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REBALANCING FOR STRONGER GROWTH

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Rebalancing for Stronger Growth

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Acknowledgments

This Regular Economic Report (RER) covers economic developments, prospects, and economic policies in six South Eastern European countries (SEE6): Albania, Bosnia and Herzegovina, Kosovo, FYR Macedonia, Montenegro, and Serbia.

The report is produced twice a year by World Bank staff economists working on the SEE6 countries. The team of authors comprises Gallina A. Vincelette (task team leader and lead author), Ekaterina Vostroknutova (task team leader and lead author), Ashley Taylor (lead author), Barbara Cunha, Agim Demukaj, Faya Hayati, Sandra Hlivnjak, Sanja Madžarević-Šujster, Suzana Petrović, Lazar Šestović, Hilda Shijaku, and Bojan Shimbov. Additional contributions were made by: Maria Davalos, Trang Van Nguyen, Cesar A. Cancho, Alexandru Cojocaru, William Hutchins Seitz, and Monica Robayo (regional poverty trends); Johanna Jaeger (financial sector); Raymond Muhula and Tony Verheijen (public wages). Anne Grant provided assistance in editing, and Budy Wirasmo in designing this report. Valentina Martinovic, Pegi Ylli, Helena Nejedla, Nejme Kotere, Samra Bajramovic, Ivana Bojic, Enkelejda Karaj, Hermina Vukovic Tasic, Jasminka Sopova, Boba Vukoslavovic, and Dragana Varezić assisted the team with logistics.

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This and previous SEE RERs may be found at: www.worldbank.org/eca/seerer.

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1. Overview

Growth in the six South East European countries (SEE6) rebounded to 2.1 percent in 2015, as investment revived (Table 1.1). In Serbia, Kosovo, Montenegro, and Albania, investment, both domestic and foreign, was the main source of growth. The investment growth push built on a sustained positive contribution from net exports. The external environment and previous structural reforms gave support especially to manufactured exports. The traditionally high contribution from consumption took a back seat in 2015.

Table 1.1: Growth to pick up through 2017

Real GDP growth, in percent	2014	2015e	2016f	2017f
Albania	2.0	2.6	3.2	3.5
Bosnia and Herzegovina	1.1	2.8	2.6	3.1
Kosovo	1.2	3.6	3.6	4.0
Macedonia, FYR	3.5	3.7	3.7	4.0
Montenegro	1.8	3.4	3.7	3.1
Serbia	-1.8	0.8	1.8	2.3
SEE6	0.3	2.1	2.6	3.0

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

The SEE6 region is not only growing but also rebalancing to more durable sources of growth. Like many other countries, the tightening in external financing conditions during the global financial crisis led to a significant economic adjustment in the SEE6. Current account deficits declined substantially, from 18.5 percent of GDP in 2007 to 6.5 percent in 2015, contributing to a rebalancing of the sources of growth. Between 2007 and 2015 the share of consumption in GDP in the region fell by 6 percentage points, while the share of exports rose by 10 percentage points. Further rebalancing was seen in 2015 in Serbia, Albania, and Kosovo where growth was increasingly driven by private investment. Across the region, wages in manufacturing have also started moving in line with productivity, a process that is vital for sustaining growth though exports. A continued shift in the sources of growth from the unsustainable pre-crisis model of consumption fueled by capital inflows to private investments and exports is needed to ensure that the economic expansion is sustained.

While higher growth in 2015 brought new jobs in the private sector, and helped poverty reduction to resume, unemployment is still entrenched. In 2015, as growth rebounded across the region, job creation picked up in the private sector. Generation of more jobs and lower inflation have supported real income dynamics, allowing poverty reduction to resume. In Albania, FYR Macedonia, Montenegro, and Serbia, the average estimated poverty rate declined by 2 percent between 2013 and 2015. That means that some 140,000 people in those four countries (or 1 percent of their combined population) have escaped poverty, measured against the regional standardized benchmark of US$5 a day (in 2005 PPP). Despite an expanding economy and employment that is finally responsive to economic growth, however, on average unemployment in the region is still 21.5 percent.

In 2015, fiscal deficits continued to narrow in all SEE6 countries except Montenegro. Expenditure consolidation was most effective in Albania and Serbia, but revenue gains were supportive across the region. Fiscal consolidation efforts in the region are focused on reforming entitlement programs, reducing the public sector footprint, and improving public sector performance. The fiscal challenges are significant: sizable public wage bills that exceed 12 percent of GDP in Bosnia and

Herzegovina and Montenegro; substantial and poorly targeted social spending that averages over 13 percent of GDP; and inefficient public investment that funds projects with low economic and social returns. For a sustained impact on deficits, shifting the composition of public spending to more productive and equitable areas and mobilizing more revenue are both important. Despite progress on cutting public spending and bringing in more revenue, public debt-to-GDP continued to increase in 2015 (Table 1.2).

With inflation at historic lows, accommodative monetary policy supported growth, and credit to the economy slowly began to grow. Lending rates fell in all countries and lending to households picked up. However, NPLs averaging 14.7 percent of total loans still burden bank balance sheets and, combined with concerns about collecting on collateral, dampen credit growth. Restrictive fiscal policy and reduced external imbalances, along with selective national bank interventions, helped keep currencies relatively stable against the euro.

The near-term baseline outlook for the region is positive. Growth is forecast to rise from 2.1 percent in 2015 to 3 percent in 2017 as domestic demand recovers. In the SEE, the revival of investment is expected to continue, and the economies are expected to benefit from the support of consumption and exports. Over the medium term the dividends of continuing structural reforms in many SEE countries should also support growth.

Downside risks threaten the recovery. The potential for higher external volatility in global financial markets threatens financing options, especially for countries with poor policy environments and more significant imbalances. Growth in major export markets, especially the EU, and movements in global oil prices also pose risks to the outlook, both upside

Table 1.2: Fiscal deficits are projected to narrow but debt ratios will remain high

Percent of GDP unless otherwise stated	2014	2015e	2016f	2017f
Real GDP growth (percent)	0.3	2.1	2.6	3.0
Consumer price inflation (percent, period average)	0.9	0.9	1.6	2.0
Public revenues	34.7	35.0	35.3	34.7
Public expenditures	38.8	38.8	38.5	37.5
Fiscal balance	-4.1	-3.8	-3.2	-2.8
Public and publicly guaranteed debt	52.1	55.1	56.9	57.4
Goods exports	24.3	25.2	25.6	26.7
Trade balance	-17.0	-15.8	-15.2	-16.1
Current account balance	-7.2	-6.3	-6.6	-6.8
External debt	64.6	67.3	68.0	67.7
Non-performing loans (percent of gross loans)	15.8	14.7	..	..
Unemployment rate (percent, period average)	22.5	21.7	..	..

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

and downside. As elections processes unfold in several countries in 2016, risks caused by domestic political dynamics are also likely to rise.

Fiscal and current account deficits must decline further to support growth. The rebound of growth in the SEE and improved near-term outlook is welcome news. But sustaining growth into the medium term will require further reduction in both fiscal and current account deficits, which are still sizable and contribute to significant financing needs, especially with the high levels of public and external debt. If not addressed, these imbalances could crowd out private investment, erode external financing options, and reduce policy space to respond to future economic shocks.

Sustaining the nascent rebalancing requires unlocking the growth potential of the SEE6 economics by reversing productivity dynamics that have been deteriorating since 2008. Between 2000 and 2008 total factor productivity, i.e. how efficiently inputs of labor and capital are used in production, provided solid support for growth. Since the global financial crisis broke, across the region productivity has fallen, often subtracting from growth. While physical and human capital are vitally important to the region's potential growth, boosting productivity is paramount, given potential headwinds for investment from financing costs, demographic factors and the time it takes to improve human capital.

The agenda for reducing the structural rigidities that impede growth is broad-based and centered on five pillars: Eliminate disincentives and barriers to formal employment; Improve the business climate and governance; Reduce the size of government while improving quality of service delivery; Deepen trade and financial integration; and Ensure that natural resource use is sustainable.

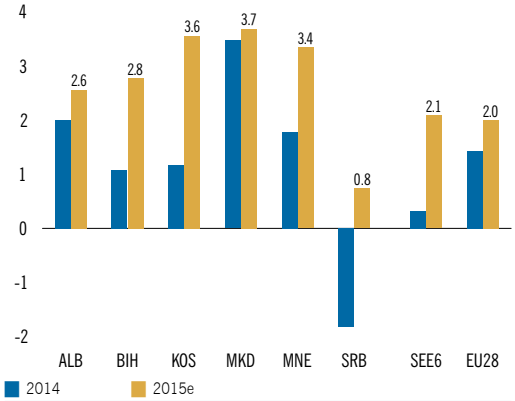
2. A Strengthening Economic Recovery

Growth Gains Momentum as Investment Revives

Growth in the six South East European countries (SEE6) averaged 2.1 percent in 2015, significantly higher than the 2014 flood-impacted figure of 0.3 percent.[1] The regional growth projection for 2015 was revised up initially from the 1.3 percent forecast in the January 2015 RER, a magnitude broadly in line with improvements in growth across Europe. After contracting by 1.8 percent in 2014, the Serbian economy grew by 0.8 percent in 2015, in spite of continuing fiscal adjustment and the drought that followed the 2014 floods. The other SEE6 countries also grew faster compared to 2014: FYR Macedonia by an estimated 3.7 percent, Kosovo by 3.6 percent, Montenegro by 3.4 percent, Bosnia and Herzegovina by 2.8 percent, and Albania by 2.6 percent (Figure 2.1).

Figure 2.1: SEE6: From stagnation to growth

Real GDP Growth, 2014 and 2015, percent



Source: Data from national statistical offices and Eurostat (2015).
Note: Growth values for 2015 are estimates.

1 The SEE6 are Albania, Bosnia and Herzegovina, Kosovo, FYR Macedonia, Montenegro, and Serbia.

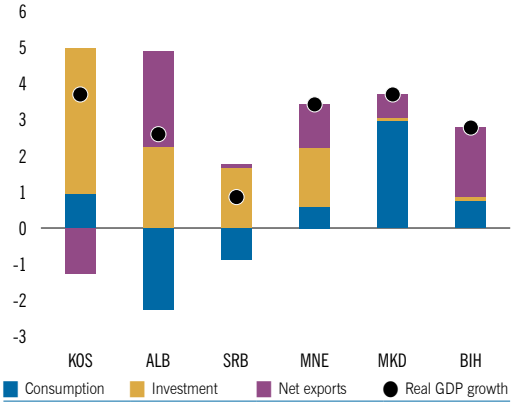
Investment has notably revived as the SEE6 economies expanded in 2015, which added to the continued push from net exports. Although the moderate expansion in economic activity in 2015 in the European Union (EU) was based on consumption, in SEE6 a main source of growth was investment, both domestic and foreign (Figure 2.2). This was the case for Serbia, Kosovo, Montenegro, and Albania, a welcome change from previous years, when consumption was the common driver of growth in SEE countries (Figure 2.3). In 2015 in Serbia, broad-based growth in manufacturing was accompanied by a marked rise in private investment, supported by regulatory reforms, cheaper credit, and a 46 percent increase in foreign direct investment (FDI). In Kosovo, the pick-up in private investment was fueled by greater access to loans and by FDI. In Albania, large energy projects were behind robust capital formation. The new growth push from investment came on top of a sustained positive contribution from net exports; especially in Albania where net exports were the strongest driver of growth in 2015. Most notable expansion of exports linked to growing manufacturing exports in Serbia and FYR Macedonia, and to tourism services in Montenegro and Albania.

Consumption contributed less to growth in 2015 than it did in the recent past. Only in FYR Macedonia did consumption pull the most weight (fueled by employment and real wage increases) as healthy growth in construction, retail trade, and services was supported by expansion of credit and by government spending related to the political

cycle. In the rest of the region, it contributed less to growth than earlier. Consumption subtracted from growth due to the fiscal adjustment that restrained nominal wages in Serbia, and to the uncertainties in the labor market and reduction of remittances from Greece and Italy in Albania. In Bosnia and Herzegovina, consumption was supportive of growth although much less so than in the recent past. In Kosovo, growth in private consumption remained strong as remittances, wages, and pensions continued to rise.

Figure 2.2: Revival of investment was seen in 2015 in most countries

Decomposition of real GDP growth, 2015

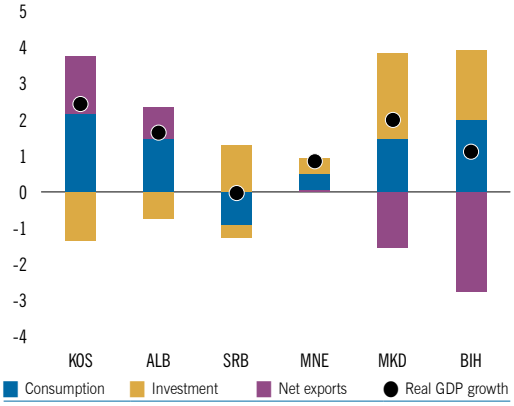


Source: World Bank estimates based on data from national statistical offices.

The change in growth drivers in 2015 may be the start of a broader rebalancing in SEE6. A continued shift in the sources of growth from unsustainable pre-crisis model of consumption fueled by capital inflows and remittances, to that driven by private investments and exports, is needed to ensure robust yet sustainable economic expansion. Consumption as a share of GDP has declined by about 6 percentage points and exports have increased by 10 percentage points in the region on average between 2007 and 2015, suggesting slow but visible progress on rebalancing. Current account deficits have also declined substantially. In 2015, there were also signs of a rebalancing towards growth driven increasingly by private investment in Serbia, Albania and Kosovo (Figure 2.4). This in part reflects the ongoing fiscal consolidation efforts in Serbia and Albania, while in Montenegro public investment dominated private investment, adding to already high fiscal pressures. FYR

Figure 2.3: Previously, consumption was the dominant driver of growth in most countries

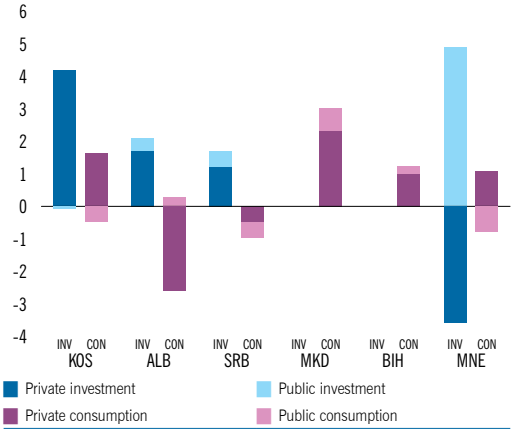
Decomposition of real GDP growth, 2012-14



Source: World Bank estimates based on data from national statistical offices.

