about 88.5 percent at end-2016, down from 119 percent in 2008. The capital adequacy of the system reached an average of 17.1 percent in Q4 2016, which is considered sufficient to absorb identified risks (Figure 6.3).

7. Sustaining reform momentum is essential

Near- and medium-term growth prospects for the region are positive. The regional growth rate is projected to average 3.4 percent in 2017–18 as investments strengthen and net exports become increasingly important, led by Serbia, the largest economy in the region. As economic activity picks up and labor market outcomes improve, robust consumption will continue to be the main driver of growth. Regional inflation is projected to rise gradually as domestic demand heats up, global commodity prices edge up, and inflation in trading partners gradually increases as their economic activity strengthens and global interest rates rise.

Table 7.1. A Positive Growth Outlook

	2015	2016f	2017f	2018f
Real GDP growth (percent)				
Albania	2.6	3.2	3.5	3.5
Bosnia and Herzegovina	3.0	2.8	3.2	3.7
Kosovo	4.1	3.6	3.9	4.2
FYR Macedonia	3.8	2.4	2.8	3.3
Montenegro	3.4	2.1	3.3	3.0
Serbia	0.8	2.8	3.0	3.5
Western Balkans	**2.2**	**2.8**	**3.2**	**3.6**

Sources: Data from central banks and national statistical offices; World Bank staff estimates and projections.

Following a substantial consolidation over the past three years, the average fiscal deficit in the WB6 is projected to increase from 2.2 percent of GDP in 2016 to 2.7 percent in 2017. Once again, this average reflects two very different trends: Serbia, Albania, and Bosnia and Herzegovina are expected to see further fiscal consolidation, whereas the remaining countries will see a widening of the deficit. For 2017 Albania, Bosnia and Herzegovina, and Serbia have budgeted for structural reforms to address spending rigidities and, for Albania, contain the growth of arrears. In Kosovo, a recent amendment of the fiscal rule will allow the deficit to exceed its current limit of 2 percent of GDP in order to finance productive investments. In FYR Macedonia, the 2017 projected budget deficit indicates a moderate increase in the deficit to 3.2 percent of GDP, with revenues stable but current spending higher, especially on pensions. In Montenegro, the 2017 budget contains a series of measures to increase revenues and reduce spending—a welcome development. Nevertheless, even if the Bar-Boljare highway project is excluded from the analysis, returning public finances to a sustainable medium-term trajectory will require additional consolidation measures on both revenues and spending.

It is projected that by 2018 PPG debt will start declining in all WB6 countries except Montenegro and Kosovo. Montenegro's surging debt stock threatens its medium-term fiscal sustainability. Stabilizing Montenegro's debt will be challenging, but doing so will be crucial to restore investor confidence and allow successful rollover of the country's current obligations, which are projected to reach an average of 16 percent of GDP in 2019–21. While Kosovo's debt is increasing, the stock of debt is relatively low and there is margin for an increase in debt to finance productive investments.

External risks remain tilted to the downside. The main external risks relate to the structurally weak growth in the EU and post-Brexit

uncertainties. Persistently poor growth in the EU is a serious risk for the WB6 region, given its high real and financial links to the EU, which is the biggest trade partner for the WB6 and home to most of the FDI flowing into the region. Political uncertainty and instability have been on the rise in some EU countries and other trading partners, such as Turkey, and could affect the Western Balkans through trade and investment links, though it could also stimulate tourism. Growing general uncertainty is another factor that could make investors more risk-averse or have an impact on the large investors that support significant shares of growth and employment in the region. Should the risk of higher protectionism materialize, it could limit rebalancing toward a more export-oriented growth model, which would raise a barrier to income convergence with the EU. For example, in 2016, 75 percent (0.6 pp) of the reduction in global trade growth was due to heightened policy uncertainty.[13] Commodity price dynamics and US monetary policy normalization are also a risk. Moreover, should the U.S. dollar appreciate it would create debt servicing risk, particularly in Serbia where about a third of PPG debt is denominated in US dollars; Montenegro is also subject to US dollar exchange rate risk.

Domestic political risks also dim WB6 growth prospects. The political tensions in several countries are likely to persist into the medium term. The resulting political uncertainty could have macroeconomic ramifications by dampening investor interest and raising concerns about possible policy changes and resistance to reform from vested interests. In FYR Macedonia, the effects of the prolonged political crisis and election-related uncertainty already threaten the economy. Perceptions of political fragility in Kosovo may result in a softening of investment. Meanwhile, Serbia recently held presidential elections in April 2017, and Albania is scheduled to hold parliamentary elections in June 2017. If political uncertainty leads to delays in delivering on structural reforms or slippages in maintaining fiscal discipline, this could reduce growth prospects and compromise the quality and durability of fiscal adjustment. To mitigate these risks, the policy mix will need to give precedence to prudent short-term policies with continued fiscal consolidation, coordinated monetary policy in countries that can pursue it, and a strategy to build up the financial sector (see Box 7.1).

External imbalances are expected to deteriorate slightly, exacerbating vulnerabilities to shocks even if FDI and international reserves are strong enough to help provide a buffer against financial volatility. Over the next three years the CAD is expected to increase in all WB6 countries except Serbia. The deterioration is mainly driven by higher trade deficits: exports will be growing slower than imports as planned investment projects materialize and consumption continues to rise. As long as external imbalances are high, the regional and global outlook will continue to be an important determinant of the ability of the WB6 to withstand external shocks. In the short term, slower growth in the region's main trading partners and reduced exchange rate competitiveness could be detrimental to WB6 export prospects. Moreover, faster normalization of global interest rates poses

13 Based on a sample of 18 countries over 30 years, see Constantinescu, C., A. Mattoo, M. Ruta (2017), *Global Trade Watch. Trade Developments in 2016: Policy Uncertainty Weighs on World Trade*. Washington, DC: World Bank.

Box 7.1. Financial development and long-term growth in the Western Balkans

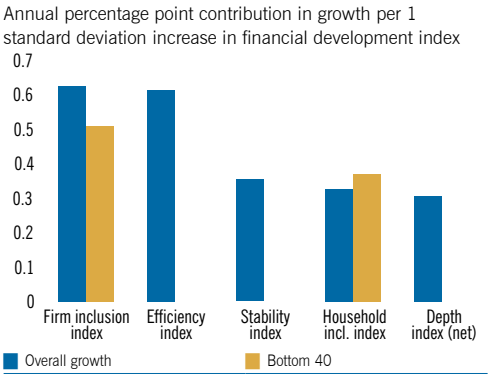
Western Balkan financial systems continue to be vulnerable to financial shocks and have not evolved sufficiently to support inclusive growth. For more than 20 years, finance in the Western Balkans has been dominated by large foreign banks. The resultant rapid credit deepening has come at the cost of financial booms and busts. Nevertheless, financial intermediation in the Western Balkans is low compared to other countries in CESEE the ratio of private sector credit to GDP averages just 45 percent. Since the 2008 financial crisis, the growth potential of the region has been limited by the inadequacy of financial sector development and stability, which has been characterized by high costs of intermediation and high NPLs. Further challenges are posed by growing risks in domestic banks in some countries, shallow nonbank financial sectors, and the volume of foreign exchange lending to unhedged borrowers. Among the external factors affecting WB6 financial systems are the global market outlook, external borrowing risks and constraints, EU regulatory and supervisory reforms, and the capitalization problems of parent banks.

To boost growth and shared prosperity, finance must become more balanced and manage the tradeoffs between financial inclusion and stability. Striking the right balance across these dimensions of financial development (stability, efficiency, inclusion, and broad depth) is crucial if finance is to support inclusive and sustainable growth. Finding the right balance in financial development also involves tradeoffs that are often overlooked—much to the peril of policy makers. This is particularly true with regard to stability and inclusion. Rapid expansion during boom periods of credit to firms and individuals with less than stellar creditworthiness may promote short-term growth—as was seen in the WB6 countries up to the 2008 crisis, which was followed by high NPLs—but it comes at the risk of a banking crisis or greater near-term vulnerability. For the Western Balkans, financial development to support inclusive growth should support balanced financial sector development that includes diversified depth (bank and nonbank) and financial stability, efficiency, and inclusion. Considering the tradeoff between household use of credit and financial stability, and the synergy between higher firm savings and stability, WB6 countries where the financial sectors are currently less stable may wish to prioritize reducing barriers to firm saving while monitoring closely the growth of household credit.

Drafting a financial strategy has been successful for many countries around the world in helping them deal with these tradeoffs. Given the gaps in and potential benefits of the various dimensions of financial development, the Western Balkans would benefit most from focusing on efficiency and diversified financial systems and including individuals in shared prosperity, especially in savings instruments. At the same time, it is also important to consider potential tradeoffs for risks to stability.

Sources: World Bank staff and Gould, David Michael, and Martin Melecky, 2017. *Risks and Returns: Managing Financial Trade-Offs for Inclusive Growth in Europe and Central Asia*. Washington, DC: World Bank.

Figure B7.2.1: Growth and shared prosperity is associated with financial development



Sources: Global Financial Development Database, Global Findex, FinStats, and World Development Indicators.

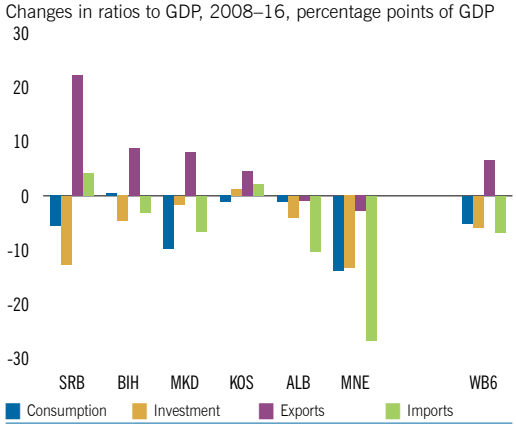
Note: Each column represents the coefficient on bivariate regression with the overall growth residual and the bottom 40 growth residual as the dependent variable. The growth residual is obtained by regressing income growth on the core set of condition variables.

a risk to both GDP growth and the external sector.

Staying the course on structural reforms has helped some economies to start the rebalancing toward sources of more sustainable growth in the aftermath of the global financial crisis. The global financial crisis led to a sudden stop in inflows of foreign capital into emerging markets, among them those in the Western Balkans. That put an end to a period of consumption booms, and the resultant waning of optimism put the brakes on growth. Lower economic activity prompted a decline in consumption and imports, and investment deteriorated across the board, as a result of both fiscal limitations and lower investor confidence. The crisis could have been an opportunity for the affected economies to rebalance the sources of growth from domestic demand to exports, while fiscal constraints meant the private sector's increased role as a source of future growth. However, thus far only Serbia has experienced robust export growth since the global financial crisis (Figure 7.1). In contrast, although Montenegro and Albania experienced temporary improvements in net exports, this was due to plunging imports when domestic demand collapsed. One reason for these differences lies with commodity exports, which suffered from a prolonged period of low prices, subtracting from export growth in Albania, Montenegro, and Kosovo; meanwhile, manufacturing sectors in Serbia, Bosnia and Herzegovina, and FYR Macedonia benefited from the lower prices of raw materials.

Figure 7.1. The rebalancing toward external demand is particularly evident in Serbia

Changes in ratios to GDP, 2008–16, percentage points of GDP



Source: Central banks and national statistical offices; World Bank staff estimates.

Accelerating structural reforms and staying on course is important for sustaining growth in all Western Balkan countries. The success of Serbia and Albania in boosting growth through private sector–friendly reforms hinges on their ability to sustain their reform momentum. Their policies have facilitated economic expansion and are also helping with the nascent rebalancing of growth toward more sustainable sources. Both countries are improving fiscal management and the business environment. Serbia is working to reduce its legacy of a dominant and inefficient state: Since 2014 it has moved over 300 commercial SOEs out of its portfolio, among other measures freeing up assets for the private sector and reducing state losses and indirect fiscal liabilities. Serbia also set out to streamline construction permits, improve the cadaster, simplify tax administration, and reform public administration. Albania has, among other reforms, cleared public sector arrears amounting to 5 percent of GDP, benefitting over 1,500 private firms; improved the reliability of electricity services; and tailored business regulations to make it easier to trade across borders and access credit (such as lowering NPL burden and improving collateral execution). Sustained reform efforts have enabled the firms to attract private investment and reap the benefits of a recovery in export demand. With progress underway, it is essential

that both countries sustain the reform momentum so as to enhance macroeconomic management, improve public-sector efficiency, and strengthen governance and the rule of law, all of which are necessary conditions for a dynamic private sector. Until recently FYR Macedonia has been enjoying the effects of previous reforms that helped its economy to withstand the effects of the prolonged political crisis. But the recent political crisis has exposed the fragility of success, heightening the importance of sticking to the reform course. As uncertainty grows in the global economy, these examples reinforce the importance for all countries to accelerate business-friendly structural reforms, to achieve higher and more sustainable economic expansion.

For all countries, heightened risks underscore the urgency of structural reforms to reinforce the nascent rebalancing from domestic to external sources of growth that rely more on investment. If the cycle of limited reforms, slow growth and massive youth emigration is to be broken, the benefits of job-creating growth need to be consolidated. Sustained attention to five areas of reforms remains particularly urgent:

- To enable faster growth, job creation, and poverty reduction, eliminate disincentives and barriers to formal employment.
- To enable firms to create more jobs, expand, and increase productivity, improve the business climate and governance.
- While reducing the government footprint, enhance the equity, quality, and efficiency of public services and social protection systems.
- So that economies benefit more from export growth, deepen regional and global integration.
- Ensure sustainable use of energy and natural resources and build resilience to natural hazards.

8. Spotlight: Fiscal Rules in the Western Balkans

Ensuring sound fiscal policy is a priority for countries in the Western Balkans. In all six countries the global financial crisis of 2008–09 strained fiscal positions by significantly eroding fiscal buffers, increasing public debt, and exposing structural weaknesses, notably the contingent liabilities generated by state-owned enterprises and other public entities. Since 2008, public debt has gone up in all the WB6 and more than doubled for the region as a whole. Moreover, many countries in the region have been unable to return to their pre-crisis growth rates and countercyclical spending has eroded fiscal reserves, jeopardizing debt sustainability and macroeconomic stability (Figures 8.1 and 8.2).

Figure 8.1. Western Balkans: Fiscal Balance

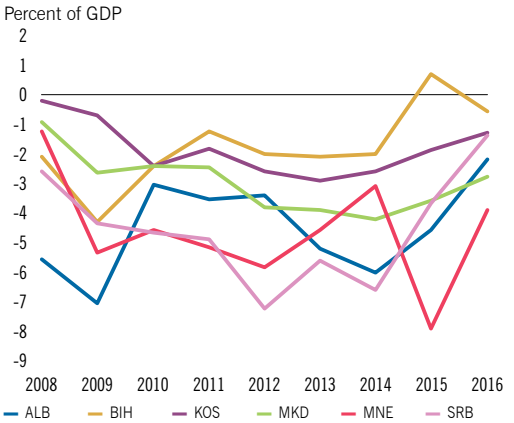
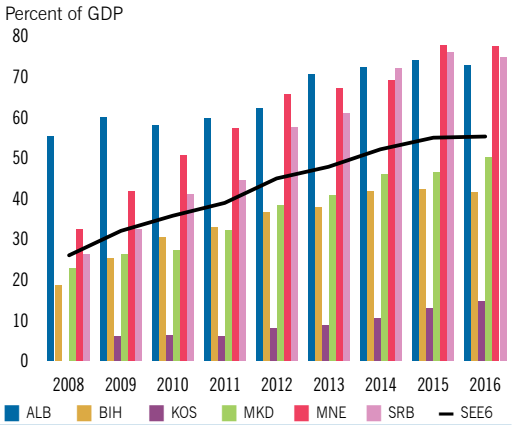


Figure 8.2. Western Balkans: Public and Publicly Guaranteed Debt



Source: Country authorities and World Bank staff estimates.