Figure 2.4: Private investment demand led growth in Serbia, Albania and Kosovo

Contributions to growth, pps, 2015



Source: World Bank estimates based on data from national statistical offices.

Note: The public-private breakdown in investments is an estimation for most countries. Investment split is not available for MKD and BIH.

Macedonia started a rebalancing process earlier than the rest of SEE6, driven by public investment and improvements in the business environment. But the contribution of investment to growth fell to zero in 2015, with domestic uncertainty one likely reason. The key question, addressed in more detail in Section 3 of this report, is whether the rebalancing can be sustained in the medium- and long-term.

Higher Employment and Lower Inflation Helped Reduce Poverty

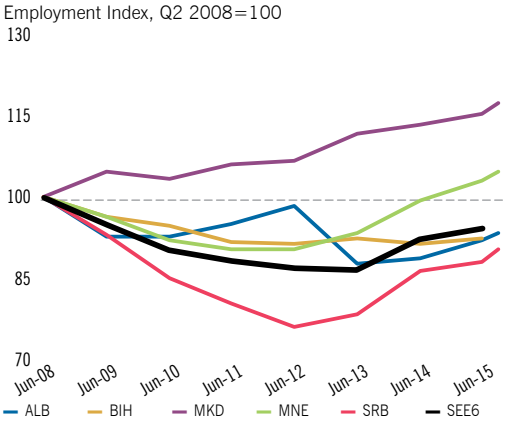
Economic growth and labor market reforms supported job creation in 2015, especially in the private sector, in most SEE6 countries (Figure 2.5). In Serbia, reform of the Labor Law in 2014 increased hiring flexibility, rationalized severance payments (limiting employer's responsibility to years with the current employer), reformed benefits, and intensified enforcement. Although overall employment fell by 1 percent (y-o-y) in the last quarter of 2015, these timely reforms supported creation of private jobs at a time when public employment fell by 5 percent as part of public sector reform and SOE restructuring. Montenegro managed to reduce unemployment by 1 percent (y-o-y) in September; but jobs were created mostly in services. In Albania, growth in employment, by 1.9 percentage points (pp), was accompanied by an increase in the labor force, leading to a modest decline in unemployment to an average of 17.1 percent for 2015. In FYR Macedonia, increases in manufacturing and public administration jobs were among the key drivers of the unemployment reduction from 28.1 to 26.1 percent in 2015. In Bosnia and Herzegovina, however, faster growth did not bring substantial employment benefits, with unemployment rising by 0.2 percentage points.[2] Notwithstanding job creation in 2015, employment remained below pre-crisis levels (Figure 2.5).

Employment growth reduced estimated poverty. In the immediate aftermath of the 2008 crisis, slow economic growth caused a reduction in employment and a contraction of consumption, reversing progress in reducing poverty. In 2015, as growth rebounded across the region and job creation picked up, poverty reduction resumed. Even though labor income constitutes only half of household income—a very low share compared to other middle-income countries—improving labor market outcomes facilitated poverty reduction. In Albania, FYR Macedonia, Montenegro and Serbia, the average estimated poverty rate[3] declined by 2 percent between 2013 and 2015.[4] Put differently, one percent of population or some 140,000 people in these four countries are likely to have escaped poverty, measured against the regional standardized benchmark. During this period, poverty is estimated to have

2 Based on LFS data.
3 Poverty line of $5/day in 2005 PPP is used henceforth.
4 The estimate for FYR Macedonia is based on an income aggregate, while estimates for the other three countries are based on consumption aggregates. Poverty data for Bosnia and Herzegovina and Kosovo using the international poverty lines is not available.

gone down in all SEE6 countries, but to a varying extent, depending on the speed of economic and labor market rebound as well as the shape of the welfare distribution, with faster reduction in countries where concentration around the poverty line is higher. Going forward, poverty is expected to decline, but challenges for poverty reduction remain with the high volatility of growth, limited fiscal space for mitigating adverse shocks, and still low labor force participation and high unemployment rates.

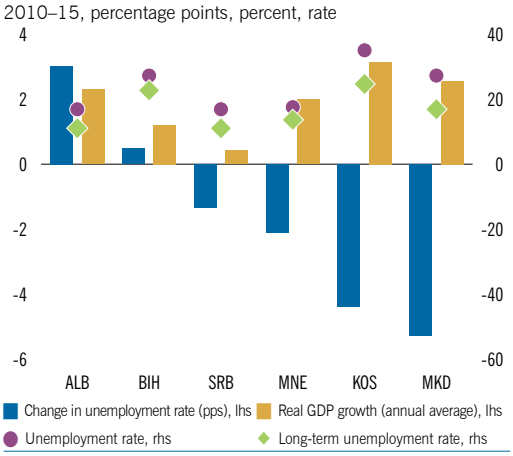
Figure 2.5: Growth in 2015 created jobs, but employment is still below pre-crisis levels in most countries



Sources: Data from national statistical offices.
Note: The regional total excludes Kosovo.

to this publication. Long-term unemployment is especially high: as many as 62 percent of the unemployed in FYR Macedonia and 82 percent in Bosnia and Herzegovina have been without a job for over a year (Figure 2.6). High long-term unemployment in the presence of positive economic growth suggests structural issues that constrain employment growth. A combination of factors have been cited as examples of such issues in the region, such as an unfinished market transition that makes for an inflexible labor supply, high labor costs, and other

Figure 2.6: Unemployment remained high, despite the rebound of economic growth



Sources: Data from national statistical offices.
Note: Long-term unemployment is presented as percentage of the labor force, instead of the conventional percentage of the unemployed. June 2010 to June 2015 changes are used. Unemployment and long-term unemployment are for 2015.

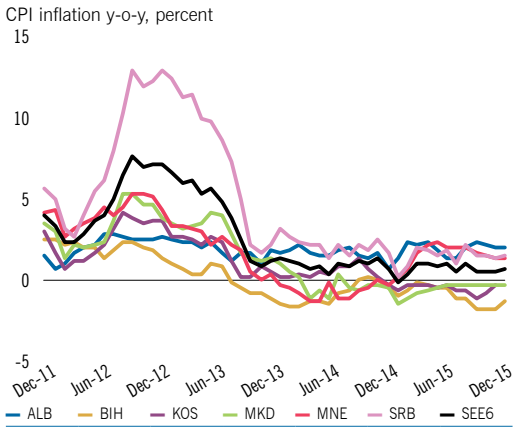
In the last five years, economic growth has not always reduced unemployment, which remains entrenched (Figure 2.6). Average unemployment in the region is still 21.5 percent. The average employment rate in SEE6 is practically unchanged since 2006 at about just 45 percent, compared with 64 percent in the EU. The youth unemployment rate is generally about double that of the working-age population, see the Special Topic supplement

rigidities. Without fundamental structural reforms, a sustainable long-term decrease in structural unemployment is unlikely.

Low inflation helped boost purchasing power of the poorest households. In 2015 inflation in the SEE6 region remained subdued, in spite of the recovery in growth. After inflation of 0.9 percent in 2014, growth in the consumer price index averaged just

1 percent in 2015, ranging from -1 percent in Bosnia and Herzegovina to 1.9 percent in Albania and Serbia (Figure 2.7). Meanwhile, deflation persisted in FYR Macedonia and Kosovo, similar to that seen in EU members in Central and Eastern Europe in 2015 where prices fell by 0.4 percent on average. Lower prices bolstered real household incomes overall. However, the SEE6 region saw food prices rise in the first half of 2015, from a low base in 2014, leading to inflation of food prices. The largest contribution came from higher prices for seasonal agricultural products, especially fruits and vegetables, but also oils and fats. The largest surge in food prices was in Montenegro; it pushed the economy from deflation in 2014 to headline inflation of 1.5 percent in 2015. Toward the end of 2015 food inflation slowed considerably, however, although in Albania food price inflation reached 5.2 percent in December 2015.

Figure 2.7: CPI inflation remained subdued



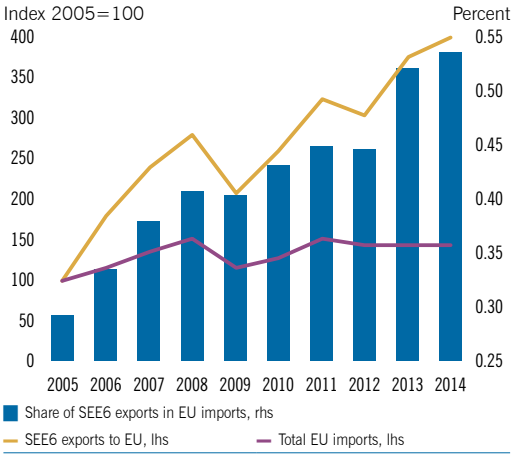
Source: National statistical offices.
Note: SEE6 is GDP-weighted average.

The External Environment Supported Exports

Faster expansion in the EU helped SEE6 countries increase exports, which became a large contributor to growth in several countries. Real GDP in the EU recovered from a contraction in 2013 to growth of 0.9 percent in 2014 and then 1.5 percent in 2015. While world trade volume again expanded by 3.6 percent in 2015 (the same rate as in 2014), imports of the EU grew by only 1.6 percent. Yet, the SEE6 countries have shown remarkably consistent progress in increasing their exports to the EU, the region's major trade partner.[5] In the past decade, the share of SEE6 exports to the EU market has doubled, though admittedly the base was very low (Figure 2.8 and Figure 2.9). Serbia was the main driver of this trend; in 2015 its exports grew across the board, but industrial exports took the lead: growth from new automotive parts exporters and from other medium-sized companies more than compensated for a steep drop of 13.6 percent in the exports of FIAT, a major investor in the country; steel, tobacco, food, and travel and professional services also contributed to export growth (see Box 2.1). Services boosted Montenegro's exports in 2015 as tourism increased due to some diversion of tourists from other destinations like Greece and Turkey. For Bosnia and Herzegovina the main contributors to export growth were food, textiles, and mechanical appliances.

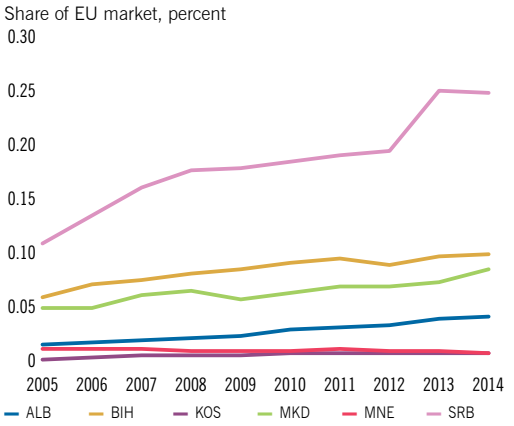
5 The EU accounts for about 65 percent of SEE6 exports, and less than 3 percent of the region's exports go to China and the USA. The majority of the remaining exports are accounted for by intraregional trade.

Figure 2.8: SEE6's share in the EU market doubled between 2005 and 2014



Source: Data from national statistical offices.

Figure 2.9: Serbia led the expansion of SEE6's exports to the EU



Source: Data from national statistical offices.

Box 2.1: The Automotive Industry: Stimulating Growth and Exports

The automotive industry has a long history in Serbia, which began exporting automobiles in 1953 as a result of cooperation between Kragujevac-based Zastava and FIAT. It continued with the 2008 joint-venture agreement with FIAT to create FIAT Automobiles Serbia (FAS), which is 67 percent owned by FIAT and 33 percent by the Serbian government. Total investment in FAS has since exceeded €1 billion.

In addition to FIAT, a lively supplier industry has since come into being, consisting of both local and foreign-owned firms. Total investments in these companies are estimated at over €200 million (1.2 percent of total foreign investment in Serbia), and they have created about 3,000 jobs (0.1 percent of total employment, and 0.5 percent of manufacturing employment). These companies have also created demand spillovers especially in services: transport services (rail in particular), as well as electricity, etc. Some of the largest foreign companies in this group are Magneti Marelli, Johnson Controls, Draxlmaier, Bosch, Lames, Yura, Leoni, Grundfos, Magna, Contitech, and Mecaplas. There are also about 20 domestic companies.

As a result, in 2015 turnover in the Serbian automotive sector exceeded €2.7 billion, about 8 percent of GDP, having quadrupled since 2005. Production of vehicles accounts for almost 60 percent of the total turnover; tires and wiring systems account for about 10 percent each. Most of these companies are export-oriented; they accounted for 21 percent of total Serbian exports in 2015, of which FAS accounted for 12 percent. FAS grosses about €1.5 billion in turnover from the Fiat 500L but has capacity to produce other models as well. Other large exporters, which produce automotive supplies, are from France, Korea, Germany, and Denmark.

FYR Macedonia also has a dynamic automotive sector, building on the country's experience since it was part of Yugoslavia. The sector has been significantly reinforced as a number of companies began operating in the country in the last five years, including Johnson Matthey, Johnson Controls, Van Hool, Key Safety Systems, Draexlmaier, and Kromberg & Schubert. Their total investments

are estimated at €235 million, about 5.5 percent of total foreign investment, and they have brought about significant changes in FYR Macedonia's export structure. In the last five years, automotive exports have expanded almost six-fold in nominal terms, reaching €1.7 billion in 2015, 20 percent of GDP. Johnson Matthey alone accounts for more than 40 percent of exports of foreign companies and about 20 percent of overall exports. Combined, these companies have since 2011 created an estimated 15,000 jobs, about 20 percent of all new jobs, of which one-third are skilled and two-thirds low-skilled (the latter are concentrated in two companies that produce wire harnessing). While this FDI segment has created spillovers in transport, logistics, tooling, and auxiliary services (including construction services) that were estimated at be worth €50 million in 2014, linkages to the local economy are still limited.

In Bosnia and Herzegovina, Volkswagen has a factory near Sarajevo, and two factories in Banja Luka and Mostar produce buses. In addition, German company Car Trimm, a large maker of seat covers and leather upholstery for the car industry, has a factory in Zepce. The German group MANN+HUMMEL has a facility in Tesanj producing filter elements for the international automotive and mechanical engineering industries. Remus Innovation, an Austrian investor and a world market leader in sport exhausts, has a production facility in Sanski Most. The well-known SIAC Group from Italy, which produces cabins for agricultural machines, also has facilities in Bosnia and Herzegovina in Krupa Kabine. Other investments include those of Bosancar from Italy which produces vehicles for construction and agriculture sectors and of Novi Most, a Slovenian investor, which produces welded safety structures for the European producers of buses, trucks, mechanical equipment and other different machines for the company. Importantly, new local companies are emerging as major suppliers to world-renowned car producers, among them Prevent Group and Bekto Precisa. Prevent, which has been in operation for about 17 years, now has three factories in the automotive industry. It produces textile and leather seat covers for Volkswagen, BMW, Citroen, Peugeot, Ford, and others. Each year two million cars around the world are equipped with seats produced in Bosnia and Herzegovina. Prevent also produces brakes and other metal and plastic car parts. In its 10-year history Bekto Precisa has also grown rapidly. It now employs about 500 people and supplies metal and plastic parts to major car producers, such as BMW, Porsche, and Audi.

Source: SIEPA, the Serbian Customs Administration, Directorate for Technological Industrial Zones of the Republic of Macedonia, the State Statistics Office, and IFC.

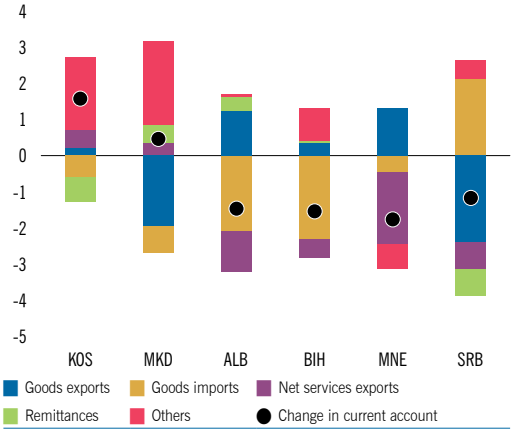
Although improved external demand was the primary reason for export growth in 2015, real depreciation against trading partners also helped export performance. With respect to trading partners, moderate real effective exchange rate depreciation occurred over the year, ranging between 1 and 3 percent, supporting higher exports in 2015 (see Section 2). But it was the improved external demand that played the leading role in export performance. Addressing other drivers of competitiveness, such as labor market and wage rigidities, education systems, quality of public services, logistics costs, and the investment climate will be essential to support any further sustained increases in exports.

While commodity exporters suffered from lower prices, higher investment fed through into higher imports. Low prices for oil and base metals in international markets particularly affected the exports of Albania, Bosnia and Herzegovina, Montenegro, and Kosovo—countries where commodities constitute a fairly large share of their exports. In Albania, where crude oil and base metals exports account for

nearly 40 percent of total exports, production was more than halved after oil prices dropped. In 2015, goods exports went down by 7.2 percent y-o-y, despite steady growth in exports of textiles and shoes. Because of the decline in base metal exports, Kosovo's goods exports stagnated, growing by only 0.2 percent, and Montenegro's fell by 7.3 percent. In contrast, countries whose exports are manufacturing-intensive, such as FYR Macedonia and Serbia, are benefitting from the current environment (Figure 2.10). Throughout the SEE6, low oil prices suppressed import growth. However, strong investment in almost all SEE6 countries was reflected in higher imports of machinery and equipment. While goods imports declined in many countries, a rebound in domestic demand explains some of the pickup in imports, by 5.6 percent y-o-y, seen in Serbia. On balance, the SEE6 trade deficit narrowed to 15.9 percent of GDP in 2015 as goods exports increased by 0.7 percent on average and goods imports declined by 2.3 percent.

Figure 2.10: Current account deficits mostly narrowed

Contribution to change in current account deficit in 2015, relative to 2014, percent of GDP

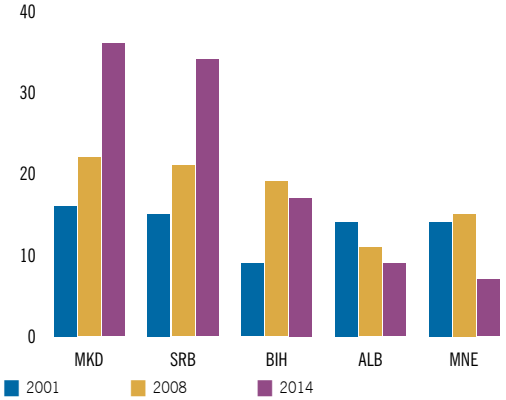


Source: Data from central banks and national statistical offices.

Albeit still mainly low-tech, export sophistication performance is improving. Within the region's medium-term goods export performance, there has been an increase in their sophistication mainly in the manufacturing-exporting countries (Figure 2.11), largely on the intensive margin. However, overall the SEE6 export basket remains predominantly low-tech.

Figure 2.11: Mixed performance on export sophistication

Share of high- and medium-tech goods exports, percent of total



Source: World Bank staff calculations based on WDI, WITS, PWT8.0 and National Statistical Agencies data.

Note: The classification is based on technological ranking of manufactured products as in Lall et al., .2006. The 'Sophistication' of Exports a New Measure of Product Characteristics.

In sum, external imbalances continued to narrow in most SEE6 countries. In 2015, Albania, Bosnia and Herzegovina, Montenegro, and Serbia reduced their current account deficits-to-GDP, while Kosovo and FYR Macedonia saw them widen (Figure 2.10). The drivers of the narrowing external deficits in SEE6 were mixed. While imports contracted as a whole, in part due to lower oil prices, their decline was muted in some countries due to

the supporting role of intermediate and capital goods in investment and manufactured export production. The boost in exports came from the services side, such as transport and travel, as well as from manufacturing shipments to Europe.

Higher External Volatility Affected Financing Availability

In 2015, heightened volatility in capital inflows affected the ability of emerging and developing economies to finance external imbalances. Most beneficial for the region has been the gradual pick-up in activity in the EU, falling global oil prices, and the weakening of the euro against the U.S. dollar. But as U.S. interest rates move to normalize, the outlook for capital flows to emerging markets weakened in 2015, with projections for inflows in 2016 and 2017 also downgraded.[6] In early 2016 global market conditions have been more turbulent, with markets reacting to global economic news and changes in expectations of the path of future U.S rate increases. This uncertainty has contributed to a reduction in U.S. Treasury and German government benchmark yields (the latter have moved into negative territory) while emerging market spreads increased through mid-February before falling back. Markets remain susceptible to further changes in risk appetite with potential impact for the future cost and availability of financing for SEE6 countries like Serbia, Albania, and FYR Macedonia that require significant gross fiscal financing. In the case of Montenegro, the interest rate on the March 2016 Eurobond issue (€300 million 5-year bond) was priced 200 basis points above the previous year's issue. The rise reflects not only global changes in investors' risk aversion, but also their reevaluation of Montenegro's fundamentals with the increase in the fiscal deficit.

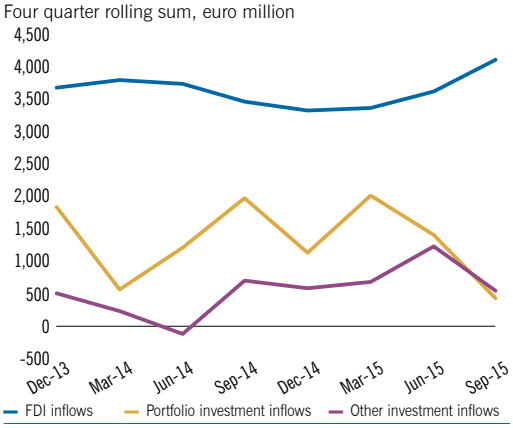
Although FDI to the region has increased, tighter international liquidity conditions are likely to make it harder to compete for external financing. The projection of sustained high current account deficits in the region, combined with the uncertain international financial environment, suggest that external financing risks remain high. FDI in both euro terms has picked up through 2015 in a number of countries in the region (Figure 2.12). For example, in Montenegro the increase was driven by real estate projects, bank recapitalizations, and the entry of banks; in Albania by the construction of the Transadriatic pipeline and a hydropower plant; and in Serbia by FDI in manufacturing (motor vehicles), trade and baking sector. In terms of overall financing risks, the basic external balance i.e. the sum of the current account balance and net direct investment inflows, was positive for FYR Macedonia, Montenegro, and Serbia, and direct investment covered 61 percent of Albania's current account deficit as well. The situation in Bosnia and Herzegovina raises

6 For example, the World Bank January 2016 Global Economic Prospects report (GEP) projects capital flows to developing ECA to be 2.7 percent of GDP in 2015, down from 4.6 percent in 2014, and rising slightly to 3.1 percent in 2016. The projections were revised downward from the June 2015 GEP by 2.3 pp for 2015 and by 2.7 pp for 2016.

concern about external financing risks, because in 2015 FDI covered only 24 percent of the projected current account deficit. Portfolio inflows, which in the region are mainly driven by sovereign bonds flows, were positive only in Albania and Montenegro. Net portfolio outflows were highest in Serbia (0.9 percent of GDP), as government external bond financing declined relative to 2014. Other investment outflows were large in the banking sector in Montenegro and in the non-banking sector in FYR Macedonia.

Policies will be key in competing for scarce financing options. Countries with credible reform programs will be more attractive to investors, and are more likely to retain or receive financing when the sources of financing are scarce. The following sections discuss short- and long-term policies that are likely to matter for growth and for attracting capital in the near-term.

Figure 2.12: FDI inflows increased to SEE6 while other capital inflows declined



Source: Data from central banks and national statistical offices.
Note: Inflows = liabilities on the financial account.

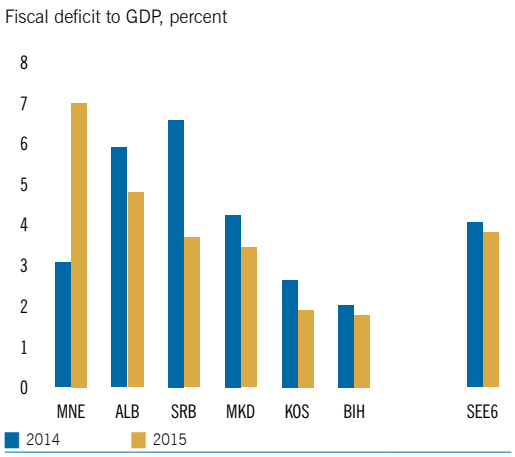
3. Supportive Policy Reforms Are Ongoing

Fiscal Adjustment Advancing

Continued fiscal consolidation in 2015 narrowed deficits in all SEE6 countries except in Montenegro. The largest reductions in 2015 were in Serbia (from 6.6 percent of GDP to 3.7 percent); followed by Albania (from 5.9 to 4.8 percent, with public arrears clearance amounting to 1.3 percent); FYR Macedonia (from 4.2 to 3.5 percent); and Kosovo (from 2.6 to 1.9 percent) (Figure 3.1). Only in Montenegro did the fiscal deficit widen significantly (from 3.1 to 7.0 percent of GDP) after a spike in capital expenditures and a shortfall in revenues. In the region, the average deficit declined negligibly between 2014 and 2015, from 4.1 to 3.8 percent of GDP, while public debt moved up to average 55 percent of GDP, revealing difficulties in overcoming structural public finance shortcomings.

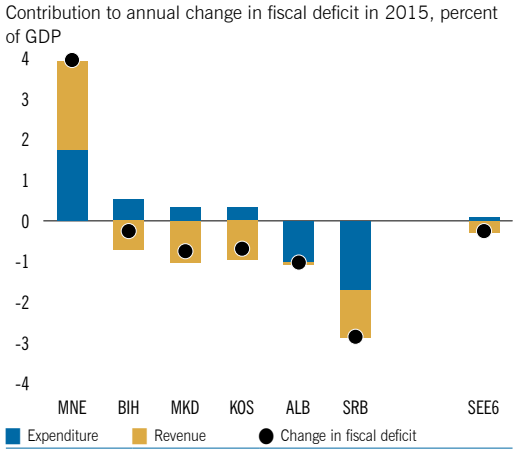
Revenue gains drove much of 2015's fiscal adjustment. Revenue increases throughout the region were related to policy changes, which in Albania, Serbia, and Kosovo were combined with one-off gains. In Serbia, one-off factors amounted to 1.1 percent of GDP; they included dividends and fees from public enterprises and payments on licenses for the 4G network. Among the more lasting policy changes were a rise in the VAT rate in Kosovo; higher excises in Serbia and in Bosnia and Herzegovina; and reintroduction of the profit tax on non-reinvested earnings in FYR Macedonia. Efforts to improve tax collection also advanced; new IT systems now support collection of 95 percent of both individual and corporate taxes in Serbia and of all corporate tax payments in FYR Macedonia. Offsetting these gains was revenue from VAT and excise duties, which came in lower than expected almost everywhere in the region. The problems can likely be attributed to still inadequate tax collection processes, tax concessions and exemptions for the foreign segment of the economy, and lower retail oil prices.

Figure 3.1: Fiscal deficits narrowed



Source: Ministries of Finance.

Figure 3.2: Spending restraint contributed to large fiscal adjustments in Albania and Serbia



Source: Ministries of Finance.

Several countries are moving to enhance revenues. Efforts to widen the revenue base, reduce the disproportionate reliance on labor taxes (notably social security contributions, SSCs), and professionalize tax administration are necessary to support structural improvements in public finance management in SEE6. To that end, Albania has launched an anti-evasion campaign that incorporates a public awareness campaign, tougher penalties in the Tax Procedures Code, and hiring of more tax inspectors. Tax procedures are also being changed to close regulatory loopholes in VAT and excises, and the country is gradually moving to risk-informed monitoring. In Serbia, the tax administration has successfully adopted the Transformation Plan approved by the government in June 2015.

Fiscal consolidation efforts have started to deliver positive results as countries reform entitlement programs, reduce the public sector footprint in the economy, and support public sector performance. Ingrained structural problems across SEE6 include high public consumption and unproductive public transfers. Serbia and Albania both reduced their expenditure-to-GDP ratio in 2015. Serbia was able to cut public spending by 1.7 percent of GDP during 2015 thanks to savings on public wages and pensions, substantially reducing the fiscal deficit (Figure 3.2). The government's ambitious fiscal consolidation program is now centered on wage bill reforms which, along with pension reforms, are expected to deliver three-quarters of the planned fiscal deficit reduction by the end of 2017 (see Box 3.1). Similarly, in Albania, restrained spending on wages, social services and interest helped reduce fiscal imbalances.

Box 3.1: Serbia's Reform of the Public Wage System

Public sector reform was one of the first priorities for the government of Serbia appointed in 2014. Fiscal weaknesses in 2012–14 caused public debt to surge by 26 percentage points of GDP and heightened the urgency of fiscal adjustment. General government expenditures averaged 45.6 percent of GDP during that period, and the largest single spending category, the wage bill, accounted for 11 percent of GDP in 2013.

Apart from wage bill expenditures being high, they were also non transparent, posing issues of fiscal predictability. The wage system included 5 different base salaries, 900 different job coefficients, 2,200 job titles, 71 different elements of remuneration, based on 19 laws and a plethora of by-laws. The payment of salary supplements under the different elements of pay was not rule-based, leading to significant distortions in the pay system. De facto, institutions have the incentive to maximize the use of wage bill resources. Establishment control principles were circumvented through the largely uncontrolled hiring of temporary employees.