Policy tools that promote fiscal sustainability, such as fiscal rules, have garnered attention in countries elsewhere that are in need of fiscal consolidation. A core objective of fiscal rules is to heighten the credibility of fiscal policy as the foundation for economic growth. Well-designed and effectively implemented fiscal rules can help improve policy predictability, smooth output volatility, and manage procyclicality.[14] Fiscal rules can smooth the distribution of public spending over time and allow for uninterrupted implementation of multiyear projects and programs. They can also provide greater transparency, make fiscal policy more resilient to the demands of public agencies and interest groups, and create an explicit commitment on the part of the government to achieving its fiscal goals. Fiscal rules can be particularly helpful for the WB6, which as small economies are vulnerable to exogenous shocks, because the lack of flexibility in their exchange rate regimes requires that their fiscal policies be credible and sustainable.

14 See Kopits and Symansky (1998, 2001); IMF (2012); and Wyplosz (2005, 2012).

All Western Balkan countries except FYR Macedonia have adopted fiscal rules. Most of these rules are amendments to budget laws that introduce numerical target to ensure long-term fiscal sustainability, discipline, and transparency. Fiscal rules in Albania, Bosnia and Herzegovina, and Kosovo target only the central government budget, deficit, and debt levels; in Montenegro and Serbia they also apply to local governments. A common feature is that the fiscal rules apply only to public debt—not arrears or liabilities stemming from public guarantee for companies or public-private partnerships (PPPs). It is worth noting that while FYR Macedonia does not have a fiscal rule in place, the country has been recognized for implementing prudent macroeconomic policies and maintaining fiscal discipline, and the authorities did not feel the need to adopt numeric fiscal rules.

The European Union (EU) accession process has given the WB6 an additional incentive to manage their finances better. Conforming to the Maastricht criteria, also known as the convergence criteria, is a precondition for EU membership. Most Western Balkan fiscal rules are in line with the Maastricht criteria, which stipulate an annual budget deficit of less than 3 percent of GDP and public debt of less than 60 percent.[15] To this effect, most of the WB6 have enacted a Public Internal Financial Control Law to support adherence to their fiscal rules, and several have established internal audit and control functions for the public sector. In addition, they are steadily enhancing the budget-execution process by consolidating separate public accounts into a single treasury account. Governments in the region are also beginning to adopt the auditing practices of the International Organization of Supreme Audit Institutions and the International Public Sector Accounting Standards.

This note describes the fiscal rules applied in each WB6 country and summarizes relevant lessons from international experience. Aspirations to join the EU are helping drive reforms in the region, such as fiscal rules. Nevertheless, as discussed next, despite similarities with the EU criteria, the fiscal rules applied in Western Balkan countries differ in significant ways that may affect their relative success.

Country Experiences

Albania

From 1998 to 2012, Albania applied a single fiscal rule established in the 1998 Organic Budget Law that required that the debt stock not exceed 60 percent of GDP. This rule was revised in June 2016 to mandate that debt decrease every year until it reaches 45 percent of GDP.[16] However, the revised rule does not specify a deadline or a path to achieve the 45 percent target, which may dilute its effectiveness. There is also a "buffer" clause mandating that 0.7 percent of total budgeted expenditures be allocated to a budgetary reserve that can be used to compensate for forecasting errors and unforeseen changes in

15 Maastricht criteria set targets or rules for inflation, public debt and the deficit, exchange rate stability, and interest rate convergence. The criteria are defined in article 121 of the treaty establishing the European Community.

16 In 2016, Albania's stock of public and publicly guaranteed debt stood at 72.7 percent of GDP, or 67.8 percent of GDP when publicly guaranteed debt is excluded.

macroeconomic variables, such as lower-than-expected growth and interest and exchange-rate fluctuations. The law also introduces the "golden rule" of borrowing—that the government should borrow only to invest and not to fund current spending—and mandates that privatization receipts be used to reduce debt or finance capital investments.

Like other countries in the Western Balkans, Albania has at times found it difficult to apply its fiscal rule. Among the challenges are budgeting for multiyear commitments, especially those related to PPPs; overestimation of revenues that leads to unrealistic spending plans that contribute to arrears in unbudgeted spending; and national accounts data that require significant revisions.[17,18] In 2016 the government adopted a new Organic Budget Law that will help improve management of public finances to support adherence to the fiscal rule. Measures include drawing the macroeconomic assumptions used for budgeting purposes from the IMF *World Economic Outlook*, special provisions for electoral years, and specifying limits on and disclosure of multiyear commitments. To mitigate fiscal risks stemming from PPPs, the Organic Budget Law limits the total stock of PPPs, integrates them into the budgetary process, and gives the Ministry of Finance a larger role in assessing and monitoring PPP proposals.

17 See IMF. 2016. "Albania, Fiscal transparency evaluation." https://www.imf.org/external/ pubs/ft/ scr/2016/cr1605.pdf; and IMF (forthcoming) Public Investment Management Assessment (PIMA).

18 See World Bank. 2014. Albania Public Finance Review. http://documents.worldbank.org/curated/en/ 457931468003296521/pdf/820130ESW0P1430C0disclosed030100140.pdf.

Bosnia and Herzegovina

BiH does not use national fiscal rules for the consolidated general government but instead maintains separate rules for each of the two constitutional and legal entities. In the Republika Srpska entity (RS), a fiscal rule introduced in 2012 through the Law on Borrowing, Debt, and Guarantees specifies that the public debt stock—which covers spending by the RS, local governments, and extra-budgetary funds for social insurance—cannot exceed 55 percent of GDP. It also stipulates that total debt (public debt plus debts held by public enterprises, the Investment Development Bank, and other public-sector institutions) cannot exceed 60 percent. In the Federation of Bosnia and Herzegovina (FBiH), the 2013 Budget Law stipulates that the current budget must be balanced. However, if there is a deficit in the current budget year, the government must plan for a surplus for the next three years. Following sustained deficits in 2008–14, in 2015 BiH ran a surplus of 0.7 percent of GDP. Consolidated fiscal data are not yet available for 2016, but estimates suggest a deficit of about 0.6 percent of GDP. The authorities are currently drafting a Public Finance Management Reform Strategy that is designed to strengthen budget planning, execution, and monitoring to better ensure fiscal discipline and accountability.

The Fiscal Council is responsible for coordinating fiscal policy and ensuring macroeconomic stability and fiscal sustainability in BiH. RS and FBiH are currently in compliance with debt rules, but there are no sanctions or other consequences should that change.

Kosovo

The fiscal rules Kosovo introduced in 2006 have been amended several times. The original rule stipulated that spending could grow in real terms by 0.5 percent each year. The rule was amended in 2007 to apply only to recurrent expenditures and was abandoned entirely in 2009. A new debt rule was introduced in 2010, which limited public and publicly guaranteed debt to 40 percent of GDP.[19] The same law also set out criteria for the eligibility of municipalities to borrow, and few are currently eligible. Moreover, based on constitutional provisions, any external borrowing is subject to ratification by two-thirds of all seats in Parliament—a very rigid requirement.[20]

The new fiscal rule was introduced in 2013; it limits overall fiscal deficit to 2 percent of GDP, with escape clauses related to recessions and natural disasters. However due to large investment needs, low accumulated debt, and the possibility to borrow at concessional terms, in 2015 the fiscal rule was amended by adding what is known as the 'investment clause'. This investment clause amendment expanded exemptions by adding productive investments in excess of 2 percent deficit financed by development partners, including international financial institutions; it also reduced the debt limit from 40 percent of GDP to 30 percent (this clause is set to expire after 10 years).

Kosovo has complied with the deficit rule since 2015, but given the frequent changes in the recent past it is difficult to predict sustainability of existing rules. Another fiscal rule introduced in January 2017 sets a ceiling on spending on veterans benefits of 0.7 percent of GDP.[21] A new wage rule to become effective in 2018 sets wage increases as a function of nominal GDP growth.[22]

Montenegro

Montenegro's 2014 Budget and Fiscal Responsibility Law introduced several fiscal rules:

1. The general government cash deficit should be less than 3 percent of GDP.
2. The public debt stock should be less than 60 percent of GDP.
3. Central government spending should grow at less than the forecasted real GDP growth rate.
4. Local government deficits should not exceed 10 percent of their projected revenues.
5. State guarantees should not exceed 15 percent of GDP.

A number of escape clauses exist, however. For example, if capital projects push up the public debt stock beyond 60 percent of GDP, the government must propose a debt-stabilization strategy, to be completed within five years.[23] Other escape clauses, such as a vague exemption for "extraordinary events" and the ability of the Ministry of Finance to

19 Law on public debt, Law nr.03/l- 175, 2010.

20 Law on public debt, Part Two Municipal Borrowing, Law nr.03/l-175, 2010.

21 Amendments to the Law on War Veterans, January 2017. This Amendment has not yet come to effect at the time of preparation of this publication.

22 Amendments to the Law on Public Finance Management and Accountability (LPFMA), 2013.

23 Due to a highway construction project that is underway, Montenegro's deficit is currently 4 percent of GDP, and its total PPG debt is 77.1 percent of GDP. Without guaranteed debt it drops to 68 percent.

approve local investments that exceed the deficit limit for capital expenditures, also limit the credibility of Montenegro's fiscal rules.

Montenegro has annual fiscal reporting and monitoring requirements. The Ministry of Finance is expected to provide ex ante notice to the government of any deviations from the fiscal rules and propose corrective measures. The ministry must also report on compliance with the fiscal rules within 90 days of the end of each fiscal year. The State Audit Institution independently reviews compliance with the fiscal rules in its annual audit report 6 months after the fiscal year ends, but it has no authority to enforce compliance.

The Budget and Fiscal Responsibility Act stipulates actions to correct noncompliance. The government has 60 days to reduce the deficit after a rule is breached. Moreover, if public debt reaches 60 percent of GDP, the government must revise the budget to keep debt below the ceiling. If the 60 percent cap is exceeded, the government must propose a five-year rehabilitation plan. Local governments that exceed their deficit ceilings forfeit a transfer from the state budget equal to the amount by which the allowed deficit was exceeded. A requirement for a five-year rehabilitation plan was adopted in December 2016, but no other corrective actions have been implemented.

Serbia

In amending the Budget System Law Serbia introduced fiscal rules in 2010. They specify that the general government deficit is to be determined by a formula that calculates the deficit ceiling for each year based on a medium- to long-term deficit target of 1 percent of GDP. This formulation is designed to allow for larger deficits in years when economic growth is below its long-term potential. The formula is:

$$D_t = D_{t-1} - A*(D_{t-1} - D_p) - B * (G_t - G_p)$$

where D_t is the ceiling for the deficit in year *t*; D_{t-1} the deficit in the previous year; A the adjustment coefficient, which indicates the pace at which the actual deficit approximates the target deficit (currently 0.3 by law); D_p the medium-term target deficit (1 percent of GDP); B the coefficient indicating the divergence of the deficit in year *t* from the target due to the difference in the GDP growth rate in year *t* from the potential GDP growth rate (0.4 percent); G_t growth in year *t*; and G_p the potential medium-term GDP growth rate (4 percent).

Serbia has adopted several other debt and deficit rules, both national and local. The general government debt limit is set at 45 percent of GDP, not counting any possible new debt related to the restitution process. Another fiscal rule that froze salaries and pensions in nominal terms until their share of GDP fell below certain thresholds has been revised several times to allow for increases in wages in some parts of the public sector. Four additional rules were introduced for local governments: (1) deficit financing can be used only for capital expenditures, (2) the deficit cannot exceed 10 percent of projected total revenues; (3) debt cannot exceed 50 percent of the preceding year's revenues; and (4) projected debt service cannot exceed 15 percent of the preceding year's revenues.[24]

24 In 2016, PPG debt stood at 74.6 percent of GDP, or 68.3 percent, when guaranteed debt is excluded.

Serbia established an independent Fiscal Council to monitor adherence to fiscal rules. However, the council has no authority to sanction noncompliance. Moreover, corrective actions are limited to requiring the government to adopt a plan for debt reduction should the public debt stock exceed the threshold. Serbia has not yet complied with any of its fiscal rules for the general government.

International Best Practices for Fiscal Rules

International experience yields several valuable lessons for crafting fiscal rules that will succeed[25]:

- *Adopt an incremental approach that recognizes political and institutional realities.* Overly ambitious fiscal rules are likely to be disregarded entirely at the first cyclical downturn. A less expansive set of functional fiscal rules is more likely to endure and provide a foundation for further reforms.

- *Base fiscal rules on a comprehensive definition of the fiscal accounts.* Government agencies may attempt to evade fiscal rules by setting up alternative spending vehicles, such as extra-budgetary funds or public guarantees. Fiscal rules should therefore explicitly encompass all government operations and the liabilities incurred. Coverage of all general government liabilities, including those generated by state-owned enterprises, development banks, and other parastatals, is an essential component of an effective fiscal rule. Limited budgetary coverage of fiscal rules is a major issue in the Western Balkans.

- *Accurate and timely reporting of fiscal risks and contingent liabilities can improve transparency, facilitate rapid corrective actions, and ensure the accuracy and comparability of data over time.* Fiscal reporting and monitoring systems in the Western Balkan states are often inadequate. To fully comply with the EU Maastricht criteria, regular fiscal reporting should include information on the general government's fiscal performance prepared according to the European System of Accounts. This would not only facilitate the EU accession process, it would also help reduce gaps between original and revised spending estimates and enhance reporting of contingent liabilities.

- *Establish a credible political commitment.* Fiscal rules are more likely to be respected if they are endorsed by both the executive branch and the legislature. In the Western Balkans, medium-term economic and fiscal guidelines often lack a credible political commitment, which contributes to lax enforcement of budget and spending ceilings.

- *Clearly define and enforce penalties for noncompliance.* As fiscal responsibility laws and frameworks mature, the political cost of breaking the law tends to increase. But because such laws are often relatively weak at first, stringent enforcement measures are necessary. While in the Western Balkans most current fiscal rules are relatively straightforward, broad escape

25 Based on the World Bank Knowledge Brief *Fiscal Responsibility in Croatia: Lessons from the Past, Rules for the Future* by Madzarevic-Sujster and Skrok, 2012, World Bank.

clauses and lax enforcement undermine their effectiveness. For instance, loosely-defined escape clauses allow for frequent exceptions. Moreover, three of the five countries that have rules—Albania, Montenegro, and Serbia—are currently violating them. Good quality and up-to-date macroeconomic and fiscal data are needed to ensure that sanctions can be applied effectively.

- *Allow for countercyclical stabilization.* Fiscal rules should target a cyclically adjusted balance[26] or build in a mechanism to accommodate cyclical changes in economic conditions.[27] Countercyclical rules allow both automatic and discretionary stabilizers[28] to function when the economy deviates from a specified target or trend. However, targeting a cyclically adjusted balanced budget is both administratively demanding and data-intensive.