Since 2014, the government has targeted reducing the wage bill through a comprehensive reform of public administration designed to raise the quality and efficiency of public services; motivate and better reward public employees; and build up the capacity of the Serbian Public Administration to manage the EU accession process. The reform is based on two strategic documents, the Public Administration Reform (PAR) Strategy and the Action Plan for Implementing the PAR Strategy.

To achieve its reform goals, the government has moved on two fronts, legislative and administrative. The Ministry of Finance (MoF) created a Registry of Employees in the core Public Sector (not including state-owned enterprises), which contains individual information on about 465,000 employees. While based on self-reporting, which poses risks of data quality, data in the registry are regularly cross checked with the data of the mandatory social insurance registry to reduce the scope for errors.

In terms of cost control, the wage indexation formula was scaled down, followed by a nominal reduction in wages by 10 percent in November 2014, and the introduction of a ceiling on maximum public sector salaries. In addition to the employee registry, the MoF, in partnership with the Ministry of Public Administration and Local Self-Governance (MPALSG), established the Registry of Institutions in the Public Sector.

Establishment control was strengthened through a hiring freeze established in January 2014, which allowed a maximum of 1:5 replacements. The hiring freeze is still in place, though is being phased out and replaced with a system of hard employment ceilings by institution, set under the Law on Maximum Number of Employees in the public sector, adopted in Summer 2015. Under this Law, ceilings for individual institutions are now being proposed and set by Government decree on a 6-monthly basis. Finally, the number of contract employees a ministry or agency could hire was limited to 10 percent of its total staff, and ministries were given 3 months to bring numbers in line with this ceiling.

Other measures are underway to ensure that this reform is sustainable. In particular, in early 2016 the government enacted the Law on Public Sector Employees Salary System, which sets the parameters for the pay and grading system that apply across the public sector, to improve transparency and equity in the compensation structure. The Law addresses the unfairness caused by the large number of legislations on public sector compensation and the resultant discretion in setting salary levels. It provides for a uniform base rate and multipliers for each position and harmonizes about ten different base rates that existed before. The law creates a uniform pay structure for all categories of employment in the public sector, introduces a catalogue of positions, lays out the methodology for setting pay for various positions and grades, and provides a transparent criteria for bonus payments. In parallel, the government is conducting a thorough functional review of ministries and agencies to determine options for optimization, focusing on those ministries and agencies that employ most staff and deliver vital services, as well as on streamlining the more than 100 central state institutions that currently exist.

Source: World Bank

It is essential to further shift the composition of public spending to more productive and equitable areas. Although all SEE6 countries except Kosovo have reduced the public wage bill as a share of GDP over the past three years, wages still comprise a notably sizeable item in SEE6 budgets. For example, in 2015, Bosnia and Herzegovina and Montenegro had wage bills of about 12 percent of GDP. Social benefits have risen as a share of GDP in Albania, Kosovo, and Macedonia and remained flat in Bosnia and Herzegovina, Montenegro, and Serbia; there is general concern about their targeting and efficiency. Moreover, some recent policies will put added pressure on budgets. In Montenegro, amendments to the Law on

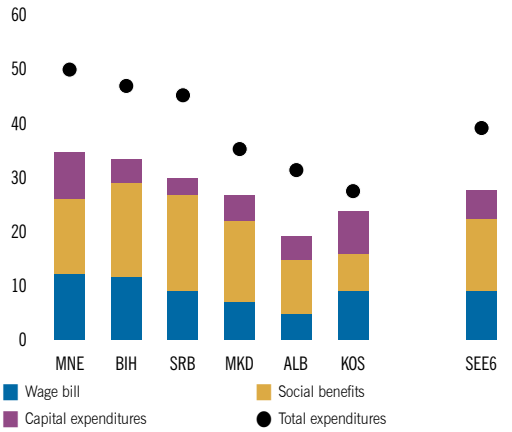
Pension Insurance which allowed for a rise in pensions on average by 3 percent and the rise in minimum pension by 20 percent, along with the amendments to the Law on Social and Child Care that introduced lifetime benefits for mothers of three or more children that amount to 70 percent of the average national net salary—would increase spending by 1.5 percent of GDP annually. In FYR Macedonia, pensions have been rising for the last four years, reaching 9.0 percent of GDP in 2015. Reforming the amounts and targeting of pensions and related social benefits is critical to effective medium-term fiscal consolidation.

Large public investment projects prompted the rise in public spending seen in several countries in 2015. Their budget share ranged from 3 percent of GDP in Serbia to 7 percent in Kosovo and 8.5 percent in Montenegro. Capital spending was cut throughout the region as part of the fiscal adjustment immediately after the 2008 global financial crisis. After growth returned, this budget item continued to grow in countries with traditionally high capital spending, though it continued to be restrained in countries that traditionally had lower capital spending. For example, in Kosovo, construction of highways added 2 percent of GDP in spending and in Montenegro 4.7 percent, and the level is expected to rise further in the medium term.

As in all countries, public capital spending in SEE6 should be rigorously evaluated to ensure that public money supports the projects with the highest economic and social returns. Bosnia and Herzegovina has made good progress in developing transparent evaluation criteria to state and entity public investment programs. Most SEE6 countries are establishing a single pipeline of public investment projects. Rigorous and transparent arrangements for appraisal, selection, and approval of investment projects and reinforcement of the institutions related to funding, management, and monitoring of projects will ensure quality delivery of public services, connect citizens and firms to economic opportunities, and serve as a central catalyst for

Figure 3.3: The burden of public wages and social spending remained high

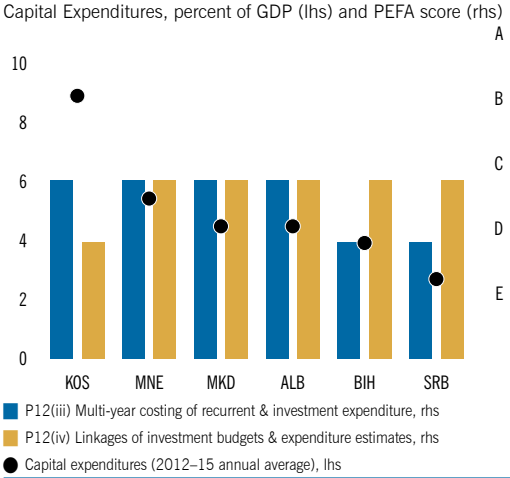
Public spending, 2015e, percent of GDP



Source: Ministries of Finance.

Figure 3.4: The efficiency of public investment management needs improvement

Capital spending (2012–15) and latest PEFA scores related to Capital Expenditures, percent of GDP (lhs) and PEFA score (rhs)



Source: Ministries of Finance, PEFA.

economic growth (see Box 3.2). In all countries, improving medium-term fiscal planning and public investment decisions will also support informed decision-making that will ultimately reinforce fiscal consolidation by raising the long-term return on public spending.

Box 3.2: Strengthening the Management of Public Investment

Improving public investment management (PIM) has been found to have significant benefits for growth and the efficiency of public spending. Countries with the most efficient PIM systems tend to have higher growth per dollar spent on public infrastructure than the least efficient countries.[7] While much of the literature confirms that public investment raises output, the magnitude of the impacts found varies due to uncertainties about fiscal multipliers on the demand side and inefficiencies on the supply side (Easterly and Rebelo 1993; and Warner 2014). The IMF (2014) found that in advanced economies public investment, defined as an unanticipated one percentage point of GDP rise in investment spending, shocks raise output by about 0.4 percent in the same year and 1.5 percent after four years; it also found that investment shocks have an even larger growth impact in countries with more efficient public investment, increasing output by 2.6 percent after four years.

The lack of clear national regulations and guidelines in the SEE6 region jeopardizes the quality and efficiency of core PIM functions. Currently, there is little or no assurance that projects are effectively screened for consistency with government policies and strategies, using formalized appraisal tools and independently reviewed. The responsibilities of stakeholders are not clear, causing ambiguity about levels of approval because of the overlap of some functions. There are also gaps in formalizing the requirements for project management and monitoring, especially for projects funded by state budgets.

A comparison with good international practice shows that in the region steps are being missed in the PIM cycle. A methodology developed by the World Bank[8] makes it possible to compare current SEE6 practices with good PIM practices at various points; among them are:

- **Strategic guidance and preliminary screening.** Lack of a national strategy that clearly articulates public investment priorities inhibits effective pre-screening of project ideas. Considerable emphasis should be given to filtering out bad project ideas at an early stage, so that only projects with a clear rationale based on government policies and strategies move forward and resources are not wasted on appraisal and design of less effective projects. Projects also tend to acquire their own planning momentum, which makes it more difficult to stop at a later stage. There needs to be a centralized process and guidelines for the format and for screening initial project proposals for consistency with national policy priorities.

- **Formal appraisal and independent review.** Currently, there are no guidelines for appraisal of public investment projects that are to be financed by domestic revenue. While standardized

7 IMF, Making Public Investment More Efficient, 2015. The study defines the efficiency of public investment as the relationship between the value of the public capital stock and the measured coverage and quality of infrastructure assets. The level of efficiency in a given country is calculated as the distance from an efficiency frontier, which is defined by the countries with the highest coverage and quality of infrastructure (output) for a given level of public capital stock (input). See also, IMF (2014) "Is It Time for an Infrastructure Push? The Macroeconomic Effects of Public Investment," in IMF World Economic Outlook, October 2014, pp. 75–114.

8 See, Rajaram et al (2010), A Diagnostic Framework for Assessing Public Investment Management, World Bank Policy Research Working Paper 5397.

appraisal tools are internationally recognized as important to ensure that projects chosen are feasible and of socioeconomic value, current regulations do not require feasibility studies. Similarly, there is usually no pre-feasibility study that incorporates cost-benefit analysis of a broader range of options contemplated for significant projects. Countries with good PIM practices typically formalize independent checks of any bias in project documentation. This is particularly important because line ministries do not always follow a stringent model for separating internally the roles of project "proposer," "appraiser," "reviewer," and "approver." For example, pre-feasibility and feasibility studies are often outsourced, with the contractor reporting to the same unit or authority that is proposing the project.

- **Selection and budgeting.** A fundamental aspect of a well-functioning PIM system is an appropriate linkage between the appraisal and selection of projects and the budget cycle. Desirable features of such a system are transparent criteria for selecting projects; a well-structured budget preparation process that takes into account both current investment and recurrent project implications over the medium to long term; effective gate-keeping to ensure that only appraised and approved projects are financed; and ensuring that projects selected have adequate financing for not only construction but also operation and maintenance costs after completion.

- **Project implementation, finalization, and evaluation.** Budget preparation and execution procedures appear to have mixed impact on how effectively projects are constructed. There is no evidence that allocation levels are insufficient to ensure timely completion of projects, and there are mechanisms in place to allow multiyear commitments when there may be spending consequences in future fiscal years. However, a skewed pattern of annual spending, with a large share of capital spending happening in the last month of the fiscal year or not executed at all, points to issues related either to timely initiation of project activities or insufficient flexibility during the budget year. Nor do most countries have any specific formal requirements or institutional arrangements in place to guide ex post evaluation of public investment projects, such as completion reviews. National audit offices have so far had only a limited role in the evaluation of public investments.

Source: World Bank.

Improving SEE6 fiscal positions would be impossible if risks are not successfully managed. Increasing fiscal transparency and strengthening budget management with credible fiscal rules, medium-term expenditure frameworks, and more stringent management of debt, guarantees, and contingent liabilities are expected to reduce risks and improve the fiscal stance. All SEE6 countries would benefit from stricter oversight of public-private partnerships (PPPs) and better integration between national strategic plans and capital budgeting and financing. PPPs and concessions might be useful for supporting infrastructure and related public services. They are, however, complex; they require not only careful risk allocation and mitigation but also a well-thought-out procurement strategy to ensure that the public sector gets value for money. Often, inefficient PFM results in the accumulation of arrears. Clearing arrears and preventing their build-up is a serious challenge for central and local governments in SEE6. However, in just two years, Albania has been able to clear public arrears amounting to 5 percent of GDP and at the same time has been reinforcing its PFM institutions to limit their accumulation (see Box 3.3).

Box 3.3. Albania: Arrears Clearance and Commitment Controls

A combination of declining government revenues post-crisis and spending commitments consistently above budget ceilings led Albania to accumulate major arrears in 2008–13. Even as financial resources tightened and there was a large overhang of social spending, the government continued to spend heavily on infrastructure. The spending ceilings assigned to budget entities for the medium term were treated as a reference baseline for their plans, rather than an upper limit. New investment projects were approved with commitments well beyond the budget limits of a year and then often cut back during the year due to lack of resources. Where executions exceeded budgets, arrears accumulated. By the end of 2013, Albania's arrears amounted to 5.3 percent of GDP, on works, goods and services, such as utility bills, VAT and CIT refunds, disability benefits, and special funds.

In 2014 the government signed a Strategy for the Prevention and Settlement of Overdue Liabilities. It set procedures for (1) settling overdue debt in an accurate, transparent, and unbiased manner within three years, and (2) tightening financial discipline to prevent future accumulation of debt. Arrears were paid using the FIFO (first in, first out) principle. The Ministry of Finance (MoF) established special units to manage the process. Reports on the processing of arrears were published regularly. An external audit validated the amounts and the clearing process. Arrears were fully cleared by the end of 2015, slightly ahead of schedule.

To prevent emergence of fresh arrears a number of controls were introduced. Budgeted entities were required to prioritize their activities within set limits and approved budget ceilings. Clear prioritization criteria ensure that poorly prepared and ill-conceived projects are not financed and that resources are applied where they will have maximum effect on the government's fiscal and other objectives. To avoid over-commitments the MoF in March 2014 issued a budget circular notifying line ministries that commitments for 2015 to 2017 were not to exceed 30 percent of the medium-term fiscal ceilings for current expenditures and 50 percent for domestic capital expenditures. Parliament approved the 3-year spending limits in the Budget Law of 2015. The government plans to amend Albania's Law on Management of the Budget System, in 2016 so that it reflects, among other things, the changes to the medium-term fiscal framework. These changes are also embedded in Albania's PFM strategy, which was approved by the Council of Ministers and published in December 2014.

To better control commitments, budget entities must now obtain authorization from the Treasury before commencing procurement for a project. The Council of Ministers in a regulation issued in January 2014 now requires all budget units to receive a Treasury stamp before procuring any goods or services. The MoF denies the stamp for buying goods for which funds are not available. This procedure has helped curtail the common practice of initiating procurement, particularly multiyear commitments, without sufficient consideration of the resources available, since the Treasury system is currently not capable of imposing hard controls on expenditure commitments. The Treasury system was also reinforced to provide greater control of commitments, including multiyear commitments. Budget units must record commitments in the Treasury District Office within three days of signing a contract. The Treasury performs periodic checks on budget users that have a high risk of incomplete compliance to ensure that the requirements are followed.

Source: World Bank.

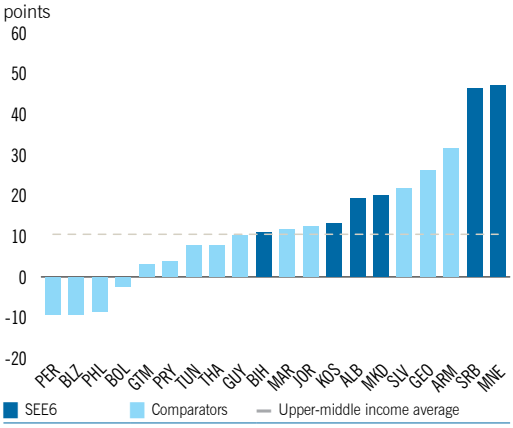
Public Debt Edging Up

Public debt rose further in 2015 despite the fiscal consolidation and tax reforms underway in several SEE6 countries. Public and publicly guaranteed (PPG) debt as a share of GDP rose in 2015 in all countries in the region, with an average increase of 3 percentage points of GDP over 2014. Montenegro led the way with a 10 percentage point increase in its public debt in 2015, which reached a new high of 78.8 percent of GDP. In addition to still-sizable fiscal deficits, valuation effects due to the appreciation of the US dollar also pushed up debt for those those countries with a large share of debt held in US dollars (Figure 3.5 and Figure 3.6). In Serbia the contribution of the valuation effect to PPG was more significant than in other countries because the depreciation against the dollar was more pronounced and more of its debt was denominated in dollars than in other countries (Figure 3.7). As a result, in 2015 Serbia's valuation effect was similar in magnitude to its budget deficit, while in its neighbors the valuation effect was more muted (Figure 3.8).

Because of heightened external uncertainty, exposure to environmental disasters, and volatile political cycles, the SEE6 economies need healthy fiscal buffers to act as essential shock absorbers. The narrowing of fiscal deficits is set against the background of high, and still rising, levels of public debt. Albeit from different levels in 2007, PPG debt as a share of GDP increased by end 2015 by at least 20 pp in Montenegro, Serbia, Albania and FYR Macedonia. Moreover, the increase in the ratio of PPG to GDP in SEE6 is almost double the one in upper middle-income emerging markets (Figure 3.5). The room for fiscal maneuver is therefore very limited. Faced with the risks of a less supportive future international environment, both for growth and financing

Figure 3.5: SEE6 PPG debt has grown fast since 2007

PPG debt to GDP change since 2007 to 2015, percentage points

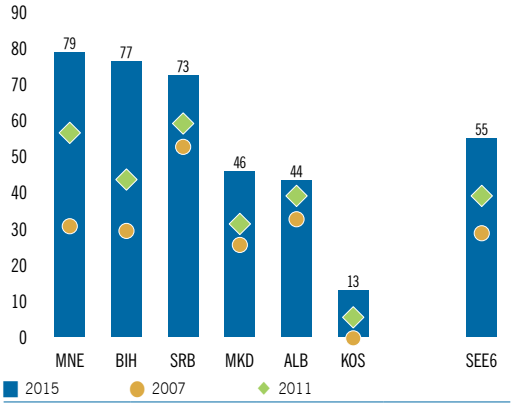


Source: Ministries of Finance.

Note: Comparable countries are emerging markets with income per capita of $2,900–$6,400, non-oil exporters, non-island states outside of Africa.

Figure 3.6: Steady upward trend of SEE6 PPG debt threatens debt sustainability

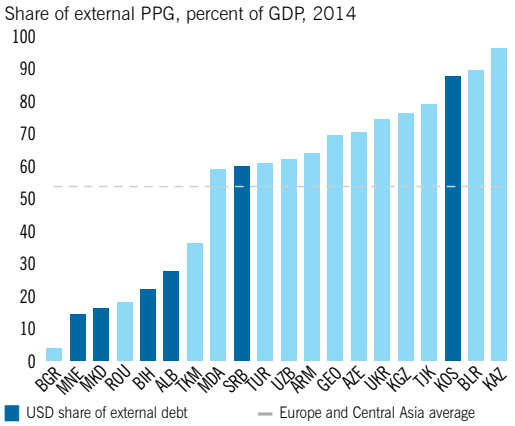
PPG debt to GDP, percent



Source: Ministries of Finance.

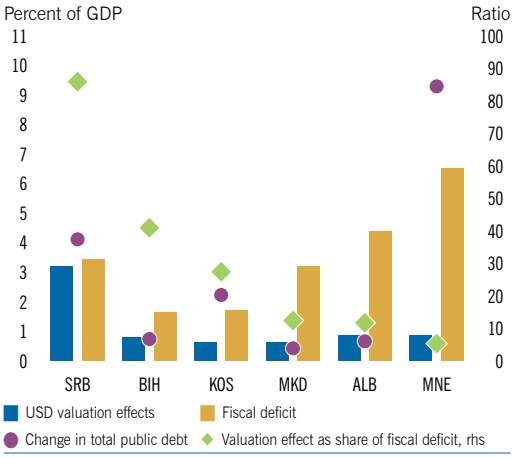
costs, policy measures to address structural fiscal rigidities, including the management of public debt, can help provide additional fiscal space and can be important to strengthen public finances to limit the adjustment required in the event of adverse shocks.

Figure 3.7: The share of dollar-denominated external PPG debt is below most Europe and Central Asia countries



Source: Ministries of Finance.

Figure 3.8: Valuation effects of public debt due to dollar appreciation in 2015 were comparable to fiscal deficits in some countries



Source: Ministries of Finance and WDI data.
Note: Valuation effects calculated by comparing US$ denominated public debt in 2014 with the increase from the change in US$: local currency exchange rates in 2015.

Accommodative Monetary Policy

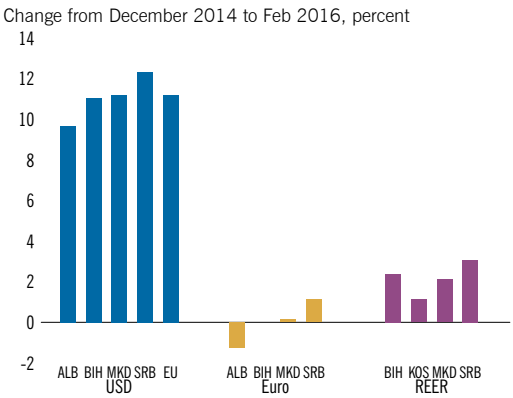
Restrictive fiscal policy and reduced external imbalances, along with the interventions of national banks, helped to keep currencies stable against the euro in SEE6 (Figure 3.9). Movements against the euro were limited for most of 2015, although the Albanian lek appreciated somewhat near the end of the year as a result of higher seasonal demand coming from migrants returning to the country. The Serbian dinar, on the other hand, depreciated slightly against the euro toward the end of 2015 and in early 2016 as a result of such seasonal factors as repayments of public debt, higher demand from importing companies, exchange rate swaps by commercial banks reacting to the Central Bank lowering the reference rate, and global developments such as the decrease in flow to emerging markets. But differences in U.S. and Euro Area monetary policies and the resulting higher U.S. bond yields contributed to a marked strengthening of the dollar against the euro in 2014 and most of 2015. From the end of 2014 to Feb 2016, nominal depreciation against the U.S. dollar of local currencies with floating exchange rates or fixed rates to the euro was between 10 and 12 percent for Albania, Bosnia and Herzegovina, FYR Macedonia and Serbia, with most of the drop occurring early in

the year.[9] Real effective exchange rate depreciation over the year was only moderate.

Subdued inflation led central banks to keep monetary policy accommodative. Overall, official policy rates held at historically low levels in SEE6 (Figure 3.10). In November 2015, based on forecasts of low inflationary pressures in the medium term, the Bank of Albania reduced its policy rate by 0.25 percentage points, to 1.75 percent, a historic low. For the same reason, between March 2015 and February 2016 the National Bank of Serbia cut the policy rate seven times, down to 4.25 percent. Only FYR Macedonia kept its policy rate unchanged; it had assessed that given economic and financial conditions, the current monetary policy was adequate.

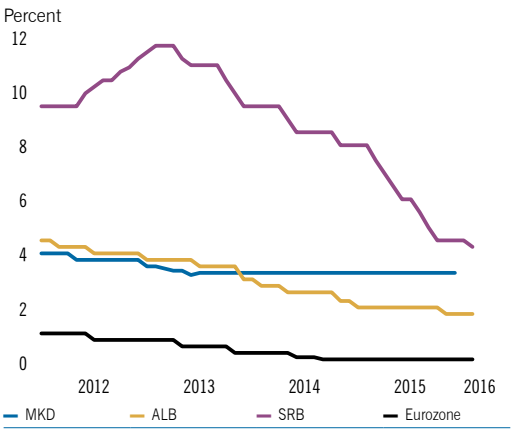
With policy rates at historic lows in SEE6, lending rates declined, providing support to the tentative growth in private credit. Lending rates fell in all SEE6 and across the region, lending to households picked up. Overall credit growth headed upward in FYR Macedonia, Kosovo, Montenegro, and Bosnia and Herzegovina (Figure 3.11). Findings of a recent survey[10] of banks highlights that the drivers of credit on both the demand and the supply side: In Kosovo, supply conditions have eased, demand for loans picked up and nonperforming loans have fallen. In Serbia, growing demand continues to be constrained by a much slower improvement in lending conditions. And in Albania, both demand and supply are tepid.

Figure 3.9: SEE6 currencies mostly followed the euro, with some recent divergence



Source: Data from central banks and the IMF.
Note: Increase = depreciation.

Figure 3.10: Official policy rates are at historical lows

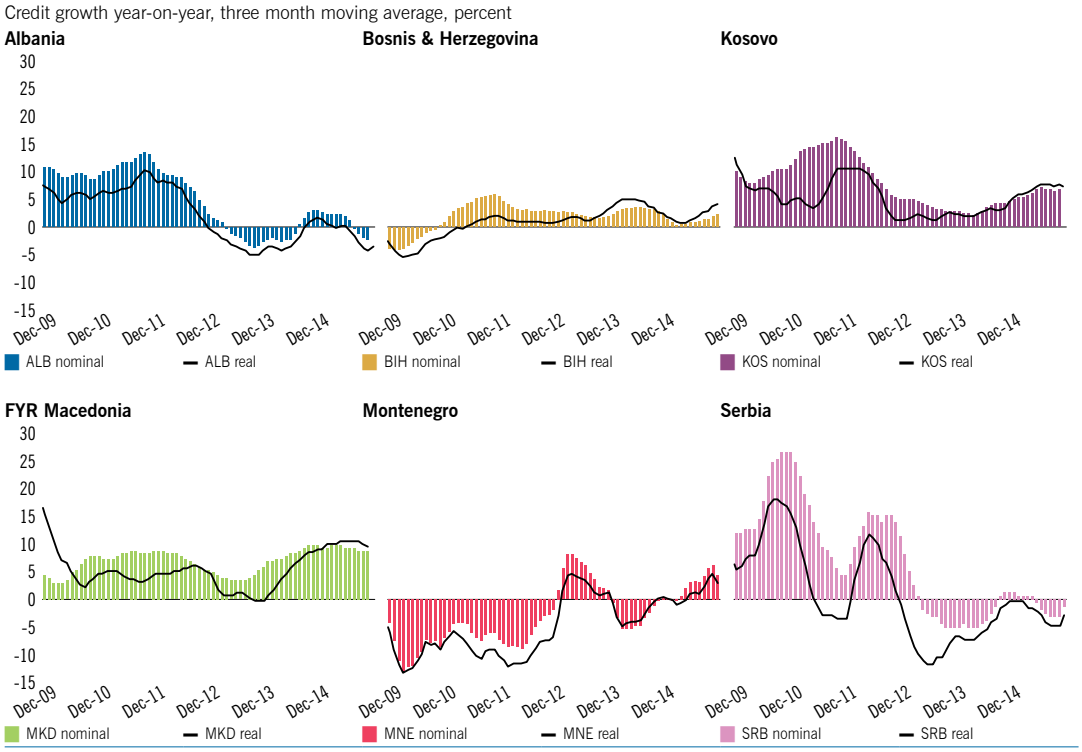


Source: ECB, National banks.

9 Montenegro and Kosovo are fully euro-ized economies.

10 EIB CESEE Bank Lending Survey, H2 2015.

Figure 3.11: Tentative recovery of private credit growth



Sources: Central bank and IMF data.

Note: Growth in real credit is calculated as ex post real growth based on CPI inflation. The three-month moving average is the average of growth rates year-on-year.

Some Concerns about Quality of Bank Assets

Banks in SEE6 remained generally well-capitalized and liquid, and are moving to increased domestic deposit mobilization. As external financing became scarce and parent banks started deleveraging from the region, local banks worked to attract domestic sources of financing. The robust pace of the growth in deposits-to-GDP ratios since the crisis allowed Bosnia and Herzegovina, Montenegro, and Serbia, which had high loan-to-deposit (LTD) ratios, to lower them notably (Figure 3.12).

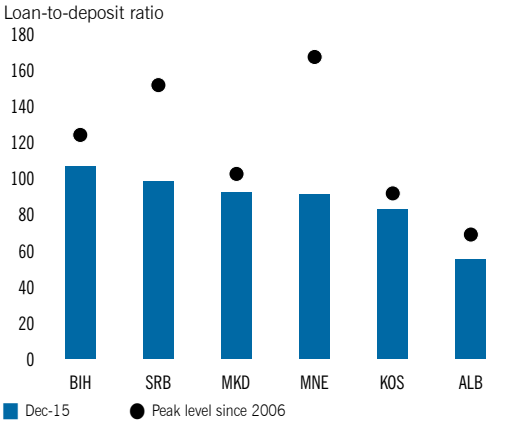
Deleveraging in SEE6 slowed in 2015. Most countries in the region continued to see reductions in foreign bank funding, though the pace of reductions is now slower. Regulatory reforms and tighter supervision under the European Banking Union are creating pressures on some parent banks to further shrink their balance sheets, reduce the amount of capital held in subsidiaries, or even sell subsidiaries. Nevertheless, for the region as a whole claims on non-bank borrowers declined more than claims on banks, likely reflecting continued weakness in corporate balance sheets. Funding costs, on the other hand, after easing for almost two years, started increasing in Q2 2015, reflecting uncertainties about the Greek crisis and other

external factors, such as the slowdown in capital flows to emerging markets (Figure 3.13).