- *Balance short- and long-term objectives.* A fiscal rule that ignores the impact of exogenous shocks may accentuate the procyclicality of fiscal policies. However, a rule that focuses on supporting countercyclical stabilization may not be consistent with long-term debt sustainability. A well-designed fiscal rule must carefully balance competing priorities.[29]

- *Ensure that fiscal rules reflect medium-term fiscal policy objectives.* Fiscal rules should be designed to ensure that annual budgets are consistent with medium-term fiscal targets. A medium-term perspective can give policymakers sufficient latitude to respond to short-term shocks without threatening long-term fiscal and debt sustainability. In the Western Balkans the quality of macroeconomic forecasting and fiscal planning is limited, and countries could build up their budget planning and execution systems even before adopting or amending fiscal rules. Many of the countries allow legislative proposals adopted within the fiscal year to become effective without having preapproved funding based on a fiscal impact assessment. Deviations from medium-term budget plans are common, as is accumulation of contingent liabilities and arrears.

- *Establish a dedicated authority to oversee compliance with fiscal rules, budget plans, and fiscal forecasts.* This agency should monitor all elements of the fiscal framework, including the accuracy of macrofiscal forecasts, the quality of the medium-term budget plan, and whether escape clauses are appropriate in the current macroeconomic environment. In addition to monitoring adherence to fiscal rules, the agency should prepare recommendations for fiscal planning, forecasting, and impact assessments; provide independent medium-term macroeconomic and fiscal forecasts; and propose reforms to the fiscal framework. No country in the Western Balkans currently has an effective

26 The cyclically adjusted budget captures changes in fiscal policy unrelated to the budgetary impact of the business cycle. The structural balance controls for other one-off factors and nondiscretionary changes in the budget.

27 Mills and Quinet (2001) argue that "a spending rule is in essence close to a cyclically-adjusted balance target" but more transparent and without the drawbacks of cyclical adjustment.

28 Automatic stabilizers are nondiscretionary budget components that change with the business cycle (e.g., progressive income tax receipts, unemployment transfers, and interest payments).

29 At present, most primary-balance limits in Western Balkans' fiscal rules are not consistent with the objective of stabilizing the debt-to-GDP ratio in the medium term, particularly in countries with heavy debt burdens.

mechanism for enforcing compliance with its fiscal rules. Only Serbia maintains an independent Fiscal Council with a certain level of authority, but due to legislative limitations it has not succeeded in enforcing compliance.

In conclusion, well-designed and appropriately enforced fiscal rules can help Western Balkan countries to ensure fiscal solvency and debt sustainability. The need to consolidate public finances across the region raises the question of whether the fiscal rules in place can deliver on their intent. A fiscal rule is effective to the extent that it helps restrict over-spending in good times for use during bad times. Western Balkan countries, however, have now always adhered to fiscal rules. The question is why? It appears from international experience that a well-designed fiscal rule is not enough; it needs to be accompanied by sound policy and solid institutions. Unfortunately, in assessing how effectively fiscal rules achieve their intended objectives and identifying factors that influence effectiveness, the literature has mostly focused on EU countries, so there is little information about others. The World Bank is ready to support Western Balkan countries in examining how their fiscal rules can achieve their intended objectives.

Country Notes

Albania

- *Economic growth strengthened to 3.2 percent in 2016 and is projected to average 3.6 percent during 2017–19, driven by private investments in large FDI-financed energy projects, a recovery in private consumption, and an increase in services exports.*
- *Growth created jobs.*
- *The fiscal position continued to improve with higher revenue collections and restrained spending.*
- *Continued fiscal consolidation efforts to reduce debt and contingent liabilities, structural reforms notably in the energy and financial sectors, better management of public investments, and judiciary reform are still critical to fostering confidence and growth.*

Recent Economic Developments

Albania's economy expanded by 3.2 percent in 2016, supported by robust domestic demand. Two large energy projects financed by foreign private capital—the Trans-Adriatic Pipeline and the Devoll hydropower plant in the south—and a recovery in consumption helped sustain positive growth momentum. Private consumption was supported by improved labor market outcomes and the easing of credit conditions. After declining for five consecutive quarters, public consumption made a small positive contribution to growth, reflecting more gradual fiscal consolidation during the second half of the year. Although exports of services expanded by 25.4 percent, the contributions of trade in goods was negative. Manufacturing production picked up, but overall, industry was affected by unfavorable commodity prices. Services were the main driver of growth, followed by more labor-intensive construction and agriculture.

Growth in 2016 stimulated job creation. In the third quarter employment grew by 5.8 percent year-on-year (y-o-y), driven by jobs in services (7.4 percent) and in construction and manufacturing (5.1 percent). Labor force participation was higher than in the same quarter in 2015, having gone up 0.4 percentage points (pp) to 57.2 percent. Unemployment declined to 15.2 percent, but more than half of those without jobs had been unemployed for the long term. Nominal wages continued their decline that had begun at the end of 2013 but should be helped in 2017 by the end of the freeze in public wages.

Prudent fiscal policy supported the stabilization of public debt. The fiscal deficit for 2016 is estimated at 2.2 percent of GDP, down from 4.6 percent in 2015, as was envisaged by the country's fiscal consolidation efforts supported by the fiscal rule. The central government registered a primary fiscal surplus of 0.2 percent of GDP in 2016. The consolidation was supported by improvements in both revenue collection and spending controls. Revenues increased by 0.4 pp of GDP in 2016 (y-o-y) thanks to increases for almost all tax categories. Public spending (excluding

arrears repayments) fell by a significant 2 pp in 2016 (y-o-y) as consolidation efforts continued. At 97.6 percent of what was planned, capital spending was also under-executed. As a result of fiscal consolidation, public debt started to decline in 2016 but remains high at 72.7 percent of GDP.[1]

Inflation has been below the target band but has begun to increase. Average annual inflation fell from 1.9 percent in 2015 to 1.3 percent in 2016, below the Bank of Albania's (BoA) target of 3±1 percent. However, as food prices rose in January 2017, inflation also began to head upward. Inflation is now expected to gradually converge to the target band as the economy continues to grow and utilization of production capacity recovers.

The BoA policy stance continues to be accommodative. The policy rate remains at the minimum of 1.25 percent, which began in April 2016 as low commodity prices and a negative output gap put downward pressure on prices. Toward the end of 2016, the transmission of monetary policy strengthened, as the average interest rate for loans in domestic currency declined to 7.5 percent, 0.6 percentage points (pp) below the 2015 level. By yearend the real effective exchange rate had appreciated by 4.1 percent because of a nominal appreciation of the Albanian lek (by 0.4 percent against the euro) and a narrower inflation differential with trading partners.

Although credit to households is recovering, the high stock of nonperforming loans (NPLs) continues to deter lending to corporations. The banking sector is profitable and well-capitalized, with a capital adequacy ratio of 15.6 percent in the fourth quarter of 2016, well above the regulatory 12 percent minimum. Lower interest rates and eased credit standards stimulated lending in domestic currency, which grew by 10.4 percent in 2016, up from 5 percent in 2015. However, the risk aversion of banks due to the high ratio of NPLs (18.2 percent of total loans) continues to suppress credit growth, particularly for corporations, lending to which increased by only 2.6 percent. Accelerated application of the Bankruptcy and Private Bailiff's laws and complementary measures, including write-offs of old loans, are necessary to resolve NPLs.

Investment-related imports widened the current account deficit (CAD) from 10.8 percent in 2015 to an estimated 12.1 percent in 2016. The expansion was caused by the rise in the trade deficit to 18.2 percent as investment-related imports picked up and exports of commodities slowed. Since the third quarter of 2016, however, there has been an improvement brought about by the favorable tourism season and heightened remittances. The CAD was financed 60 percent by FDIs and 10 percent by budget support inflows. At yearend, Albania's foreign exchange reserves were estimated to be about €2.9 billion, sufficient to cover about 5.7 months of imports of goods and services and 170 percent of gross short-term external debt. In February, Standard & Poor's confirmed the 2017 B+ rating for Albania; the rating was based on the country's ongoing fiscal consolidation efforts and positive economic outlook.

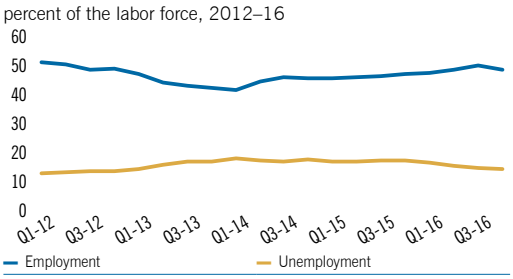
1 Since 2015, general government debt includes fully documented unpaid bills owed by local governments, most of which were inherited after the June 2015 territorial reform by the new municipalities.

Outlook and Risks

Albania's economic outlook is expected to improve over the medium term. Growth is projected to be 3.5 percent in 2017 and 2018 and then go up to 3.8 percent in 2019. Private investments in two large energy projects will continue to support growth, aided by private consumption as the labor market improves, and net exports supported by demand from the EU. Construction, tourism-related services, and trade are expected to continue driving growth. The CAD will remain high as imports continue to grow, tracking the pace of investment, and will be financed primarily by FDI. Continued fiscal consolidation and other reform efforts are expected by 2019 to gradually reduce the fiscal deficit to 0.7 percent of GDP. As a result, the debt-to-GDP ratio is projected to fall below 60 percent of GDP by 2021. Political uncertainty as a result of elections scheduled for mid-2017 could affect the pace of reforms and fiscal consolidation, which would weaken Albania's fiscal position and push up risk premiums.

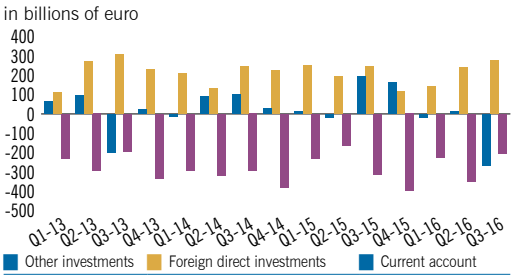
Economic prospects are also vulnerable to risks. Uncertain global market conditions, in particular slower growth in the Euro area, could reduce exports and FDI inflows, which would then translate into lower tax revenues, less public investment, and thus slower growth in output. The faster pace of normalization of global interest rates also poses a risk: An appreciation of the Albanian lek could affect competitiveness and lead to a deceleration in exports. Should that happen, harnessing growth will require keeping the economy stable while putting in place structural reforms to improve the business climate, such as continuing judiciary reforms, enhancing the management of public investments, addressing high NPLs, and improving the skills of the labor force.

Unemployment declined and employment increased as growth created jobs.



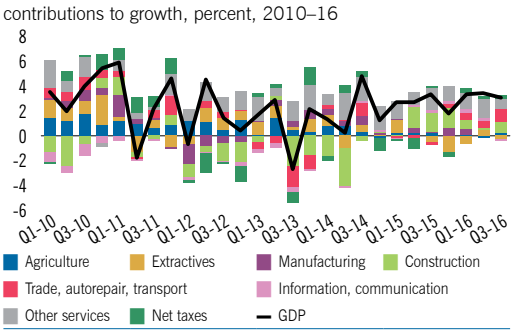
Source: INSTAT, WB calculations.

Current account financing relies on FDI and budgetary support from development partners.



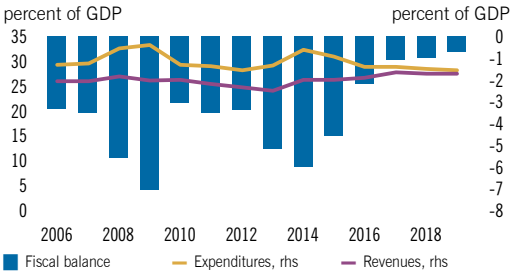
Source: Bank of Albania.

The pickup in growth was supported by services and construction.



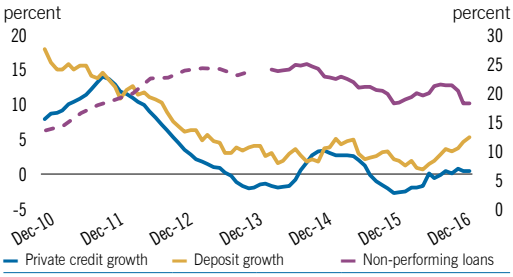
Source: INSTAT, WB calculations.

Steady revenue collection and expenditure control should gradually reduce fiscal deficit over the medium term.



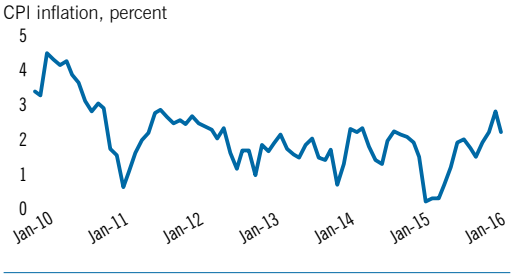
Source: MoF, WB calculations.

Credit growth has started to pick up, but high NPLs are preventing more rapid growth.



Source: BoA, WB calculations.

CPI inflation is rising as domestic consumption recovers.



Source: MoF, INSTAT, WB calculations.

ALBANIA	2013	2014	2015	2016[e]	2017[f]	2018[f]	2019[f]
Real GDP growth (percent)	1.0	1.8	2.6	3.2	3.5	3.5	3.8
Composition (percentage points):							
Consumption	1.4	2.5	-1.0	0.9	1.1	1.8	1.8
Investment	-0.6	-1.2	2.8	2.8	2.5	2.0	1.5
Net exports	-12.8	3.9	-1.0	3.7	6.5	6.5	6.1
Exports	-7.2	0.9	-0.1	1.6	3.2	3.1	3.3
Imports (-)	-5.6	3.0	-0.9	2.1	3.3	3.4	2.8
Consumer price inflation (percent, period average)	1.9	1.6	1.9	1.3	1.5	2.9	3.0
Public revenues (percent of GDP)	24.0	26.3	26.3	26.7	27.7	27.5	27.5
Public expenditures (percent of GDP)	29.2	32.3	30.9	28.9	28.8	28.5	28.2
Of which:							
Wage bill (percent of GDP)	5.2	5.1	5.1	4.5	4.6	4.6	4.4
Social benefits (percent of GDP)	9.5	9.9	9.8	10.1	10.1	10.0	10.0
Capital expenditures (percent of GDP)	4.8	4.3	4.4	3.9	4.5	4.4	4.4
Fiscal balance (percent of GDP)	-5.2	-6.0	-4.6	-2.2	-1.1	-1.0	-0.7
Primary fiscal balance (percent of GDP)	-2.0	-3.1	-1.9	0.2	1.2	1.1	1.4
Public debt (percent of GDP)	66.7	68.0	69.6	67.8	64.7	64.0	63.5
Public and publicly guaranteed debt (percent of GDP)	70.4	72.1	73.7	72.7	69.9	67.0	63.5
Of which: External (percent of GDP)	26.9	29.6	34.2	33.8	34.8	34.2	34.7
Goods exports (percent of GDP)	18.3	9.4	7.5	6.4	7.0	7.0	6.8
Goods imports (percent of GDP)	34.9	29.9	29.9	28.5	30.0	29.1	27.7
Net services exports (percent of GDP)	-0.2	3.2	5.1	3.9	3.6	3.6	3.8
Trade balance (percent of GDP)	-16.8	-17.3	-17.3	-18.2	-19.4	-18.5	-17.1
Remittance inflows (percent of GDP)	7.1	7.3	7.5	7.2	6.9	6.7	6.5
Current account balance (percent of GDP)	-10.5	-12.9	-10.8	-12.1	-13.7	-13.0	-11.8
Foreign direct investment inflows (percent of GDP)	9.6	8.1	7.7	7.1	8.0	6.9	5.3
External debt (percent of GDP)	64.4	72.4	74.2	75.5	77.8	80.9	81.7
Real private credit growth (percent, period average)	-1.4	2.0	-0.8	0.5	n.a.	n.a.	n.a.
Nonperforming loans (percent of gross loans, end of period)	24.1	22.4	18.2	n.a.	n.a.	n.a.	n.a.
Unemployment rate (percent, period average)	17.1	18.0	17.3	15.2	n.a.	n.a.	n.a.
Youth unemployment rate (percent, period average)	29.7	35.6	32.3	28.95	n.a	n.a.	n.a.
Labor force participation rate (percent, period average)	52.5	53.7	55.7	57.5	n.a	n.a	n.a.
GDP per capita, PPP (current international $)	10,255	10,645	10,926	11,276	11,670	12,079	12,538
Poverty rate at US$5/day, PPP (percent of population)	47.2	46.7	46.2	45.5	n.a.	n.a.	n.a

Sources: Country authorities, World Bank estimates and projections.