While the SEE6 banking sector reduced the number of non-performing loans, there are differences in asset quality at the individual bank level. The region's commercial banks are reasonably healthy, but provisioning for high NPLs may erode some bank earnings and capital buffers (Figure 3.14). Still-high NPLs continue to put significant pressure on SEE6 banking systems, although recently all SEE6 countries except Serbia have seen improvements. On average, NPLs across the region declined in 2015 by about 1 percentage point, with the biggest declines in Montenegro, Albania and Kosovo. In Serbia, NPLs are about 23 percent; but this might be underestimated due to loan classification, according to the recent asset quality review in 14 banks. Moreover, pockets of vulnerability among domestically-owned banks in Bosnia and Herzegovina and Montenegro need to be addressed. Also a continuing concern are the large stocks of foreign exchange lending to unhedged borrowers. For example, in Albania and Serbia foreign currency lending is at 60 percent of total lending.

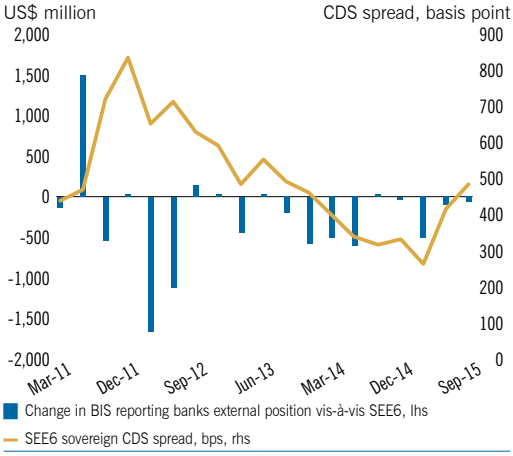
High NPLs burden bank balance sheets, undermine profits and capital, and suppress bank consideration of new lending—and reduce the general ability of banks to boost economic activity (Figure 3.15). All SEE6 countries have moved to better resolve NPLs, either through their own initiatives or through regional cooperation, such as the Vienna Initiative. Supervisory authorities in Albania, Montenegro, and Serbia have launched comprehensive programs to provide incentives for banks to take specific actions to promptly recover viable loans and enforce collection against nonviable borrowers. The authorities in Bosnia and Herzegovina, Kosovo, and Serbia have initiated reforms to build up their insolvency regimes. In FYR Macedonia and

Figure 3.12: Mobilization of domestic deposits is increasing



Source: National authorities.

Figure 3.13: After declining, credit risk moved up

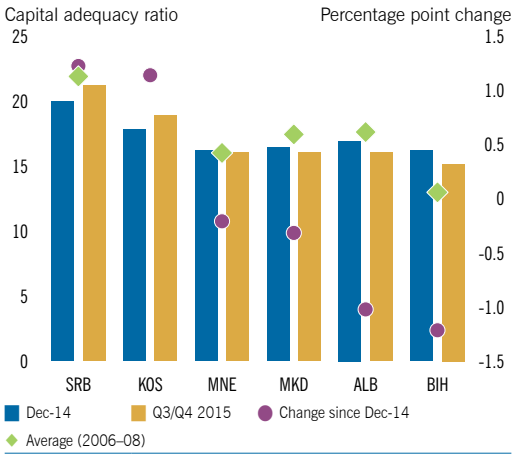


Source: National authorities, BIS.
Note: Country CDS spreads are those for Albania, FYR Macedonia, Montenegro and Serbia. Change in BIS reporting bank external position are for claims on SEE6 excluding Kosovo.

Albania, regulators now require banks to write off fully provisioned NPLs that are older than two years in the former and three years in the latter. Montenegro has off-loaded large NPL portfolios to special purpose vehicles belonging to parent banks operating in the country.

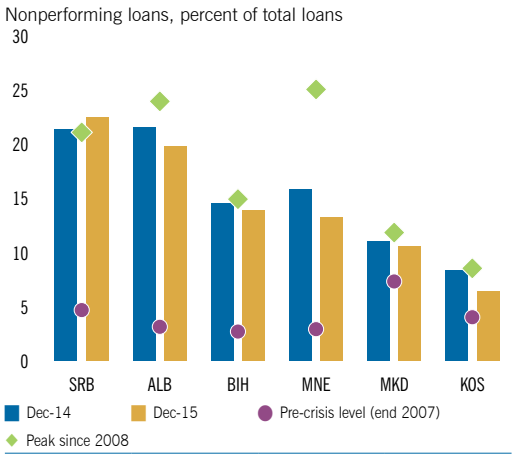
The global financial market outlook, external borrowing risks, EU regulatory and supervisory reforms, and parent bank capital constraints may all negatively affect financial sectors in the SEE6. Recognizing that prospects for the region are significantly dependent on external developments, an analysis of alternative scenarios was recently conducted to help financial sector policymakers and regulators prepare for a range of possible futures (Box 3.4). The analysis, while hypothetical, demonstrates how external shocks would have an immediate impact on SEE6 financial systems and that moving to improve the health of the financial sector is an important risk-mitigating strategy that countries in the region should employ.

Figure 3.14: Banks are well-provisioned



Source: National authorities.

Figure 3.15: NPL ratios are improving, but remain far above pre-crisis levels



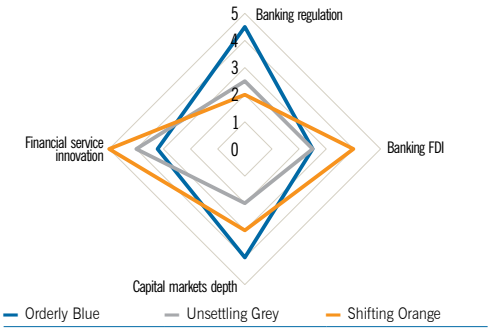
Source: National authorities.

Box 3.4: 2025 Western Balkans Financial Systems Structure: Scenarios[11]

Because prospects for the region depend heavily on external developments, a regional scenario analysis portrays possible futures for SEE6 financial sectors. The objective was to support policymakers and regulators discussing strategic challenges and policy responses, and increase their understanding of the critical uncertainties SEE6 financial sectors will confront. The World Bank through consultations with stakeholders from the region and international development partners prepared the building blocks for the scenarios by identifying 14 areas of uncertainty that might prove to be major drivers of change. These cover global economic dynamics, geopolitics, financial regulation and markets, and technology-based innovation, as well as uncertainties more specifically related to the EU.

11 The 2025 scenarios and their regional implications are discussed in World Bank. 2016. Western Balkans Financial Sector Outlook. (forthcoming).

Figure B3.4.1: 2025 Financial Landscape Scenarios



Source: World Bank (2016).

Note: On the scale from 0 to 5, 3 represents the 2015 baseline. Higher numbers (4 and 5) represent growth in bank FDI, deepened capital markets, increased financial innovation and tightened bank regulation compared to the 2015 baseline; and vise-versa for lower numbers (1 and 2). The methodology relies on identification of uncertainties followed by determination of end-points for each uncertainty with the aim to define the range in which each of the 2025 scenarios can possibly play. Based on the uncertainties and their end-points, built into internally coherent stories of the future, the four dimensions are rated.

Each scenario sketches out a different shape the world could be in in 2025 (Figure B3.4.1). The dynamism of the global economy in the *Shifting Orange* scenario presents booming financial innovation, but also raises issues of mandate adequacy for financial regulators. With the center of gravity no longer in the old advanced countries, this scenario is characterized by growth of multidimensional capital flows and major new players in the banking FDI scene. The turmoil in the global economy reflected in the *Unsettling Grey* scenario raises problems for the financial system, stemming from low growth environment and assumed political fragility, including in the EU. Piecemeal innovation is taking place in capital markets, financial services and payment systems. The positive evolution of the EU economy and integration that the *Orderly Blue* scenario would offer countries in the region many opportunities for banking and capital markets integration. Strengthening of banking regulation and its consequences is a significant feature of the *Orderly Blue* scenario. The Basel-driven regulatory environment, however, would have unintended effects because compliance costs and capital requirements act as a disincentive for small banks and for exposure through foreign subsidiaries on which the region is quite dependent. Figure B3.4.1 is an illustration of how select financial sector uncertainties (bank FDI, financial services innovation, bank regulation and capital market depth) were combined into internally coherent, and both plausible and provocative scenario plots.

The scenarios are intended to facilitate regional and national conversations about the possible policy responses to the implied challenges and opportunities. As a first step, a seminar was held in Vienna on November 13, 2015, for regional stakeholders and international partners. Central to the discussions were topics of regional integration, management capabilities and corporate governance, technology, and the building of efficient and stable financial system the structuring of robust economic and financial sectors. EU harmonization was recognized as an important anchor of reform in the region. Cross-country harmonization will continue to be vital both for attracting and facilitating investments and for transferring knowledge. The scenario analysis gave a sense of the importance of acting now to ensure that all countries in the region arrive at 2025 with financial systems that are prepared to make the best possible contribution to economic growth and prosperity.

Source: World Bank.

4. Sustaining the Rebalancing of Future Growth

Positive Near-Term Outlook with Downside Risks

The near-term growth prospects for the SEE6 are positive. Growth in the region is forecast to rise from 2.1 percent in 2015 to 3.0 percent in 2017 because of recovering domestic demand (boosted by investment and support from consumption) and continuing support of exports. The dividends of ongoing structural reforms in many of the countries of the region should also support growth over the medium term.

the reduction in current account deficits in 2015, which was supported by lower oil prices, on average they are not projected to narrow further over the projection period. Although the gradual improvement in growth should help to generate employment and wage growth, overcoming structural weaknesses in SEE6 labor markets will be necessary to help reduce poverty sustainably.

Table 4.1: Growth trend to continue through 2017

Percent of GDP unless otherwise stated	2014	2015e	2016f	2017f
Real GDP growth (percent)	0.3	2.1	2.6	3.0
Consumer price inflation (percent, period average)	0.9	0.9	1.6	2.0
Public revenues	34.7	35.0	35.3	34.7
Public expenditures	38.8	38.8	38.5	37.5
Fiscal balance	-4.1	-3.8	-3.2	-2.8
Public and publicly guaranteed debt	52.1	55.1	56.9	57.4
Goods exports	24.3	25.2	25.6	26.7
Trade balance	-17.0	-15.8	-15.2	-16.1
Current account balance	-7.2	-6.3	-6.6	-6.8
External debt	64.6	67.3	68.0	67.7
Non-performing loans (percent of gross loans)	15.8	14.7	..	..
Unemployment rate (percent, period average)	22.5	21.7	..	..

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

Within the aggregate SEE6 growth picture, there is marked country diversity. The Serbian economy is growing more slowly than the others (at 2.3 percent in 2017 versus 3.1–4.0 percent for the other SEE6 countries) but its growth pick up in 2016 is the largest in the region. The narrowing in fiscal balances is expected to continue, although public and publicly guaranteed debt will continue to move up to 57.4 percent of GDP in 2017. Following

Even though growth projections were revised upwards, the risks to the generally positive outlook are weighted to the downside. Growth in the SEE6 region for 2015 was revised from 1.8 percent in the SEE6 RER September 2015 edition to 2.1 percent with upward revisions for all countries. The risks on the downside are notable. They include volatile international financial markets, slower-than-projected growth in major export markets,

especially the EU, and the movement of global oil prices, which could provide upside support to trade balances and consumption if prices are below projections. In terms of other global risks, given their lower trade linkages countries in the region are relatively insulated from direct spillovers from the slowdown in China and the problems of the other BRICS, but they could be impacted via second-round channels, particularly international financing conditions.

As the turbulence in international financial markets has risen, so have financing risks. Early 2016 saw a significant sell-off in many equity markets, particularly in Europe, and a rise in spreads on emerging market bonds. The mid-year referendum on a possible British exit from the EU and geopolitical factors are also weighing on market sentiment. Given significant external and fiscal financing needs international market volatility exacerbates refinancing risks. Furthermore, if there are currency mismatches, in both private and public sectors, there is the risk of adverse balance sheet effects impacting investment, for example.

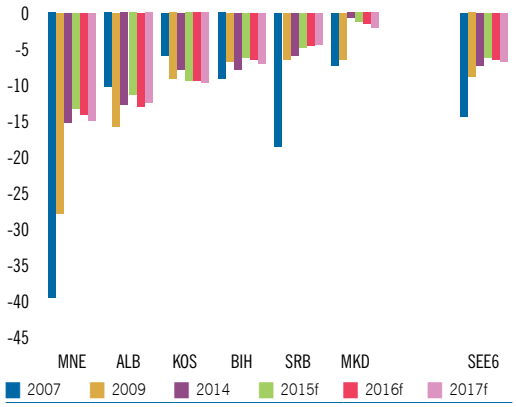
In addition to the external risks, domestic political dynamics are also likely to come to the fore because several countries in the region have elections scheduled for 2016. Parliamentary elections are due in FYR Macedonia and in Serbia in the first half of 2016 and in Montenegro later, and there will be local elections in Bosnia and Herzegovina. While the political context clearly differs by country, in general as elections approach the appetite for progress on reforms tends to wane. Given the external conditions, the extent to which either incumbent or new governments sustain progress on necessary structural and fiscal reforms will be a key determinant of the growth outlook.

Rebalancing the Drivers of Growth and Addressing Twin Deficits

The global financial crisis forced an adjustment in the region's current account deficits that eventually led to a rebalancing of sources of growth in SEE6 countries. Prior to the global financial crisis, SEE6 economies grew unsustainably: with consumption fueled by public spending, remittances and excessive capital inflows. After the crisis, with drastically reduced capital inflows and private transfers from abroad, the SEE6 economies were forced to undertake adjustment to reduce their external financing needs. As a result, the region's average current account deficit fell from 18.5 percent in 2007 to 6.6 percent in 2013 (Figure 4.1). In line with this adjustment, the SEE6 economies saw shifts in the drivers of growth from predominantly domestic to external ones. In the years after the 2008 crisis, with decreased inflows of remittances and large contractions of domestic credit, consumption fell from 101 percent of GDP in 2007 to 95 percent in 2015. On average, domestic demand fell by 9 percent of GDP in the same period, while net exports share in the economy increased by 10 percent of GDP, leading to an increased role of net exports in growth (Figure 4.2).

Figure 4.1: Current account imbalances narrowed somewhat in 2015, but remain high

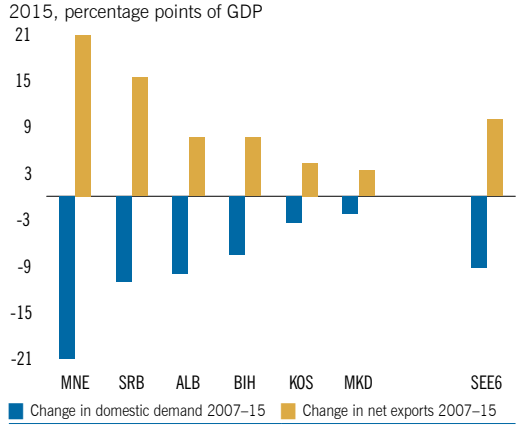
Current account deficit, percent of GDP 2009–17



Source: Data from central banks and national statistical offices, World Bank staff projections.

Figure 4.2: Economic structures are rebalancing from domestic to external demand

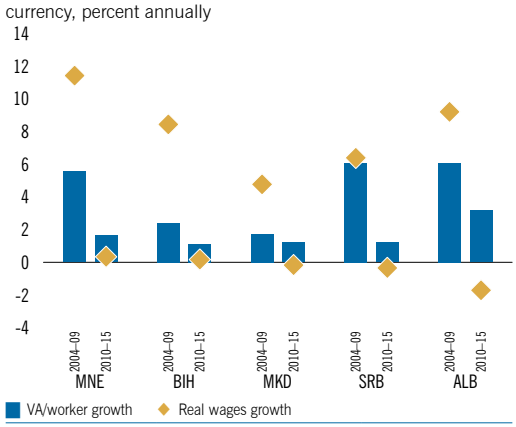
Decomposition of structure of GDP, change between 2007 and 2015, percentage points of GDP



Source: World Bank staff calculations based on data from national statistical offices.

Figure 4.3: Labor costs starting to move more in line with labor productivity

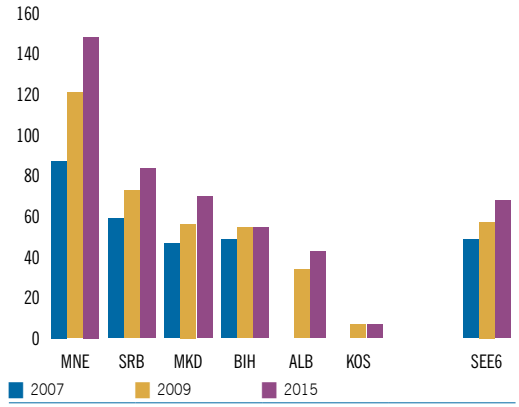
Increases in real value added per worker and real wages in local currency, percent annually



Source: Data from central banks and national statistical offices, World Bank staff projections.

Figure 4.4: External debt ratios have risen

External debt, percent of GDP



Source: Data from central banks and national statistical offices, World Bank staff projections.

Rebalancing towards exports has been supported by wages moving more in line with productivity. Before the global financial crisis, real wages grew much faster than worker productivity, creating concerns about the competitiveness of the SEE6 economies (Figure 4.3). As part of the rebalancing process, while value added continued growing at a modest pace, real wages have been nearly flat during the 2010–15 period. In combination with the real depreciation that was seen for some countries over 2014 and 2015, this fall in the relative pace of labor costs increases compared with that of productivity has allowed SEE6 to expand exports and their contribution to growth.

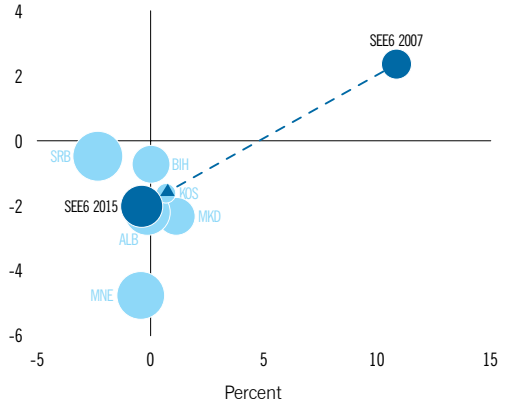
But with low interest rates post-2008, external debt rose to finance still sizeable current account and fiscal deficits. When countries grow fast or enjoy low interest rates

on their debt, they can sustain relatively higher debt levels. In 2008, the nominal growth rate in the SEE6 countries was between 6 and 14 percent higher than the effective interest rate on public debt, pushing down debt ratios. In 2015 this differential was between 1.7 percent and minus 2.3 percent.[12] While primary fiscal balances have narrowed since the global financial crisis, the SEE6 have ended up with notably higher public debt-to-GDP ratios (Figure 3.6). Moreover, SEE6's growth to effective interest rate differential worsened substantially compared to 2007 (Figure 4.5).

Countries with both fiscal and external imbalances are at a particular disadvantage to compete for scarce financing options. While FDI flows and remittances have increased, debt-financing inflows also rose in recent years as governments and corporates took advantages of lower yields. As a result external debt has risen in parallel with public debt for many countries making them vulnerable on both fiscal and external sides (Figure 4.6). The need to raise resources to finance these twin deficits is intensifying pressure for structural reforms. On the external side, net current account financing needs are in the order of 7 percent of GDP through the projection period. Gross external financing needs are even higher (for example, 26 percent of GDP in Bosnia and Herzegovina and 13 percent of GDP in Serbia in 2016).[13] Similarly, fiscal amortization requirements have risen with the increase in the size of debt. For example, Serbia's gross fiscal financing needs are estimated at 17 percent of GDP in 2016 with a deficit projected at just under 4 percent of GDP.

Figure 4.5: Weak growth, growing interest costs and high deficits put pressure on public debt sustainability

Primary fiscal balance percent of GDP in 2015; nominal growth rate minus effective interest rate on public debt

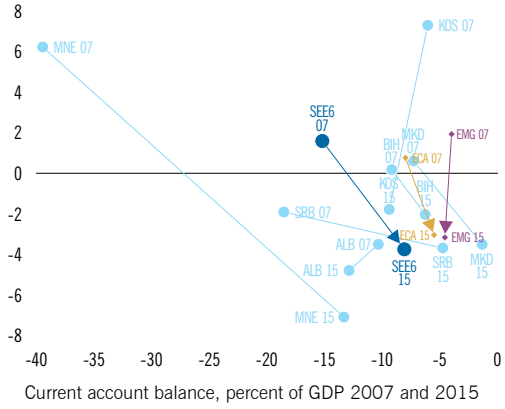


Source: Ministries of Finance, World Bank, IMF.

Note: Bubble size is total public debt (percent of GDP) and interest rate is the nominal effective interest rate of public debt. For a given primary balance, a higher nominal growth rate and lower effective exchange rate will reduce the debt-to-GDP ratio.

Figure 4.6: Twin deficits restrict policy options in the face of deteriorating external conditions

Fiscal balance, percent of GDP 2007 and 2015



Source: World Bank calculations based on data from central banks and national statistical offices, IMF World Economic Outlook.

Note: EMG refers to the IMF's Emerging and Developing economies classification of countries and ECA refers to Europe and Central Asia classification of countries by the World Bank.

12 Sample for 2008 excludes Kosovo.

13 See recent IMF Article IV reports. Gross financing needs include debt amortization.

Going forward the availability and cost of financing may be impacted by uncertainty arising from the political cycle in a number of countries and by any downturn in international financing conditions. As such, it will be important to ensure that domestic policy stances are supportive of financing inflows, particularly more stable FDI which has performed relatively strongly in 2015. Otherwise, there is a risk that a tightening of the availability of financing could require a sharper current account adjustment, either through an adjustment in relative prices (i.e. the exchange rate) or volumes (contraction in domestic absorption). Put another way, in such a scenario a lack of significant further fiscal consolidation would require a marked rise in private sector net saving, potentially dampening investment and growth.

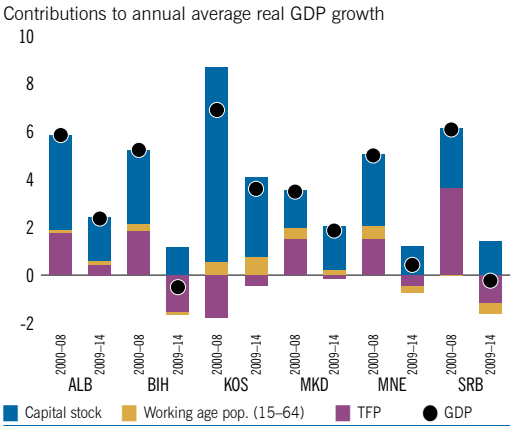
Improving Productivity is Paramount for Boosting Potential Growth

As SEE6 economies rebalanced post-crisis, the contribution of total factor productivity (TFP) to economic growth has fallen, often into the negative territory. Before the crisis, growth rates of capital accumulation had been supported by large capital inflows, domestic credit expansion and low interest rates, and moderated as these inflows declined in the post-crisis period. Labor, measured by the broad proxy of working age population, has played a minor but steady role, reflecting the demographic dynamics in the region with low birth rates and large out-migration. Total factor productivity (TFP) growth provided strong support during the pre-crisis period, most notably in Serbia, but it became negative in the post crisis period (Figure 4.7).[14]

Labor markets dynamics and human capital accumulation seem to have contributed little to regional growth in the past 15 years. With activity rates at about 50 percent of the population and persistently low employment, human resources have been consistently under-used in SEE6 during the last 15 years. Albania and Bosnia and Herzegovina have had stable employment shares, while Serbia's employment declined in the pre-2008 period; only in FYR Macedonia employment expanded. The underutilization of labor had been aggravated prior to crisis by increasing labor costs, as real wages grew faster than productivity gains in most countries of the region during the boom years (Figure 4.3). While education attainment increased, particularly in tertiary education where enrollment rates more than doubled since the early 2000s, the quality of education remains low compressing the returns to education and lowering the quality of human

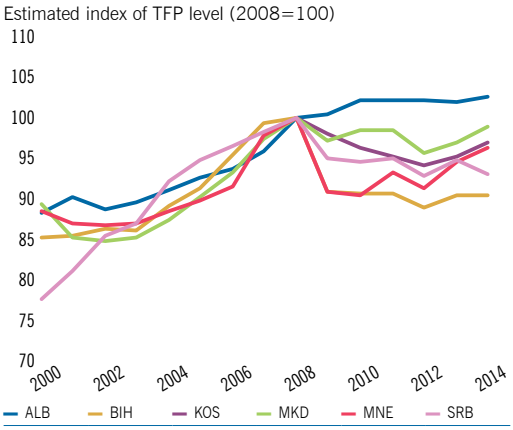
14 The growth accounting exercise is based on the Solow model and covers data for 2000–2014. Despite its many well established caveats, this simple exercise can provide some intuition about the main drivers of GDP growth during the last 15 years. Annual GDP is assumed to be a function of the aggregate physical capital stock (K) and labor (L), following a Cobb-Douglas technology. In the absence of consistent employment data for all countries, the working age population (age 15–64) is used as a proxy for labor. In the absence of data on capital stocks, physical capital is estimated through a highly simplified perpetual inventory method. In this simple growth accounting exercise, TFP includes the main component—efficiency with which the economy uses the main factors of production—but likely also hides the impact from a combination of factors including skills and labor market dynamics (i.e. converting the working age population into employed human capital), enabling factors that affect the overall efficiency of the economy, as well as technological progress.

Figure 4.7: Productivity subtracted from growth post-crisis in most countries



Source: World Bank staff calculations.

Figure 4.8: Total factor productivity levels have at best stagnated since 2008



Source: World Bank staff calculations.

capital. As an example, in Montenegro and Albania, more than half of the students could not reach minimum proficiency in reading and math on the PISA test. Skill gaps have been identified as particularly severe in the region.

Boosting growth in SEE6 requires a reversal of this deteriorating productivity dynamics. Productivity dynamics have deteriorated significantly since the global financial crisis (Figure 4.8). Physical and human capital inputs clearly have very important roles to play in improving the region's potential growth (see, for example, the discussion on public investment management in the preceding section). But the need to enhance productivity performance is of particular importance, given potential headwinds for investment dynamics from financing costs and time lags for improving human capital and skills. Generating productivity gains consistently faster than competitors is what will ensure the continuation of successful sources of growth rebalancing toward export and investment in SEE6.

Addressing structural rigidities is crucial to unleashing SEE6 productivity performance and economic potential and for increasing living standards of the population. While cyclical factors such as lower oil prices and external recovery are expected to drive the SEE6 outlook in the near term, addressing structural issues along five policy fronts are required to dismantle the key obstacles to productivity performance and sustainable growth in SEE6:[15]

1. **Eliminate disincentives and barriers to formal employment.** Labor markets across the region are anemic. They suffer from persistently high unemployment, low labor force participation, high levels

15 This section is based on several Systematic Country Diagnostics (SCD) reports prepared by the World Bank. The SCD for Albania can be found at http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2015/07/31/090224b083041523/2_0/Rendered/PDF/Next0generatio0m0country0diagnostic.pdf; the Bosnia and Herzegovina SCD can be found at http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2015/11/16/090224b0831becfd/1_0/Rendered/PDF/Rebalancing0Bo0c0country0diagnostic.pdf; the Serbia SCD can be found at http://documents.worldbank.org/curated/en/2015/06/24559780/serbia-systematic-country-diagnostic. SCDs in other SEE6 countries are also in preparation.

of informality and sluggish formal job creation. Sticky unit labor costs have undermined competitiveness, constraining the scope of external rebalancing of economies. Labor market outcomes are particularly weak among some groups of the population such as youth, Roma and women. Reducing labor law rigidity would help to activate the most vulnerable groups on the mostly dual labor markets in the region; the laws overprotect insiders and largely exclude youths, females, and elderly from the labor force. Reforms to education systems to better align them with skills the labor market demands and remove disincentives and barriers to formal labor engagement are shown to have meaningful impacts for growth. Increasing income-generating opportunities in the labor market, including for the less well-off and excluded, is critical to boost growth prospects and increase living standards across SEE6.

2. **Improve the business climate and governance.** Even though some progress has been made in easing the problems of the investment climate, including regulatory simplification (e.g., in FYR Macedonia and Montenegro), there is still room for improvement. Applying the law in a non-discretionary and consistent manner and protecting rights to property (including land) and contracts are central to ensure a level playing field. Regulatory reforms that simplify legislation, promote e-governance, and establish one-stop registration shops, are shown to reduce business costs and encourage private sector development in countries around the world. Improving the governance of SOEs and reducing their burden on the state is also a priority for policy reform in the SEE6.

3. **Enhance the equity, quality and efficiency of public services and social protection systems, while reducing the governments' footprint.** In most SEE6 countries, the public sector tends to deliver public services that are too expensive and can improve in quality. Addressing structural rigidities related to the efficiency, size, equity and quality of public service delivery, while maintaining fiscal sustainability, is a key policy agenda. For example, improving the delivery of health services is particularly important because it has potential spillovers to human capital and productivity of workers. At the same time, ensuring that vulnerable groups are effectively and efficiently protected will remain central to addressing issues of poverty and inclusion in the region. Efforts targeted at reinforcing pension systems, improving the targeting and coverage of social protection systems, modernizing benefits administration, and making active labor market programs more effective would have important social impacts, while contributing to needed fiscal consolidation.