Notes: Labor market indicators and credit growth for 2015 reflect year-to-date annual rolling averages. Nonperforming loans show year-to-date actuals. Youth unemployment rate is for those in the labor force aged 15–29.

Bosnia and Herzegovina

- *Economic growth in Bosnia and Herzegovina (BiH), which reached an estimated 2.8 percent in 2016, is expected to hold at about 3 percent into the medium term.*
- *Consumption is still the main driver of growth, although, with only modest improvements in the labor market, unemployment remains high.*
- *Deleveraging is limiting financial sector support to economic activity.*
- *Reforms are starting to unlock rigidities in public employment, pharmaceutical pricing, pensions, and debt.*
- *As a result of a planned push in public investments, the fiscal stance could deteriorate over the medium term unless there are structural and fiscal reforms to reduce the high public wage bill and improve tax collection.*

Recent Economic Developments

Growth reached an estimated 2.8 percent in 2016—a bit below the 3 percent in 2015. Although this is consistent with this publication's earlier projection, it is 0.4 percentage points (pp) lower than the official estimates (BiH Global Fiscal Framework). Consumption remains the dominant driver of growth, contributing 1.8 pp, supported by net exports (0.7 pp) and investments (0.3 pp). On the production side, agriculture and manufacturing contributed about 70 percent to the growth of real value-added in the first three quarters and industry about 40 percent; together they offset a contraction in services (mainly health and communications).

The unemployment rate remains high, with only modest improvements in the labor market. Unemployment fell from 27.7 percent in 2015 to 25.4 percent in 2016, masking a reduction in employment in absolute terms, in spite of the positive economic growth.[1] Still, the employment rate was not affected and rose slightly to 32.2 percent in 2016, on account of a reduction of the working age population. The industrial sector created new employment while agriculture and services shed employment in absolute terms; public employment was also in decline. Unemployment among youth (ages 15–24 years) decreased in 2016, but it is still high at 54.3 percent (52.0 percent for men and 58.9 percent for women).

Consumer price deflation slightly boosted real incomes. The consumer price index (CPI) dropped by 0.2 percent year-on-year (y-o-y) in December—the 24th consecutive month of decline. The biggest driver of the fall was imported goods, reflecting low prices especially, on food (down 0.6 percent y-o-y), clothing and footwear (down 9.6 percent), and outpatient services (down 4.6 percent). In contrast, prices rose notably on alcohol and tobacco, followed by education, housing, and utilities. Given the limited growth in nominal salaries, declining consumer prices provided a small boost to real incomes: the net monthly salary in December 2016 averaged €436, up by 1.3 percent y-o-y in nominal terms.

1 According to the latest Labor Force Survey (2016).

In 2016, the fiscal balance is expected to register a small deficit of about 0.6 percent of GDP, down from a surplus of 0.7 percent in 2015. In 2016, gross revenue from indirect taxes rose by 9.1 percent y-o-y compared to growth of 1.7 percent for 2015. With the 2016 revenues-to-GDP ratio expected to be stable, the recovery in capital spending—now that the implementation delays of 2015 are over—are projected to move the fiscal balance into a small deficit of 0.6 percent of GDP. Public and publicly guaranteed (PPG) debt in 2016 increased by 0.6 percent of GDP reaching 42.5 percent of GDP (external PPG was 29 percent of GDP) and consisted largely of concessional debt to international financial institutions. However, the 2017 budget of the BiH Institutions includes a 31 percent increase over 2016 for paying down foreign debt. Financing of the BiH Institutions is holding at the same level as in the four previous years.

Risks associated with the quality of bank assets continue to be a major barrier to healthy growth in credit. Growing risks in regulation and oversight of domestic banks may jeopardize fiscal and financial stability. Although gradually declining, the share of nonperforming loans (NPLs) in commercial bank portfolios is still high: at the end of Q3 2016 NPLs reached 12.1 percent of total loans, down from 13.8 percent at the end of 2015. High NPLs burden bank balance sheets, undermine profits and capital, constrain new lending, and thus reduce the general ability of banks to support growth. The Central Bank of BiH (CBBH) maintains monetary stability through a currency board under which the BiH convertible mark is fixed to the euro. International reserves in 2016 were a comfortable 6.5 months of imports. Given its link to the euro, in 2016 the convertible mark saw sustained depreciation against the dollar.

There were no substantial changes in the current account deficit. The CAD is estimated to have narrowed slightly from 5.7 percent in 2015 to 5.5 percent in 2016, thanks to trade in goods: In 2016 the euro value of goods exports increased by 4.8 percent y-o-y driven by food, wood, chemical products, and mechanical appliances; imports went up by 1.8 percent. The services surplus and remittances are projected to remain almost unchanged. Estimated net FDI inflows dropped from 1.5 percent of GDP in 2015 to 1.2 percent in 2016, causing significant dependence on debt-creating inflows. This level of FDI is enough to finance only about 25 percent of the CAD and does little to support possible larger positive spillovers to economic growth.

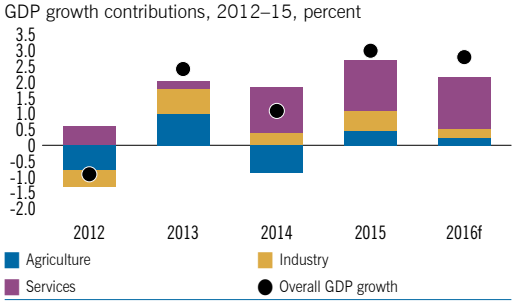
Outlook and Risks

Supported primarily by consumption, economic growth is projected to strengthen to more than 3 percent in the medium term. As the BiH reform agenda advances, a moderate rise in exports is expected, but strong demand for imports implies that net external demand will continue to be a drag on growth. Remittances are likely to remain stable, and, together with progress on reforms, will underpin a gradual pickup in consumption, which will remain a major driver of growth. Investments in energy, construction, and tourism will support investment growth generally, as well as job creation in those sectors. As a result of these dynamics, real GDP growth is projected to build up gradually from 2.8 percent in 2016 to 3.2 percent in 2017 and up to 4 percent in 2019.

Achieving prudent, efficient, and effective fiscal policy, safeguarding the banking sector, and addressing persistent unemployment and underemployment are central to the BiH reform agenda. Although deficits continue to be moderate, the tax burden is high, and public spending is inefficient, as evidenced by poorly-targeted benefits. Fiscal consolidation and provision of an effective safety net will not be effective if structural rigidities in spending are not addressed—especially the high public wage bill. However, support from the IMF Extended Fund Facility program and other partners can help the BiH authorities to deliver on their challenging reform agenda.

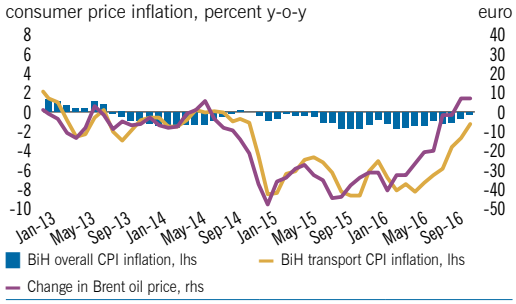
There are notable risks, both domestic and external. The main domestic risk is the challenging political environment, which makes effective structural reform difficult in such areas as pensions, the energy sector, and transport; in jeopardizing the reform agenda, it also raises risks to the country's economic outlook. Despite some delays, BiH and the European Union (EU) have signed the Protocol on the Adaptation of the Stabilization and Association Agreement (SAA). In December 2016, BiH also received a detailed Questionnaire from the European Commission. This represents an important step because the Commission will assess the replies provided by BiH and based on that recommend to the EU Council whether BiH may be granted candidate status. On the other hand main external risk for BiH remains slow growth in EU and the challenging political situation in the region.

Moderate GDP growth continued, supported by the services sector.



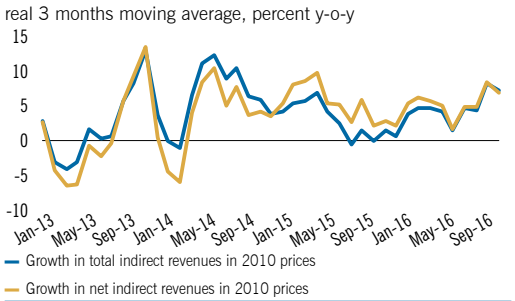
Source: BiH Agency for Statistics, World Bank.

Consumer price deflation persisted.



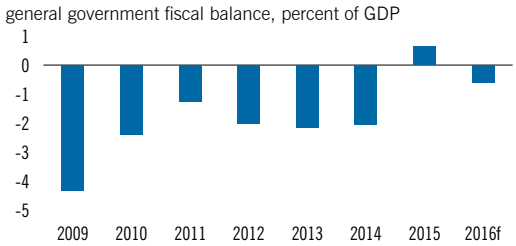
Source: BiH Agency for Statistics, World Bank.

Collection of indirect gross tax revenues remains strong.



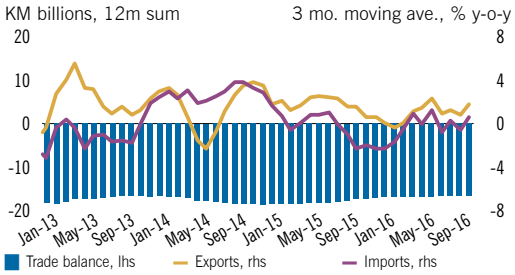
Source: BiH Indirect Tax Office, World Bank

The rise in spending, particularly capital spending, is projected to move the fiscal balance back into deficit.



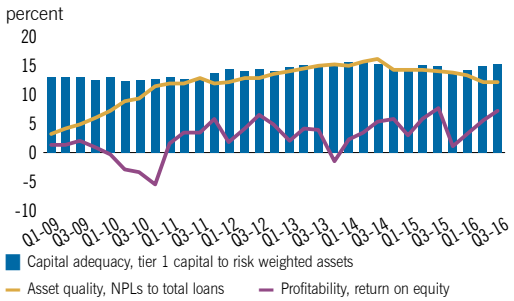
Source: Fiscal authorities, World Bank estimates.

The deficit in the goods trade continued to narrow.



Source: BH Agency for Statistics, World Bank.

Nonperforming loans in commercial bank portfolios remain high and deleveraging remains a risk.



Source: Central Bank of BiH, World Bank calculations.

BOSNIA AND HERZEGOVINA	**2013**	**2014**	**2015**	**2016[e]**	**2017[f]**	**2018[f]**	**2019[f]**
Real GDP growth (percent)	2.4	1.1	3.0	2.8	3.2	3.7	4.0
Composition (percentage points):							
Consumption	n.a.	n.a.	0.9	1.8	2.2	2.6	2.4
Investment	n.a.	n.a.	0.4	0.3	1.2	1.7	1.8
Net exports	n.a.	n.a.	2.0	0.7	-0.3	-0.6	-0.3
Exports	n.a.	n.a.	1.0	1.4	0.9	1.0	1.2
Imports (-)	n.a.	n.a.	-0.9	0.6	1.2	1.7	1.4
Consumer price inflation (percent, period average)	-0.1	-0.9	-1.0	-1.4	-0.5	0.5	0.5
Public revenues (percent of GDP)	42.7	43.8	43.2	43.1	43.8	43.3	43.3
Public expenditures (percent of GDP)	44.8	45.8	42.6	43.7	44.4	43.6	43.3
Of which:							
Wage bill (percent of GDP)	12.3	12.0	11.5	11.3	11.0	10.4	10.4
Social benefits (percent of GDP)	16.5	17.1	16.6	17.2	16.3	16.0	16.0
Capital expenditures (percent of GDP)	3.9	4.3	2.0	3.6	5.0	5.2	6.5
Fiscal balance (percent of GDP)	-2.1	-2.0	0.7	-0.6	-0.6	-0.3	0.0
Primary fiscal balance (percent of GDP)	-1.4	-1.2	1.6	0.5	0.5	0.9	1.3
Public debt (percent of GDP)	34.5	40.5	40.5	39.8	38.0	35.6	35.3
Public and publicly guaranteed debt (percent of GDP)	37.7	41.8	41.9	42.5	40.6	39.1	37.4
Of which: External (percent of GDP)	28.3	30.9	30.8	29.5	28.4	26.3	23.1
Goods exports (percent of GDP)	24.0	24.2	24.4	24.6	24.6	24.4	24.2
Goods imports (percent of GDP)	51.4	53.9	50.4	49.6	49.1	48.2	47.1
Net services exports (percent of GDP)	7.0	7.0	7.3	7.7	7.7	7.7	7.7
Trade balance (percent of GDP)	-20.4	-22.7	-18.7	-17.4	-16.7	-16.1	-15.2
Remittance inflows (percent of GDP)	8.1	8.5	8.3	8.2	8.0	7.8	7.5
Current account balance (percent of GDP)	-5.7	-7.5	-5.7	-5.5	-5.8	-6.2	-6.3
Foreign direct investment inflows (percent of GDP)	-1.4	-2.6	-1.5	-1.2	-1.2	-1.2	-1.1
External debt (percent of GDP)	73.8	76.9	76.6	76.2	74.3	72.1	70.0
Real private credit growth (percent, period average)	2.4	1.8	2.5	2.6	n.a.	n.a.	n.a.
Non-performing loans (percent of gross loans, end of period)	15.1	14.2	n.a.	n.a.	n.a.	n.a.	n.a.
Unemployment rate (percent, period average)	27.5	27.5	27.7	25.4	n.a.	n.a.	n.a.
Youth unemployment rate (percent, period average)	58.8	62.9	62.3	54.3	n.a.	n.a.	n.a.
Labor force participation rate (percent, period average)	43.6	43.7	44.1	43.1	n.a.	n.a.	n.a.
GDP per capita, PPP (current international $)	9,798	10,084	10,550	11,034	11,661	12,403	13,198
Poverty rate at US$5/day, PPP (percent of population)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Sources: Country authorities, World Bank estimates and projections.

Notes: Labor market data for 2015 are preliminary. Credit growth for 2015 reflects year-to-date annual rolling averages. Nonperforming loans show year-to-date actuals.

Kosovo

- *Consumption and investment drove growth to an estimated 3.6 percent in 2016, despite a drop in net exports. In 2017 projected growth is 3.9 percent, fueled by public investments and consumption.*
- *The fiscal deficit stayed low at 1.3 percent of GDP in 2016, supported by strong revenues and under-execution of the capital budget and despite pressures from the veteran benefits program.*
- *Improvements in the quality of bank assets and lower lending rates contributed to increased lending, stimulating domestic demand.*
- *Kosovo's diaspora continues to support economic growth through remittances, FDI, and exports of services.*

Recent Developments

Kosovo's economy is estimated to have grown at 3.6 percent in 2016. The growth was due to consumption (contributing 4.5 percentage points [pp]) and an investment-driven recovery in domestic demand (2.2 pp).[1] Net exports, however, subtracted 3.1 pp from growth—the better performance of travel services exports could not match that of imports as domestic demand for consumption and investment goods increased. Healthy expansion of activities in trade, transportation, finance, and accommodation made services the chief contributor to growth, followed by agriculture and industry.

Preliminary data for 2016 show improvements in most labor market outcomes. Although the improvements are driven by the continued economic growth, the average number of those employed is still lower than its peak in 2013.[2]

The fiscal deficit declined further in 2016 to 1.3 percent of GDP, thanks to healthier revenues and slow execution of the capital budget. A combination of both collection efforts and policy change contributed to a rise in tax revenues of 2.3 percent of GDP. The increase in the VAT rate to 18 percent boosted revenues enough to more than offset the impact of the coming into force in April 2016 of the Stabilization and Association Agreement (SAA) with the EU, which reduced 2016 customs revenues by 0.3 percent of GDP, as well as of tax exemptions introduced to stimulate production. On the expenditure side, the 0.9 percent of GDP increase in social transfers was offset by under-execution of the capital budget; the result was an increase in overall spending of 1.4 percent of GDP. A key contributor to the increase in transfers

1 Growth contributions by component are based on the latest GDP data published by the Statistics Agency of Kosovo (SAK) and are subject to change after SAK incorporates revised balance of payments data into the national account statistics. Likewise, the current account deficit data are subject to change as well.

2 Quarterly data on employment in Kosovo were made available for the first time in 2016, and thus it is not possible to compare with earlier years. Yet, the available data suggests that in 2016 there was a healthy increase in employment.

was the rise in the number of war veterans qualifying for support in 2016 (bringing the fiscal impact of the scheme to 0.9 percent of GDP). To mitigate that impact, the Law on War Veterans was amended at the end of 2016 to set a ceiling on the scheme's annual fiscal impact of 0.7 percent of GDP starting in fiscal year 2017.[3] The Law on Public Finance Management and Accountability (LPFMA) and its recent amendment set the baseline deficit at 2 percent of GDP and introduce the "investment clause" that relaxes this deficit rule for productive investments financed by the development partners; it also reduces the debt ceiling from 40 to 30 percent of GDP, all for a limited period of 10 years. Though public and publicly guaranteed debt is still low, it is trending upward, having risen from 12.9 percent of GDP in 2015 to 14.6 percent in 2016.

Improvements in the quality of banking sector assets helped stimulate much-needed credit growth as inflation moved into positive territory. Average inflation for the year increased to 0.3 percent year-on-year (y-o-y), driven by rises in prices for fuel, food products, tobacco and alcohol, and household items. Nonperforming loans (NPLs) continued to decline, from 6.2 percent of total loans in January to just 4.9 percent by December, as improving corporate performance induced NPL repayments; meanwhile, the credit base grew. Improved market conditions and lower interest rates fueled growth in private credit to 10.4 percent.

The current account deficit (CAD) widened from 10.4 percent of GDP in 2015 to 11.5 percent in 2016. The deterioration of the external balance was due to an increase in the trade deficit by 3.2 percent y-o-y, although it remained flat as a share of GDP. Driven by domestic demand, imports grew by 6.7 percent y-o-y. On the other hand, exports of goods fell by 4.6 percent y-o-y as a result of lower prices of base metals. Ferronikeli, the main exporter of these metals, temporarily halted production due to low prices.

Declining FDI inflows weighed down the financial account balance in 2016. Net FDI fell by 34.4 percent y-o-y at the end of November because FDI inflows declined by 29.2 percent (likely signaling the start of saturation in diaspora demand for real estate and financial intermediation services), and outflows of equity investment and fund shares went up 25.7 percent. Real estate, rentals, and business activities continued to attract most of the FDI in 2016. FDI related to the Brezovica Ski resort did not materialize in 2016, lowering projected growth.

Outlook

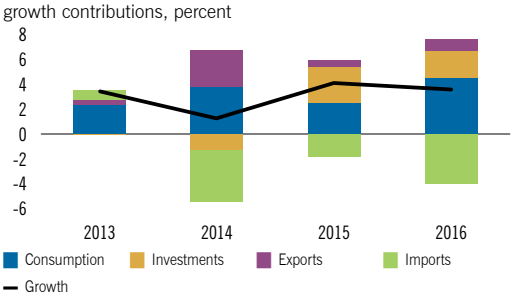
Economic growth in Kosovo is projected to reach 3.9 percent in 2017, driven investment, followed by consumption. Investments are expected to be the main drivers of growth, contributing 2.7 pp. Consumption is expected to contribute 2.3 pp, fueled by higher disposable incomes. Net exports are projected to subtract about 1.1 pp from growth, however, because of fast growth in imports driven by investment and consumption, and weak exports of goods due to a small export base.

3 The amendment covers only the category of war veterans, it does not include other war-related beneficiaries. The law is yet to become effective, after the review of the Constitutional Court.

Investment growth will cause the CAD to widen slightly in 2017–18. The recent launch of the SAA with the EU is expected to act as an incentive to boost FDI in the medium term. The recent amendment to the fiscal rule stating that certain types of IFI would not be counted for deficit target purposes, opened up room for investment in strategic sectors and is expected to increase public investment.

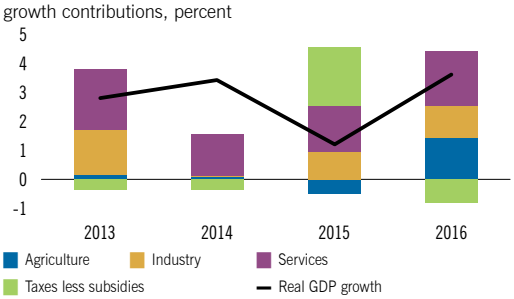
Kosovo's positive economic outlook is, however, subject to risks. Among main downside risks are a sensitive political situation in the North and the contentious Montenegro border demarcation issue. Should these risks intensify, they would disrupt Kosovo's economic agenda. On the upside, a better absorption capacity of the public investment projects could lead to a slightly higher growth, especially in 2017, but a lower growth in 2018 due to a higher base. The positive economic forecasts depend on growing FDI inflows. To counterbalance the risks, reform priorities should be to shift the sources of growth toward tradable sectors, increase domestic productivity, engage and employ youth, address corruption, improve environmental sustainability, and address the constraints in the energy sector.

Consumption and investment drove growth, despite a negative contribution from net exports.



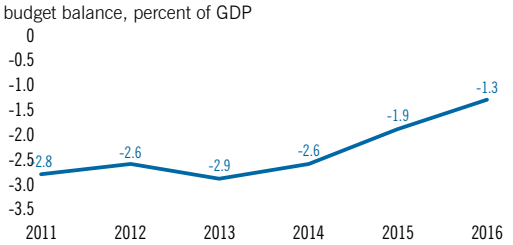
Source: Statistics Agency of Kosovo and World Bank.

Services were the chief contributor to growth in 2016, followed by agriculture and industry.



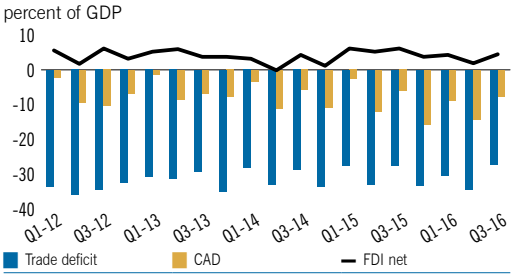
Source: Statistics Agency of Kosovo and World Bank.

The general government deficit declined in 2016 as reform-driven revenue growth outstripped that of spending.



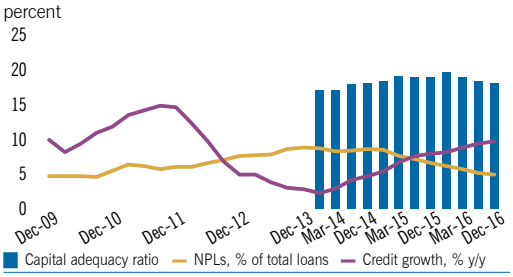
Source: Ministry of Finance and World Bank.

Although declining, FDI remains the main source of CAD financing.



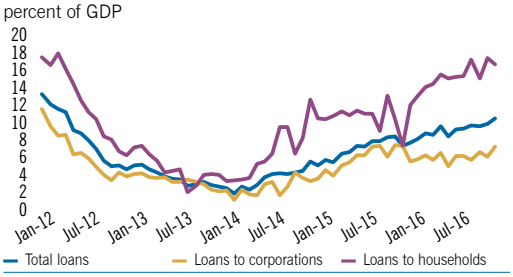
Source: Central Bank and World Bank.

Improvements in the quality of banking sector assets, among other factors,…



Source: Central Bank and World Bank.

…helped stimulate lending.



Source: Central Bank.

KOSOVO	2013	2014	2015	2016	2017	2018	2019
Real GDP growth (percent)	3.4	1.2	4.1	3.6	3.9	4.2	4.4
Composition (percentage points):							
Consumption	2.3	3.8	2.5	4.5	2.3	3.1	2.2
Investment	-0.1	-1.4	2.9	2.2	2.7	2.2	2.0
Net exports	1.2	-1.2	-1.3	-3.1	-1.1	-1.1	0.2
Exports	0.4	2.9	0.5	0.9	0.6	1.0	1.7
Imports (-)	0.8	-4.1	-1.8	-4.0	-1.7	-2.1	-1.5
Consumer price inflation (percent, period) average)	1.8	0.4	-0.5	0.3	0.6	1.0	1.7
Public revenues (percent of GDP)	25.2	24.4	25.4	26.9	27.2	27.7	28.3
Public expenditures (percent of GDP)	28.1	27.0	27.3	28.2	29.7	30.6	31.2
Of which:							
Wage bill (percent of GDP)	7.8	8.7	9.0	9.1	9.2	9.3	9.3
Social benefits (percent of GDP)	4.2	6.1	6.9	7.3	7.2	7.0	7.0
Capital expenditures (percent of GDP)	10.0	7.4	7.0	7.4	8.6	9.4	10.0
Fiscal balance (percent of GDP)	-2.9	-2.6	-1.9	-1.3	-2.6	-2.9	-2.9
Primary fiscal balance (percent of GDP)	-2.7	-2.4	-1.7	-0.9	-2.1	-2.4	-2.4
Public debt (percent of GDP)	8.9	10.4	12.7	14.3	17.2	19.6	21.3
Public and publicly guaranteed debt (percent of GDP)	8.9	10.6	12.9	14.6	17.6	20.2	22.0
Of which: External (percent of GDP)	6.1	5.8	6.2	6.2	7.5	8.8	9.2
Goods exports (percent of GDP)	5.5	5.8	5.6	5.1	5.1	5.1	5.3
Goods imports (percent of GDP)	42.9	42.8	42.1	43.4	44.0	43.3	44.2
Net services exports (percent of GDP)	6.4	5.9	6.0	6.1	8.0	8.0	8.3
Trade balance (percent of GDP)	-31.5	-30.9	-30.4	-30.3	-30.9	-30.9	-29.5
Remittance inflows (percent of GDP)	11.0	10.9	10.8	11.6	11.8	12.1	12.4
Current account balance (percent of GDP)	-7.2	-9.1	-10.4	-11.5	-12.5	-13.3	-12.9
Foreign direct investment inflows (percent of GDP)	5.3	2.7	5.4	4.0	4.4	4.6	5.7
External debt (percent of GDP)	30.2	31.2	33.5	33.7	35.3	36.9	37.7
Real private credit growth (percent, period) average)	1.9	3.0	7.3	10.4			
Nonperforming loans (percent of gross loans, end of period)	8.7	8.5	6.2	4.7	4.2	3.9	3.5
Unemployment rate (percent, period average)	30.0	35.3	32.9				
Youth unemployment rate (percent, period) average)	55.9	61.0	57.7				
Labor force participation rate (percent, period average)	40.5	41.6	37.6				
GDP per capita (current US$)	3,877.2	4,053.6	3,559.2	3,641.6	3,737.6	3,840.7	3,953.3

Sources: Country authorities, World Bank estimates and projections.
Notes: Real GDP growth and composition of growth are annual projections. Nonperforming loans show actuals up to November.

FYR Macedonia

- *Economic growth slowed down to 2.4 percent in 2016 as political uncertainty caused a drop in private investment. Growth is projected to average 3.3 percent during 2017–19—provided that political uncertainties dissipate and confidence is restored.*
- *A sizable fiscal stimulus and a declining labor force pushed down unemployment.*
- *Under-execution of capital spending narrowed the fiscal deficit in 2016, even though current spending continued to increase. Public and publicly guaranteed debt reached 48 percent of GDP.*
- *Fostering confidence and growth will require determined fiscal consolidation and structural reforms of the business environment, education, and public investment management.*

Recent Economic Developments

Political uncertainty took a toll on growth in 2016, slowing it from 3.8 percent in 2015 to 2.4 percent. Growth was largely driven by household consumption, which contributed 3 percentage points (pp), supported by rising employment, wages, pensions, and household lending. Relatively flat government consumption contributed just 0.2 pp to growth. Concern about the political situation affected investment, which fell by 4.3 percent from 2015 and subtracted 1.4 pp from growth in 2016, despite significant investment in roads. Net-exports added 0.7 pp to growth, supported by solid FDI-related exports and IT and transport services growth.

Growth in 2016 was mainly driven by construction, while manufacturing output declined. Construction grew by 18.5 percent year-on-year (y-o-y) and contributed 2. pp to growth, mainly supported by three publicly financed highway projects. But, manufacturing output declined by 2.2 percent, subtracting 0.2 pp from growth as more traditional domestic industries, which account for more than half of industrial output, declined compared to 2015, among them mining and quarrying, food, apparel, electricity and gas supply, and manufacturing of basic metal and nonmetal mineral products.

Unemployment continued to fall in 2016 because of fiscal interventions to create jobs and as labor force participation contracted. Employment grew 2.1 percent y-o-y in 2016, with a large share of net created positions linked to government stimulus programs. Yet, labor force participation fell from 57.2 percent in 2015 to 56.8 percent in 2016, the lowest rate since 2012. As a result, the average unemployment rate was 23.7 percent at end-2016. Despite a government stimulus for youth employment in particular, mainly in the form of exemptions from social contributions, in this age group unemployment went up from 47.4 percent in 2015 to 48.3 percent. Of all age groups, youth is the only one whose participation in the labor force has been declining since 2012. Long-term unemployment remains high at 81 percent of all unemployed.

The fiscal deficit declined in 2016, largely due to under-execution of capital spending. The deficit declined to 2.6 percent of GDP, significantly lower than the 4 percent announced in the second budget revision. The decline relates mainly to a low execution of capital spending in the context of a prolonged election cycle. Total revenues were 27.9 percent of GDP, declining from 2015 by 1 pp, due largely to lower personal income tax and contributions related to the tax-exempt job-creation. . The revenue decline was more than matched by an expenditure decline of 1.8 pp. However the change in composition makes budget less sustainable: significant underperformance in capital spending is now combined with current spending that surpassed 90 percent of the overall public expenditure.

Public debt continued upward in 2016, driven by government borrowing and guarantees to state-owned enterprises (SOEs). In July 2016, FYR Macedonia issued a 450 million Eurobond Additionally, due to the accelerated pace of construction of two highways, guaranteed debt also increased. Public and publicly guaranteed debt reached 47.7 percent of GDP in 2016 (of which 8.7 pp are debt guarantees), compared to 46.4 percent in 2015.

After a brief interruption in the second quarter of 2016, monetary policy has normalized. In reaction to large deposit withdrawals and the foreign exchange market crisis in the second quarter, the Central Bank raised the interest rate from 3.25 to 4 percent and intervened further to stabilize the exchange rate. As the situation settled down in the second half of 2016, the Bank lowered the interest rate, bringing the rate down to 3.25 percent. Deflation persisted in 2016, at 0.2 percent for the third consecutive year, driven by the prices of food, oil, and utilities. Meanwhile, core inflation remained positive at 1.4 percent, driven by higher prices for housing and furnishings, tobacco, and recreation and culture.

Although credit continued to expand in 2016, it masked a significant slowdown in corporate lending because of the uncertain political climate. Overall credit growth was strong at 6.5 percent in 2016 (y-o-y), but corporate lending growth plunged from 7.1 percent in 2015 to 3.2 percent. The banking sector is profitable and well-capitalized, with a capital adequacy ratio of 15.7 percent as of Q3 2016, well above the regulatory minimum of 8 percent. The loan-to-deposit ratio stood at 88 percent, which suggests that banks have significant room to increase lending, especially to the corporate sector, once the political uncertainties are resolved. In mid-2016 there was a marked statistical effect in the ratio of nonperforming loans (NPLs), which dropped from 10.6 percent at yearend 2015 to 6.5 percent a year later as the Central Bank changed the regulation requiring banks to write off fully-provisioned loans on their books after more than two years.

The current account deficit (CAD) widened but remains manageable at 3.1 percent of GDP in 2016, up from 2.1 percent in 2015. The solid increase of goods and services exports was supported by FDI projects but was not enough to compensate for the significant rise in capital outflows in the form of dividend payment and profit repatriation. In addition, a continued decline in private transfers also helped to push up the CAD. Nevertheless, the CAD was more than fully financed by net FDIs (largely concentrated in the automotive industry), which reached 3.6 percent of GDP

in 2016, significantly above the 2.2 percent registered in 2015. As of yearend 2016, foreign exchange reserves were still solid at 4.9 months of imports, supported by the €450 million Eurobond that Macedonia issued in July.

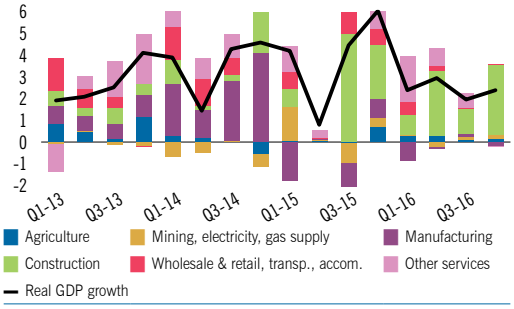
Outlook and Risks

Growth is expected to accelerate to 2.8 percent in 2017 and continue on up to 3.3 percent in 2018. Growth projections assume that political uncertainties are resolved in early 2017, which would improve the confidence of both consumers and private investors. The fiscal deficit is expected to remain at a sizable 3.2 percent of GDP in 2017 but then to decline gradually to 2.3 percent in 2019. As a result, public and publicly guaranteed debt is expected to increase to 55 percent by 2019 (of which 13 pp are projected to be guarantees). The CAD is expected to average 2.6 percent of GDP in 2017-2019, driven by consumption and investment demand.

Harnessing growth will require a shift from short-term fiscal stimulus to acceleration of structural reforms. A solid, credible fiscal consolidation program will help to stabilize public debt and rebuild fiscal buffers against shocks. In addition, an assessment of the fiscal costs and economic returns of recent policy and investment proposals will help the government to prioritize and sequence its initiatives to more effectively promote growth, while keeping debt levels manageable. Future growth will depend on accelerating structural reforms to improve the business environment, build labor skills, and enhance the management of public investments. The main downside risk to the outlook is that continued political uncertainty will further erode consumer and private investor confidence and postpone the necessary structural reforms. External risks related to a slowdown in the Eurozone, the main trading and investment partner, also pose a sizable risk to the economy.

The political turmoil took a toll on growth, which in 2016 was largely driven by public works.

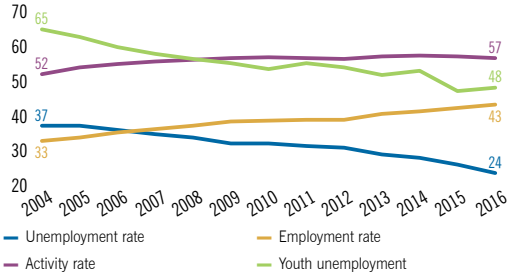
GDP growth by sector, contributions to growth in percent



Source: State Statistics Office.

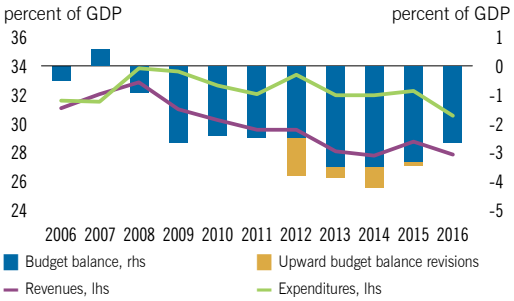
Unemployment continued to fall, as fewer entered the labor force and fiscal stimulus created jobs.

labor market developments



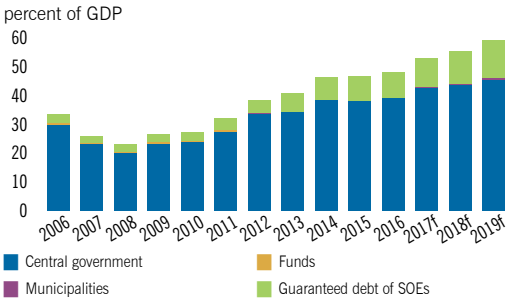
Source: State Statistics Office and World Bank estimates.

The fiscal deficit declined in 2016, largely due to under-execution of capital spending.



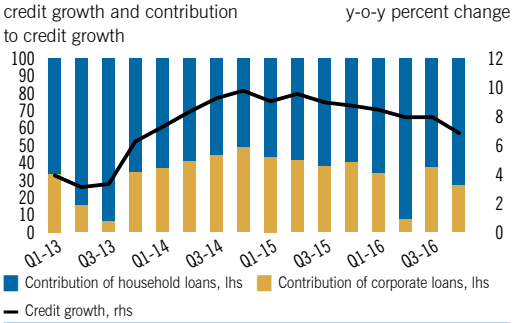
Source: Ministry of Finance and World Bank estimates.

Public debt continued to rise in 2016, driven by government borrowing and guarantees to SOEs.



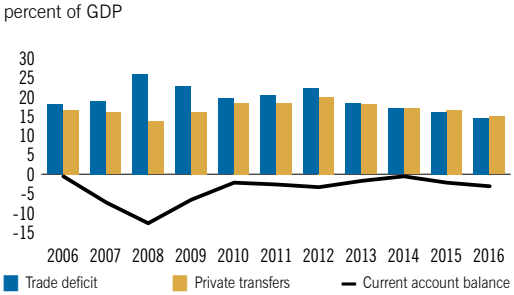
Source: National Bank data.

Continuing credit expansion masked a plunge in corporate lending caused by political uncertainties.



Source: National Bank and World Bank estimates.

The CAD widened, but was more than fully financed by FDI inflows.



Source: National Bank and World Bank estimates.

FYR MACEDONIA	2013	2014	2015	2016f	2017f	2018f	2019f
Real GDP growth (percent)	2.9	3.6	3.8	2.4	2.8	3.3	3.8
Composition (percentage points)							
Consumption	1.4	1.6	3.0	3.1	2.5	2.1	2.0
Investment	0.1	3.8	0.0	-1.4	0.0	0.7	1.1
Net exports	1.3	-1.7	0.7	0.7	0.3	0.4	0.7
Exports	2.6	8.2	2.4	5.9	4.3	4.0	3.9
Imports	1.3	9.9	1.7	5.2	4.0	3.6	3.2
Consumer price inflation (percent, period average)	2.8	-0.3	-0.3	-0.2	0.6	1.4	1.8
Public revenues (percent of GDP)	30.2	29.8	31.0	30.0	30.3	30.3	30.3
Public expenditures (percent of GDP)	34.2	34.0	34.4	32.6	33.5	33.0	32.6
Of which:							
Wage bill (percent of GDP)	7.2	7.0	7.0	6.9	6.9	6.8	6.8
Social transfers (percent of GDP)	14.8	14.9	14.8	14.8	14.8	14.8	14.8
Capital expenditures (percent of GDP)	4.4	4.3	4.2	3.0	4.1	4.2	4.3
Fiscal balance (percent of GDP)	-3.9	-4.2	-3.5	-2.6	-3.2	-2.7	-2.3
Primary fiscal balance (percent of GDP)	-2.9	-3.2	-2.3	-1.5	-1.9	-1.4	-0.8
Public debt (percent of GDP)	34.2	38.2	38.0	39.0	41.0	42.1	44.0
Public and publicly guaranteed debt (percent of GDP)	40.5	45.9	46.5	47.7	50.6	52.3	55.8
Of which: External (percent of GDP)	25.5	31.9	31.3	33.8	34.7	35.9	37.2
Goods exports (percent of GDP)	29.2	32.4	33.5	34.3	34.2	34.3	34.5
Goods imports (percent of GDP)	52.0	54.1	53.6	53.1	54.5	54.6	54.5
Net services exports (percent of GDP)	4.6	4.2	3.8	4.0	4.2	4.5	4.6
Trade balance (percent of GDP)	-18.3	-17.6	-16.4	-14.7	-13.6	-12.2	-11.5
Remittances inflows (percent of GDP)	2.2	2.2	2.1	2.1	2.0	2.0	1.9
Current account balance (percent of GDP)	-1.6	-0.6	-2.1	-3.1	-3.0	-2.7	-2.1
Foreign direct investment inflows (percent of GDP)	2.8	2.3	2.2	3.6	2.5	2.7	2.9
External debt (percent of GDP)	64.0	70.0	69.3	74.1	74.7	75.1	73.8
Real private credit growth (percent, period average)	4.9	10.3	9.9	6.7	6.0	5.3	5.0
Nonperforming loans (percent of gross loans, end of period)	11.3	11.1	10.6	6.5	6.0	5.7	5.2
Unemployment rate (percent, period average)	29.0	28.0	26.1	23.7	22.0	20.2	19.4
Youth unemployment rate (percent, period average)	51.9	53.1	47.3	48.3	48.5	48.0	47.6
Labor force participation rate (percent, period average)	57.2	57.3	57.0	56.8	56.6	56.7	56.9
GDP per capita, PPP (current international $)	12,468	12,938	13,330	13,583	13,936	14,355	14,814
Poverty rate at US$5/day, PPP (percent of population)	34.3	32.9	31.5	30.7	29.7	27.3	

Sources: Country authorities, World Bank estimates and projections.
Notes: Data on remittances reflect only worker remittances and not overall private transfers which are significantly higher.

Montenegro

- *Economic growth slowed from 3.4 percent in 2015 to 2.1 percent in 2016, due to delays in construction of the Bar-Boljare highway (an investment with a high import component) and levelling off tourism.*
- *Unemployment remained high, amplified by a surge in female registration in order to access the mother's lifetime benefit that became effective in January 2016.*
- *Public finances improved temporarily in 2016 due to under-execution of capital expenditures, despite higher spending on wages and social transfers, which the new government attempted to rein in.*
- *In the absence of a more ambitious fiscal consolidation program, public and publicly guaranteed debt would grow towards 86 percent of GDP by 2019 at a time of historically high debt refinancing needs.*

Recent Economic Developments

Montenegro's real GDP grew by an estimated 2.1 percent in 2016, down from 3.4 percent in 2015. Investment, largely driven by tourism, energy, and highway construction, continued to drive growth, contributing more than 4 percentage points (pp) to growth in 2016. Household consumption was also robust, contributing an additional 2.2 pp, and government consumption contributed another 1.8 pp, led by a rise in public sector wages. In contrast, net exports subtracted 6 pp from growth as a surge in imports of equipment and materials for the highway and windmill projects overwhelmed continued weak exports of services. Industrial production in 2016 fell by 4.7 percent year-on-year (y-o-y); growth in the energy sector was not enough to offset steep declines in manufacturing and mining. While tourist arrivals grew by about 6 percent, tourist night-stays rose by only 1.8 percent compared to double-digit growth in 2015.

The labor market deteriorated in 2016 despite an employment pick-up driven by growth. The Law on Social Care and Child Protection in 2015 provided a lifetime benefit to mothers with three or more children, leading to some 17,000 women withdrawing from employment and the labor force. The large infrastructure projects are not having a visible employment impact because they rely largely on imported labor. As a result, the unemployment rate went up, reaching 17.8 percent by September 2016, as employment stagnated at 44.7 percent. Despite a major employment program tailored to youth, their unemployment rate remained high at more than 37 percent; 75 percent of the unemployed had been so for the long-term. Led by higher public wages, real wages grew by 3.4 percent in 2016, well above productivity growth, which pushed up unit labor cost by over 7 percent in 2016.

Despite under-execution of capital spending related to construction of the Bar-Boljare highway, fiscal pressures continue to be high, although the general government deficit did

fall from 7.9 percent of GDP in 2015 to below 4 percent. Revenues increased by about 12 percent in 2016 based on higher collection of VAT, excises, and the personal income tax. At the same time, spending declined by 5 percent because highway construction was stalled by delays in obtaining construction permits. However, current spending increased by about 8 percent due to the rise in public sector wages, social benefits, and pensions. To accommodate the resulting current budget shortfall of 1.1 percent of GDP, and recognizing the shortfall in realizing the capital budget, the new government, which took office in November, revised the budget for 2016 downward. The lower deficit led to a slower rise in direct public debt, from 66.7 percent of GDP in 2015 to 68 percent.

Deflation persisted through most of the year, with international oil and food prices low. Although private consumption rose considerably, average inflation in 2016 was negative at 0.2 percent. However, prices grew in the last quarter of 2016 by 0.5 percent, pushed up by spillovers from international oil price increases.

Lending activity recovered slightly and there were fewer nonperforming loans (NPLs). Credits to households grew substantially by close to 11 percent, given the low base effect, while after bottoming out for the year in September, corporate lending also recovered, growing by 1.9 percent in December. Deposits remained a substantial source of bank financing strategy; they grew by more than 9 percent. The credit-to- deposits ratio is now nearing historical lows of 84 percent. During the year NPLs declined from 12.6 percent at end-2015 to 10.3 percent in December 2016, with factoring companies playing a major role in the NPL clean-up, although write-offs and debt restructuring are being used increasingly to resolve NPLs. The proposed amendments to the Voluntary Restructuring Law would further incentivize NPL resolution.

After narrowing to 13.3 percent of GDP in 2015, the current account deficit (CAD) widened again, to 19.2 percent. Tourism and transport revenues were higher by 3.3 percent (y-o-y) but that was still not enough to offset the significant surge in imports of close to 12 percent (y-o-y), largely of machinery and equipment for the highway and windmill construction. Frontloaded dividend payments further widened the CAD. The trade deficit continued to deteriorate, ending at 45 percent of GDP, up from 40.4 percent in 2015. While errors and omissions leave financing flows unexplained by about 6 percent of GDP, net FDI fell significantly in 2016. After reaching 17 percent of GDP in 2015, net FDI plunged in 2016 to 10 percent, mainly due to an outflow of telecom dividends. In 2016 net FDI financed about half of the CAD.

Outlook and Risks

Although positive, Montenegro's medium-term economic outlook faces substantial risks. The economy is expected to average growth of 2.8 percent annually through 2019, but currently growth is based on an unsustainable model that relies on publicly-financed investments and consumption even as the fiscal position weakens. External imbalances are expected to widen again, worsening already high vulnerability to external shocks. Moreover, once the public investment impetus to growth slows, so will overall growth, further exposing Montenegro to existing risks.

While a recent rise in social benefits will likely help to reduce poverty in the short term, it is also heightening economic vulnerabilities in that people who are becoming detached from the labor market are more vulnerable to changes in social benefit policies. With inflation forecast to rise, given growing domestic demand and the spillover effect from international prices, real net disposable incomes are likely to fall.

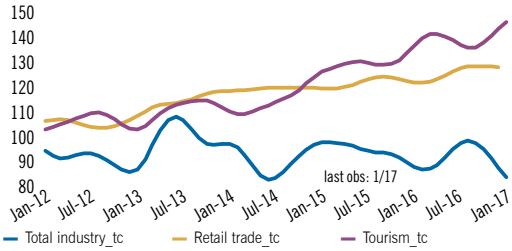
Fiscal deficits and refinancing needs over the medium term are high. The deficit for 2017 is budgeted at 6.6 percent of GDP, despite consolidation measures already adopted that amount to 3.2 percent of GDP. Among the measures are a rise in excise taxes and a reduction in VAT exemptions, improvements in collection of tax arrears, a 25 percent reduction of the amount of the mother's benefit, an 8 percent reduction in the wages of officials, a freeze of seniority bonus payments until 2019, and selective cuts in capital expenditures.

Although the recent consolidation program is a move in the right direction, additional measures to reduce permanent spending and bring in more revenue will be needed. The high fiscal deficits and rising public debt mean the path of public finances is not sustainable; more ambitious fiscal consolidation will be necessary to create space for an orderly servicing of the refinancing needs for 2019–21, which amount to more than 16 percent of GDP. Reducing the deficit will not be easy but is of the utmost urgency given the need to reassure markets and allow for a successful rollover of existing obligations considering the credit rating of B+ with a negative outlook.

To move forward, accelerating structural reforms to keep public finances sustainable and Montenegro competitive are crucial. A new coalition government led by the Democratic Party of Socialists, which has a slim majority, adopted the Economic Reform Program for 2017–19, which plans reforms in social sectors, public administration, management of public finances, and the investment climate.

Mixed growth dynamics.

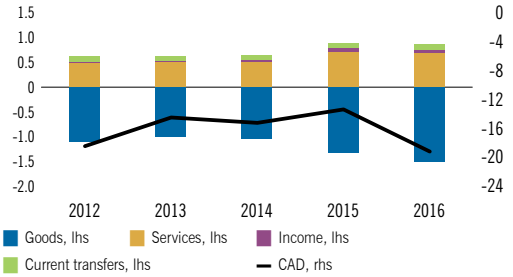
high-frequency data, trend-cycle, 2012–16, index, 2011=100



Source: MONSTAT data.
Note: tc = trend cycle

Widening current account deficit.

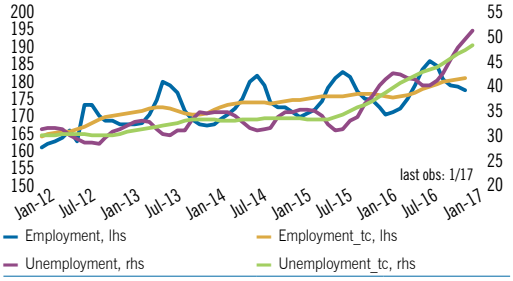
US$ billion, 2012–16 | percent of GDP



Source: CBCG and MONSTAT data.

Unemployment on the rise.

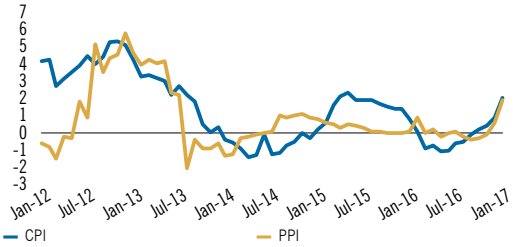
adm. data, in thousands, 2012–16 | in thousands



Source: MONSTAT data.

Inflationary pressures revived.

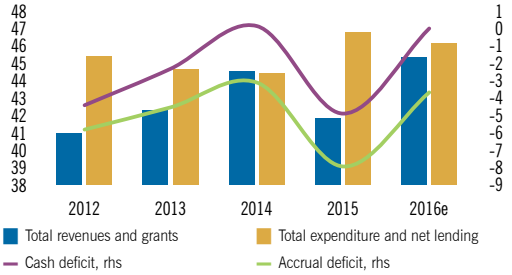
2012–17, annual growth rates



Source: MONSTAT data.

Fiscal deficit declined recently.

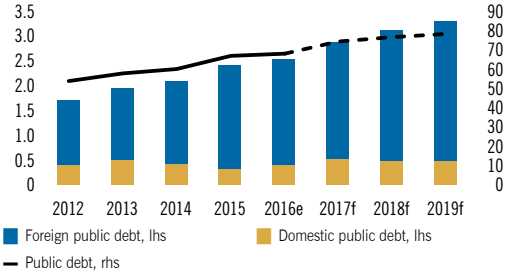
percent of GDP, 2012–16 | percent of GDP, 2012–16



Source: MOF and MONSTAT data.

Public debt to rise over the medium term.

2012–19, € billions | percent of GDP



Source: MOF and MONSTAT data.

MONTENEGRO	2013	2014	2015	2016[e]	2017[f]	2018[f]	2019[f]
Real GDP growth (percent)	3.5	1.8	3.4	2.1	3.3	3.0	2.0
Of which (percentage points):							
Consumption	1.6	2.6	2.2	4.0	1.8	2.0	2.9
Investment	0.5	0.5	1.8	4.2	5.0	2.0	0.0
Net exports	1.5	-1.2	-0.6	-6.1	-3.5	-0.9	-0.9
Exports	-0.5	-0.3	2.1	0.8	1.1	1.1	0.9
Imports (-)	2.0	-1.0	-2.7	-6.9	-4.6	-2.0	-1.7
Consumer price inflation (percent, period average)	2.2	-0.7	1.5	-0.2	1.5	2.2	2.2
Public revenues (percent of GDP)	42.3	44.6	41.9	45.4	44.0	43.1	42.1
Public expenditures (percent of GDP)	46.9	47.7	49.8	49.1	50.7	49.0	46.4
Of which:							
Wage bill (percent of GDP)	12.8	13.2	13.2	13.8	13.2	12.5	12.1
Social benefits (percent of GDP)	14.4	14.3	13.9	14.9	15.0	14.8	14.6
Capital expenditures (percent of GDP)	4.1	5.8	9.0	4.6	8.4	8.9	7.5
Fiscal balance (percent of GDP)	-4.6	-3.1	-7.9	-3.7	-6.6	-5.9	-4.3
Primary fiscal balance (percent of GDP)	-2.4	-0.9	-5.6	-1.4	-4.0	-3.5	-1.7
Public debt (percent of GDP)	57.5	59.9	66.7	68.0	74.0	76.4	78.1
Public and publicly guaranteed debt (percent of GDP)	66.8	68.8	77.5	77.1	82.7	84.7	86.1
Of which: External (percent of GDP)	42.6	47.9	57.9	57.4	60.5	64.4	66.9
Goods exports (percent of GDP)	11.8	10.3	9.0	9.2	9.0	8.9	8.7
Goods imports (percent of GDP)	51.3	50.1	49.3	54.0	56.0	56.2	56.5
Net services exports (percent of GDP)	19.4	20.0	21.8	21.0	20.7	20.8	21.1
Trade and services balance (percent of GDP)	-20.1	-19.8	-18.6	-23.9	-26.3	-26.6	-26.7
Remittance inflows (percent of GDP)	4.6	4.3	4.2	3.1	4.1	3.9	3.8
Current account balance (percent of GDP)	-14.5	-15.2	-13.3	-19.2	-19.9	-20.5	-20.9
Foreign direct investment inflows (percent of GDP)	9.6	10.2	17.1	10.0	10.2	9.8	9.8
External debt (percent of GDP)	153.6	159.3	160.8	161.1	160.0	159.5	156.5
Real private credit growth (percent, period average)	3.1	-1.9	0.8	1.3	..	..	..
Nonperforming loans (percent of gross loans, end of period)	17.5	15.9	12.5	10.3	..	..	..
Unemployment rate (percent, period average)	19.5	18.0	17.6	17.8	17.5	17.2	16.9
Youth unemployment rate (percent, period average)	41.7	36.3	37.7	37.4	..	..	..
Labor force participation rate (percent, period average)	50.1	52.7	53.7	54.4	..	..	..
GDP per capita, PPP (current international $)	14,884	15,410	16,050	16,195	16,389	16,586	16,785
Poverty rate at US$5/day, PPP (percent of population)	19.7	13.2	13.2	12.8	11.5	11.1	10.1

Sources: Country authorities, World Bank estimates and projections.
Notes: Labor market indicators and credit growth for 2015 reflect year-to-date annual rolling averages. Nonperforming loans show year-to-date actuals.

Serbia

- *Economic growth in 2016 was an estimated 2.8 percent, the highest growth since 2008—and achieved despite continued fiscal consolidation that resulted in a record low deficit.*
- *Growth continued to stimulate job creation and improve labor market outcomes. In 2016, employment was 5.8 percent higher than in 2015.*
- *Growth in 2017 is expected to accelerate to 3 percent, with a stable contribution from consumption, and supported by growth in investment and exports.*
- *Sustaining growth will require continued efforts to address structural challenges, and especially to resolve the fiscal and contingent liability risks stemming from state-owned and utility companies.*

Recent Economic Developments

Serbia's economy expanded by an estimated 2.8 percent in 2016, the highest growth rate since 2008. Growth was broad-based, with all components of GDP contributing. Strong investment and net exports were the main drivers, adding to the recovery in consumption after seven years of decline and stagnation. Government consumption saw a robust increase of 2.3 percent year-on-year (y-o-y), and there was a partial relaxation of the public sector wage policy and higher spending on goods and services. Private consumption tracked the increase in credit activity as interest rates fell and private sector wages recovered, rising 4.7 percent y-o-y through November. On the production side, the main driver of growth was services; also adding significant value were industry, value-added up 3.6 percent, and agriculture, up 8.3 percent.

Growth continued to stimulate job creation and to enhance labor market outcomes. Improved economic performance was reflected in the labor market as employment rates at last exceeded the rates from before the international financial crisis. The number of employed in the fourth quarter of 2016 (the latest available data from the Labor Force Survey) was 5.8 percent higher than in the same quarter of 2015. In the same quarter unemployment fell to 13 percent—the lowest level since 2008. In 2016, after declining for three consecutive years real wages reversed course, going up 2.6 percent (y-o-y). However, almost a third of the new jobs were in the informal sector as the good agricultural season pushed up informal jobs by 8.2 percent. Youth unemployment dropped as well, however, it remains high at 31.2 percent.

Massive fiscal adjustment resulted in a record low 2016 fiscal deficit of 1.4 percent of GDP. Solid revenue performance (up 8.7 percent, y-o-y) driven by more efficient collection of VAT and excises, control of spending on public sector wages and pensions, and savings on subsidies, pushed down the deficit significantly in 2016, to 1.4 percent of GDP. This is well below the 3.7 percent recorded in 2015 and even below the deficit of 4 percent of GDP that had been budgeted. There was also a shift from a primary deficit of 0.5 percent of GDP in 2015 to a primary surplus of 1.8 percent.

The combination of better budget performance and strong economic growth helped to reduce public debt as a share of GDP from 75.9 percent in 2015, to 74 percent at the end of 2016.[1]

Inflation started to pick up in early 2017. Although monetary policy was loosened in 2016, inflation remained subdued, averaging 1.2 percent, well below the National Bank of Serbia (NBS) target of 4±1.5 percent. Low inflation and improved macroeconomic fundamentals led the NBS to lower its target band to 3±1.5 percent. In the last quarter of 2016 inflation went up slightly, averaging 1.5 percent (y-o-y), as prices of all product groups in the CPI basket increased. NBS increased the money supply throughout 2016: in December M1 was 20.5 percent higher than at the end of 2015 (in nominal terms), and M3 was up by 11.6 percent (y-o-y). From July on, the policy rate was kept unchanged at 4 percent. However, inflation started to pick up in early 2017, to reach 3.2 percent (y-o-y) in February. By end-February the exchange rate depreciated 0.4 percent against the euro (compared to end-2016) despite ocassional NBS interventions in the foreign exchange market. In January and Febraury alone, NBS sold €330 million in order to prevent a more significant depreciation of the dinar.

Improved banking sector performance also supported growth. Credit growth, to government and private sector, of 6 percent by yearend 2016 (y-o-y) was driven by more lending to both households (up 10.5 percent) and government (19 percent, in nominal terms). The banking sector remains sound and well-capitalized, and NPLs declined gradually to 17 percent after hitting a record high 21.6 percent at the end of 2015. There was also a consolidation of banks when Direktna Banka acquired Findomestic bank and AIK banka expressed interest to acquire Alpha bank, the third largest Greek bank in Serbia. In addition, the Bank of China opened up operations in Serbia.

Serbia's external position improved in 2016 as the current account deficit (CAD) narrowed to 4 percent of GDP, supported by improvements in the trade balance. By December 2016, the CAD had fallen by 13.1 percent compared to a year earlier (in euro terms), down to 4 percent of GDP. The drop in the trade deficit was primarily driven by stronger exports, which went up by 12.1 percent in euro terms. The growth in exports was broad-based, but the chemical, automotive, electronics, and food industries contributed most. Moreover, 70 percent of the increase was due to the rise in exports to the EU. Over the same period, the surplus in trade in services rose by 23.4 percent. These improvements overshadowed a 5.6 percent drop in net transfers compared to the same period of 2015 precipitated by a 9.4 percent fall in remittances (a narrow definition). Because net FDI continued to be relatively stable compared to a year earlier, it remained more than sufficient to cover the CAD. However, by yearend 2016 equity investment had dropped by 31.7 percent compared to 2015, probably because of both the time it took to form the government and to regional instability.[2]

1 Public and publicly guaranteed debt including non-guaranteed debt of local governments.

2 In addition, there was a high base effect from 2015.

Outlook and Risks

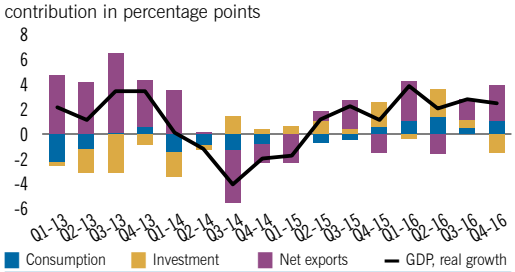
Growth is projected to rise gradually from an estimated 2.8 percent in 2016 to 3.5 percent by 2019. After contracting in 2013 and 2014, private investment has been supporting recent growth in response to improvements in the investment climate; over the medium term it is projected to contribute about 1.1 percentage points to growth. As activity and employment pick up, after 2017 consumption is again expected to be the main driver of growth, with an average annual contribution of 2.3 percentage points.

The gradual narrowing and stabilization of the CAD is expected to continue, with it settling at 3.9 percent of GDP in the medium term. The goods trade deficit should continue to improve, in part due to external developments (low energy prices and recovery in the EU) and in part due to recent foreign investment; the services surplus should also rise gradually.

Inflation is expected to move up slowly in parallel with the recovery in domestic demand. As demand picks up more, inflation is projected to be within the NBS target band in 2017. Monetary policy will continue to be implemented through inflation targeting combined with a flexible exchange rate; any intervention is likely to be concerned with managing excess volatility of the currency.

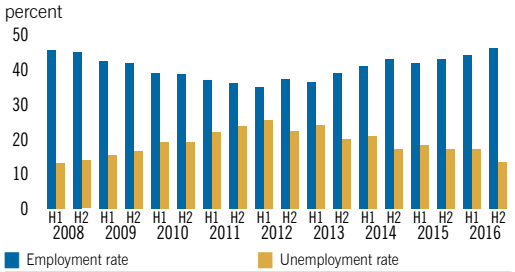
The main risks relate to political developments, both internal and foreign. In 2017 Serbia must deal with yet another round of elections, which is expected to slow progress with structural reforms, and might also possibly raise the costs of maintaining the status quo. There are also risks that the economic outlook in Europe could deteriorate once the Brexit process begins and elections throughout the EU are over.

All components of GDP contributed to growth…



Source: Statistics Office of Serbia.

…leading to improvements in the labor market.

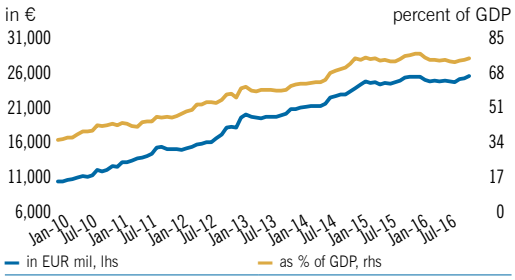


Source: Statistics Office of Serbia.

There was a major reduction in the budget deficit…

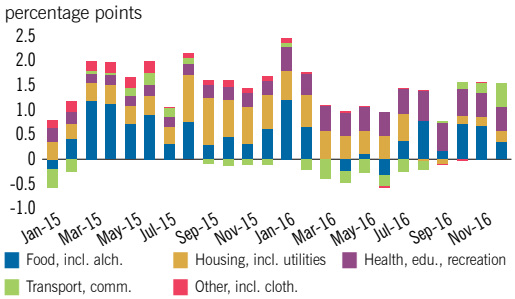
Source: Ministry of Finance.

…which helped to stabilize public debt.



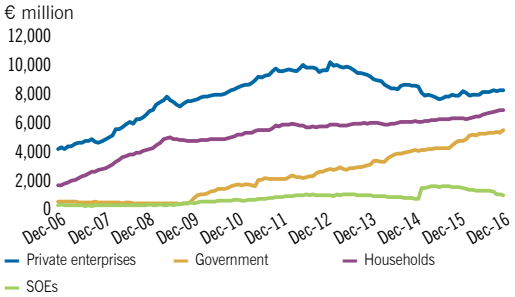
Source: Ministry of Finance.

Inflation rose only in Q4…



Source: Statistics Office of Serbia.

…while credit was growing throughout the year.



Source: National Bank of Serbia.

SERBIA	2013	2014	2015	2016	2017f	2018f	2019f
Real GDP growth (percent)	2.6	-1.8	0.8	2.8	3.0	3.5	3.5
Composition (percentage points):							
Consumption	-0.6	-1.1	0.1	1.0	1.5	2.2	2.6
Investment	-1.5	-0.1	1.5	0.2	1.0	1.3	1.0
Net exports	4.8	-0.6	-0.8	1.5	0.5	0.1	-0.1
Exports	7.4	2.3	4.5	5.7	3.9	4.0	4.2
Imports (-)	-2.6	3.0	5.4	4.2	3.3	3.9	4.4
Consumer price inflation (percent, period average)	7.7	2.1	1.9	1.2	2.6	3.0	3.0
Public revenues (percent of GDP)	37.9	39.7	40.4	42.4	41.2	40.8	40.5
Public expenditures (percent of GDP)	43.5	46.3	44.0	43.7	42.5	42.0	41.5
Of which:							
Wage bill (percent of GDP)	10.1	9.9	8.8	8.4	8.4	8.3	8.1
Social benefits (percent of GDP)	17.7	17.8	17.6	17.1	16.5	16.3	16.0
Capital expenditures (percent of GDP)	2.1	2.5	2.9	3.3	3.3	3.5	3.6
Fiscal balance (percent of GDP)	-5.6	-6.6	-3.7	-1.4	-1.4	-1.2	-1.0
Primary fiscal balance (percent of GDP)	-3.2	-3.7	-0.5	1.8	1.7	1.8	1.8
Public debt (percent of GDP)	52.6	64.1	68.5	68.3	67.8	65.8	62.9
Public and publicly guaranteed debt (percent of GDP)	60.9	71.8	75.9	74.0	73.1	70.2	66.9
Of which: External (percent of GDP)	36.2	42.9	45.6	46.1	44.8	42.1	38.7
Goods exports (percent of GDP)	30.7	31.9	33.9	37.3	38.2	39.0	41.0
Goods imports (percent of GDP)	42.8	44.3	45.8	47.5	48.9	49.7	50.9
Net services exports (percent of GDP)	0.9	1.4	2.2	2.6	3.1	3.1	3.5
Trade balance (percent of GDP)	-11.2	-10.9	-9.8	-7.6	-7.6	-7.5	-6.3
Remittance inflows (percent of GDP)	6.3	5.6	6.2	5.5	5.9	5.8	5.6
Current account balance (percent of GDP)	-6.1	-6.0	-4.7	-4.0	-3.9	-3.9	-3.9
Foreign direct investment inflows (percent of GDP)	3.8	3.7	5.4	5.5	4.7	4.4	4.4
External debt (percent of GDP)	74.8	77.1	78.7	77.4	73.9	70.9	68.2
Real private credit growth (percent, period average)	-1.9	-2.3	3.7	3.3	n.a.	n.a.	n.a.
Non-performing loans (percent of gross loans, end of period)	21.4	21.5	21.6	17.0	n.a.	n.a.	n.a.
Unemployment rate (percent, period average)	22.1	19.2	17.7	15.3	15.0	14.8	13.5
Youth unemployment rate (percent, period average)	49.4	47.6	43.2	37.2	n.a.	n.a.	n.a.
Labor force participation rate (percent, period average)	50.1	52.7	53.7	54.3	n.a.	n.a.	n.a.
GDP per capita, PPP (current international $)	13,400	13,436	13,671	14,047	14,561	15,378	16,257
Poverty rate at US$5/day, PPP (percent of population)	14.5	14.9	14.5	13.6	12.8	11.9	10.9

Sources: Country authorities, World Bank estimates and projections.
Notes: For remittances, a narrow definition is used. External debt for 2016 is a projection.

Key Economic Indicators

	2013	2014	2015	2016[e]	2017[f]	2018[f]	2019[f]
Real GDP growth (percent)							
Albania	1.0	1.8	2.6	3.2	3.5	3.5	3.8
Bosnia and Herzegovina	2.4	1.1	3.0	2.8	3.2	3.7	4.0
Kosovo	3.4	1.2	4.1	3.6	3.9	4.2	4.4
Macedonia, FYR	2.9	3.6	3.8	2.4	2.8	3.3	3.8
Montenegro	3.5	1.8	3.4	2.1	3.3	3.0	2.0
Serbia	2.6	-1.8	0.8	2.8	3.0	3.5	3.5
WB6	*2.5*	*0.3*	*2.2*	*2.8*	*3.2*	*3.5*	*3.7*
Consumer price inflation (percent, period average)							
Albania	1.9	1.6	1.9	1.3	1.5	2.9	3.0
Bosnia and Herzegovina	-0.1	-0.9	-1.0	-1.4	-0.5	0.5	0.5
Kosovo	1.8	0.4	-0.5	0.3	0.7	1.2	1.7
Macedonia, FYR	2.8	-0.3	-0.3	-0.2	0.6	1.4	1.8
Montenegro	2.2	-0.7	1.5	-0.2	1.5	2.2	2.2
Serbia	7.7	2.1	1.9	1.2	2.6	3.0	3.0
WB6	*0.8*	*0.2*	*0.5*	*0.7*	*1.3*	*1.9*	*2.1*
Public expenditures (percent of GDP)							
Albania	29.2	32.3	30.9	28.9	28.8	28.5	28.2
Bosnia and Herzegovina	44.8	45.8	42.6	43.7	44.4	43.6	43.3
Kosovo	28.1	27.0	27.3	28.1	29.7	30.6	31.2
Macedonia, FYR	34.2	34.0	34.5	32.5	33.5	33.0	32.6
Montenegro	46.9	47.7	49.8	49.1	50.7	49.0	46.4
Serbia	43.5	46.3	44.0	43.7	42.5	42.0	41.5
WB6	*37.8*	*38.9*	*38.2*	*37.7*	*38.3*	*37.8*	*37.2*
Public revenues (percent of GDP)							
Albania	24.0	26.3	26.3	26.7	27.7	27.5	27.5
Bosnia and Herzegovina	42.7	43.8	43.2	43.1	43.8	43.3	43.3
Kosovo	25.2	24.4	25.4	26.8	27.1	27.7	28.3
Macedonia, FYR	30.2	29.8	30.9	29.8	30.3	30.3	30.3
Montenegro	42.3	44.6	41.9	45.4	44.0	43.1	42.1
Serbia	37.9	39.7	40.4	42.4	41.2	40.8	40.5
WB6	*33.7*	*34.8*	*34.7*	*35.7*	*35.7*	*35.4*	*35.3*

	2013	2014	2015	2016[e]	2017[f]	2018[f]	2019[f]
Fiscal balance (percent of GDP)							
Albania	-5.2	-6.0	-4.6	-2.2	-1.1	-1.0	-0.7
Bosnia and Herzegovina	-2.1	-2.0	0.7	-0.6	-0.6	-0.3	0.0
Kosovo	-2.9	-2.6	-1.9	-1.3	-2.6	-2.9	-2.9
Macedonia, FYR	-3.9	-4.2	-3.6	-2.6	-3.2	-2.7	-2.3
Montenegro	-4.6	-3.1	-7.9	-3.7	-6.6	-5.9	-4.3
Serbia	-5.6	-6.6	-3.7	-1.4	-1.4	-1.2	-1.0
WB6	*-4.0*	*-4.1*	*-3.5*	*-2.0*	*-2.6*	*-2.3*	*-1.9*
Public debt (percent of GDP)							
Albania	66.7	68.0	69.6	67.8	64.7	64.0	60.5
Bosnia and Herzegovina	34.5	40.5	40.5	39.8	38.0	35.6	33.5
Kosovo	8.9	10.4	12.7	14.3	16.9	19.6	21.3
Macedonia, FYR	34.2	38.1	38.1	38.5	39.1	39.8	38.7
Montenegro	57.5	59.9	66.7	68.0	74.0	76.4	78.1
Serbia	52.6	64.2	68.8	67.8	67.5	65.7	62.7
WB6	*42.4*	*46.8*	*49.4*	*49.4*	*50.0*	*50.2*	*49.1*
Public and publicly guaranteed debt (percent of GDP)							
Albania	70.4	72.1	73.7	72.7	69.9	67.0	63.5
Bosnia and Herzegovina	37.7	41.8	41.9	41.5	39.7	37.4	35.3
Kosovo	8.9	10.6	12.9	14.6	17.6	20.4	22.0
Macedonia, FYR	40.5	45.9	46.7	47.7	49.9	51.7	53.6
Montenegro	66.8	68.8	77.5	77.1	82.7	84.7	86.1
Serbia	60.9	71.8	75.9	74.0	72.8	70.1	66.7
WB6	*47.5*	*51.8*	*54.8*	*54.6*	*55.4*	*55.2*	*54.5*
Goods exports (percent of GDP)							
Albania	18.3	9.4	7.5	6.4	7.0	7.0	6.8
Bosnia and Herzegovina	24.0	24.2	24.4	24.6	24.6	24.4	24.2
Kosovo	5.5	5.8	5.6	5.1	5.1	5.1	5.3
Macedonia, FYR	29.2	32.5	33.6	36.2	37.2	37.6	38.2
Montenegro	11.8	10.3	9.0	9.2	9.0	8.9	8.7
Serbia	30.7	31.9	33.9	37.3	38.2	39.0	41.0
WB6	*24.8*	*24.4*	*25.0*	*26.5*	*27.0*	*27.2*	*28.0*

	2013	2014	2015	2016[e]	2017[f]	2018[f]	2019[f]
Trade balance (percent of GDP)							
Albania	-16.8	-17.3	-17.3	-18.2	-19.4	-18.5	-17.1
Bosnia and Herzegovina	-20.4	-22.7	-18.7	-17.4	-16.7	-16.1	-15.2
Kosovo	-31.5	-30.9	-30.4	-30.3	-30.9	-30.9	-29.5
Macedonia, FYR	-18.3	-17.3	-16.4	-15.7	-19.0	-18.8	-18.1
Montenegro	-20.1	-19.8	-18.6	-23.9	-26.3	-26.6	-26.7
Serbia	-11.2	-10.9	-9.8	-7.6	-7.6	-7.5	-6.3
WB6	*-16.5*	*-16.7*	*-15.4*	*-14.5*	*-15.3*	*-15.0*	*-14.0*
Current account balance (percent of GDP)							
Albania	-10.5	-12.9	-10.8	-12.1	-13.7	-13.0	-11.8
Bosnia and Herzegovina	-5.7	-7.5	-5.7	-5.5	-5.8	-6.2	-6.3
Kosovo	-7.2	-9.1	-10.4	-11.5	-12.5	-13.3	-12.9
Macedonia, FYR	-1.6	-0.6	-2.0	-3.1	-3.0	-2.7	-2.1
Montenegro	-14.5	-15.2	-13.3	-19.2	-19.9	-20.5	-20.9
Serbia	-6.1	-6.0	-4.7	-4.0	-3.9	-3.9	-3.9
WB6	*-6.6*	*-7.2*	*-6.3*	*-6.6*	*-7.0*	*-7.0*	*-6.8*
External debt (percent of GDP)							
Albania	64.4	72.4	74.2	75.5	77.8	80.9	81.7
Bosnia and Herzegovina	73.8	76.9	76.6	76.2	74.3	72.1	70.0
Kosovo	30.2	31.2	33.5	33.5	35.2	36.9	37.7
Macedonia, FYR	64.0	70.3	69.9	74.1	74.7	75.1	73.8
Montenegro	153.6	159.3	160.8	161.1	160.0	159.5	156.5
Serbia	74.8	77.1	78.7	77.4	73.9	70.9	68.2
WB6	*76.8*	*81.2*	*82.3*	*83.0*	*82.7*	*82.6*	*81.3*
Unemployment rate (period average, percent)							
Albania	17.1	18.0	17.3	15.2	n.a.	n.a.	n.a.
Bosnia and Herzegovina	27.5	27.5	27.7	25.4	n.a.	n.a.	n.a.
Kosovo	30.0	35.3	32.9	n.a.	n.a.	n.a.	n.a.
Macedonia, FYR	29.0	28.0	26.1	23.7	n.a.	n.a.	n.a.
Montenegro	19.5	18.0	17.6	17.8	17.5	17.2	16.9
Serbia	22.1	19.2	17.7	15.3	15.0	14.8	13.5
WB6	*24.2*	*24.3*	*23.2*	*19.5*	*n.a.*	*n.a.*	*n.a.*

Source: World Bank calculations and projections using data from national authorities and World Economic Outlook (2016)

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