4. **Deepen regional and global integration.** Improving the physical and institutional connectivity of the SEE6 within and across the region and the rest of the world would help make these countries more competitive, supporting domestic and foreign firms in reaching beyond established markets and products. Advancing in the EU accession process represents an opportunity for the SEE6 to pursue an EU integration agenda that will have positive

impact on potential growth through improved trade and export performance. For all SEE6 countries, strategically upgrading obsolete infrastructure would boost economic potential—provided such investments target projects with strong economic returns and do not threaten the sustainability of public debt.

5. **Ensure sustainable use of energy and natural resources and stewardship of the environment.** The energy sectors of SEE6 economies are inefficient. Persistent distribution losses, regulated tariffs that are below cost recovery, and low collection rates lead to recurrent energy shortages (especially, in economies that rely heavily on hydro generation) as well as either high costs for the private sector or an extra burden on public finances, or both. Addressing these issues would make the energy sectors financially viable, ensure reliable energy supplies, and support economic growth. The SEE6 are endowed with natural beauty, cultural heritage, and resources that, used well, can boost long-term national growth potential. However, SEE6 countries are also among those most vulnerable to natural hazards and weather changes, which necessitate efforts to build resilience against them.

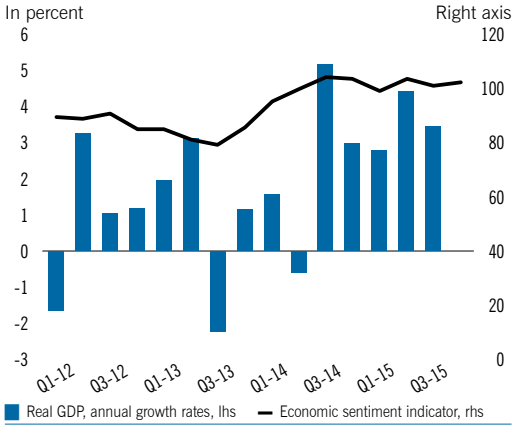
5. SEE6 Country Notes

Albania

Albania's economy grew by 2.6 percent in 2015, supported by robust private investment. The pace of expansion is expected to gradually continue at 3.2 percent in 2016, and 3.5 percent in 2017. Investment in the Trans Adriatic Pipeline and a hydropower plant in the Southern Albania will help expand domestic demand. As fiscal consolidation takes course, government spending will be limited. Public debt is expected to start heading down in 2016 as a result of the fiscal consolidation measures approved in the 2016 budget law. The medium-term outlook depends on the pace and depth of additional structural reforms in the energy and financial sectors and better management of public investment in infrastructure. Judicial reform is also crucial to make the investment climate more attractive and revive credit growth.

Albania's economy continued to recover in 2015, supported by robust private investment. Real GDP grew by 3 percent in the third quarter, maintaining positive momentum, and is estimated to have expanded 2.6 percent for the full year. Growth was led by a recovery in private investment; gross fixed capital formation increased by 12.6 percent (y-o-y) in the third quarter. Imports of machinery and equipment expanded by 13.6 percent (y-o-y) in the last quarter, a sign of robust investment growth. After three consecutive quarters of decline, household consumption went up 1.9 percent (y-o-y) in the third quarter. Growth in consumer loans, higher trade, consumer confidence, and VAT receipts all reinforced the positive consumption trend in the last quarter. Affected by unfavorable international oil and mineral prices, real exports fell by 2 percent (y-o-y), but because real imports also fell, net exports contributed positively to growth.

Figure 1. Real GDP, Annual Growth Rates and Economic Sentiment Indicator, 2012–15



Source: Bank of Albania, INSTAT.

Growth in the first three quarters of 2015 was led by construction (14.2 percent y-o-y) and services (2.8 percent), especially health and administrative services. In the last quarter, the confidence of businesses in trade, construction, and industry improved, but fell for services other than trade. Industrial businesses increased capacity utilization and reported more export contracts. In construction, new permits for

nonresidential buildings and investments in hydropower and telecommunications went up in the third quarter. Government capital expenditures were concentrated in the last quarter, supporting an expansion of this sector.

Inflation was below the target band. Average annual inflation reached 1.9 percent in 2015, below the Bank of Albania's target of 3±1 percent. Because low external inflation and the negative output gap continue to put downward pressure on prices, the Bank of Albania kept an accommodative monetary policy, reducing the main policy rate to a historic low of 1¾ percent in November 2015. Although T-bill yields and deposit rates responded quickly, rates on loans are falling more slowly. In the fourth quarter the Albanian lek appreciated slightly against the euro, up 1.4 percent (y-o-y). By yearend the real effective exchange rate had appreciated 2.5 percent.

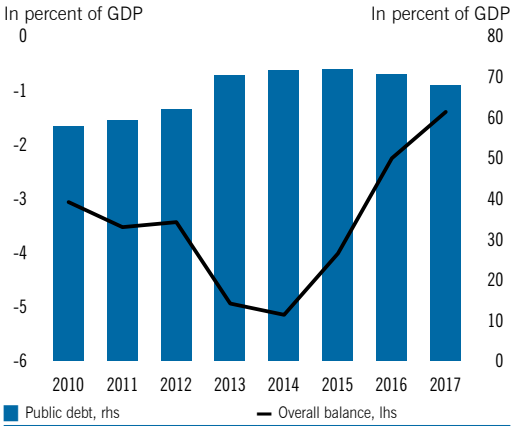
Concerned about high NPLs, quality of projects, and difficulties in enforcing contracts, banks were reluctant to expand credit. The banking sector continued to be profitable. The capital adequacy ratio held at 15.7 percent in the fourth quarter, far in excess of the regulatory minimum of 12 percent. Risk aversion by banks that are still plagued by high NPLs continues to suppress credit growth, although policy initiatives such as write-off of old loans have brought NPLs down to 18.2 percent from their peak of 25 percent in September 2014. Lending requirements for households relaxed in the second part of the year, but credit to business remains tight, partially because it is difficult to enforce contracts and execute on collateral through the court system.

Sustained growth stimulated modest job creation in 2015. Jobs increased in non-market services, and agriculture, the biggest employer. Growth in employment, by 1.9 percentage points (pp) was accompanied by more people moving into the labor force (1.9 pp), leading to a modest 0.4 pp decline in unemployment to an average of 17.1 percent for 2015. Youth unemployment (those aged 15–29) declined by 1.7 pp from a year earlier but was still high at 32.2 percent. The disparity in labor force participation by males and females remained high at about 20 basis points.

The current account deficit (CAD) is estimated to have narrowed in 2015. After declining for the first two quarters, the CAD expanded by 10.1 percent annually in the third quarter. The net result for the year is an estimated 11.4 percent, lower than in 2014. The deterioration was caused by worsening lower balance of trade in goods and services and an 18.1 percent decline in remittances. Despite a large expansion in tourism exports, exports of goods and services dropped by 3.4 percent because of lower oil and minerals prices. Total imports contracted by 1.9 percent due to lower merchandise imports. In the third quarter capital controls on banks in Greece limited the extent to which transfers could be made to Albanian families, which contributed to a drop in remittances. However, large inflows in the same quarter that are identified as "errors and omissions" suggest that such transfers might have taken place through other means. Despite declining in the third quarter by 4.5 percent, net FDI financed about 70 percent of the current account deficit. Issuance of €450 million in Eurobonds in early November complemented the external financing and helped build up international reserves, which

at year-end exceeded five months of goods and services imports.

Figure 2. Fiscal Balance and Public Debt, 2010–17



Source: Ministry of Finance and INSTAT data.

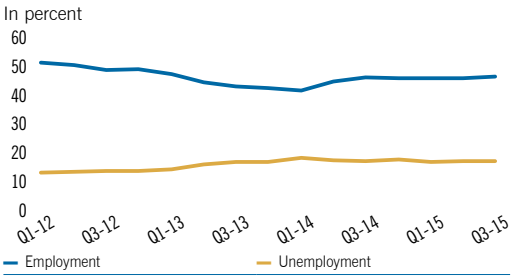
The budget deficit remained on track despite a shortfall in revenues. The budget deficit is estimated to have reached 4.8 percent of GDP in 2015, down from 5.9 percent in 2014. The outturn in 2015 included arrears clearance of 1.3 percent of GDP. Revenues are estimated to have underperformed by approximately 4.2 percent against the revised budget plan. The shortfall was greater in VAT and excise duties, reflecting both problems in revenue administration and forecasting issues, such as under-estimation of tax credits, and also lower than expected GDP growth, interest rates, and oil prices. However, a spike in non-tax revenues due to one-off sales of mobile telecom licenses worth 0.4 percent of GDP, interest savings, and under-execution of spending by 1.2 percent of GDP across the board kept the budget in line with expectations. Public debt continued to rise and is estimated to have reached 72.2 percent of GDP by yearend. In December, the Parliament adopted the 2016 budget, which targets a headline deficit of 2.5 percent of GDP and a primary surplus of 0.3 percent—an adequate pace of consolidation. The budget proposes tighter control of expenditures and increased revenues through more effective administration. Tax adjustments, which aim at broadening the tax base, will have only a minor role.

On February 5, 2016, Standard & Poor's raised its long-term foreign and local currency sovereign credit ratings on the Republic of Albania from B to B+ and confirmed short-term foreign and local currency sovereign credit ratings at B, still below investment grade like the rest of the region. S&P assessed the outlook as stable, on the expectation that fiscal performance will remain strong through 2019 as authorities continue to make progress on an International Monetary Fund (IMF) program that targets fiscal and structural reforms. Earning a higher rating would require continued structural reforms, more robust fiscal institutions, and more encouraging economic prospects. However, if government finances begins to deteriorate, potentially tied to noncompliance with conditions in the IMF arrangement, the rating will be lowered.

The Albanian economy is expected to accelerate gradually. Growth will emerge with a pickup in investment in large FDI-financed infrastructure projects, such as the Trans Adriatic Pipeline and a hydropower plant in Southern Albania, and with gradual recovery of consumption. Net exports are expected to grow as the EU also gradually recovers. Improvement in the business climate and reforms to address high NPLs could further strengthen private investment and consumption in the medium term. Fiscal consolidation, supported by the 2016 budget exercise, limits the push from the government side. Growth is projected to reach 3.2 percent in 2016 and 3.5 percent in

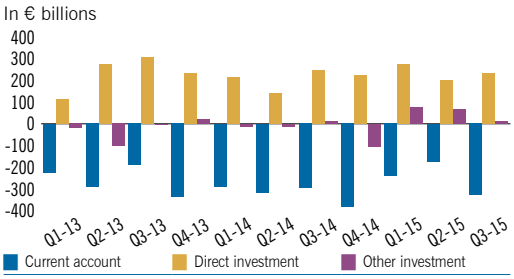
2017. Growth prospects for Albania hinge on accomplishing the structural reform agenda on energy, management of public investment, and pensions. Reforms already in progress are expected to both promote growth and have positive distributional effects. Going forward, it will be critical to maintain the momentum on reforms and fiscal consolidation efforts. Priorities are to address high NPLs, reinforce tax administration and close loopholes, undertake additional reforms in the energy sector, improve public investment management, and mitigate the fiscal risks associated with local government arrears, public-private partnerships, and claims for compensation.

Figure 3. Unemployment and Employment, 2012–15



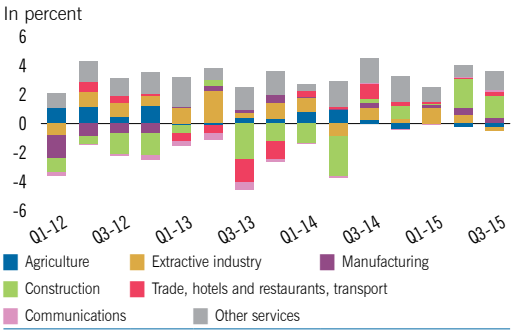
Source: INSTAT data.

Figure 4. Current Account Balance, FDI and Other Investments, 2013–15



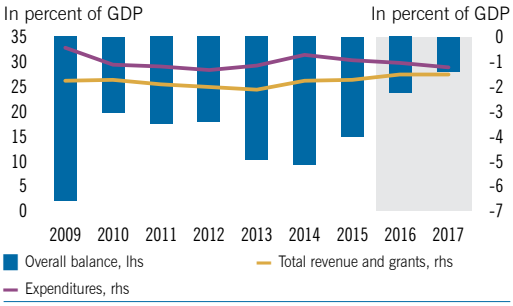
Source: CBCG and MONSTAT data.

Figure 5. GVA Growth by Sector, 2013–15



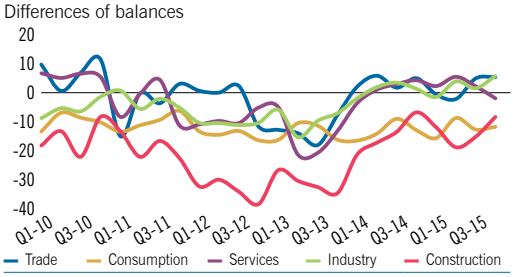
Source: INSTAT data.

Figure 6. General Government Revenues, Expenditures, and Deficit, 2009–17



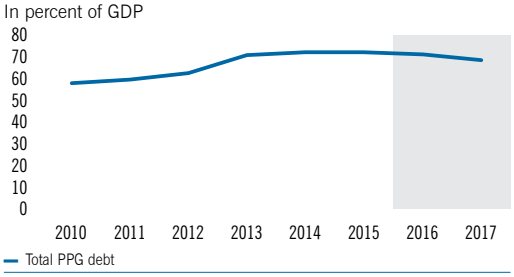
Source: MOF and INSTAT data.

Figure 7. Confidence Survey Indicators, 2010–15



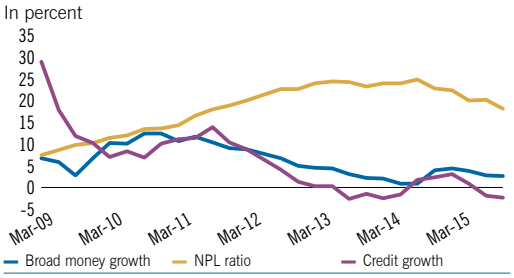
Source: INSTAT data.

Figure 8. General Government Debt, 2010–15



Source: MoF and INSTAT data.

Figure 9. Monetary Aggregates, Annual Growth and NPLs, 2009–15



Source: BoA data.

Figure 10. CPI Inflation, 2010–15

Source: INSTAT data.

ALBANIA	**2012**	**2013**	**2014**	**2015e**	**2016f**
Real GDP growth (percent)	1.6	1.1	2.0	2.6	3.2
Composition (percentage points):					
Consumption	0.3	1.2	3.0	-2.3	2.2
Investment	-2.3	-0.8	0.9	2.2	3.2
Net exports	3.7	0.7	-1.8	2.7	-2.2
Exports	-0.3	3.5	-6.0	1.1	
Imports (-)	4.0	-2.8	4.4	1.7	
Consumer price inflation (percent, period average)	2.0	1.9	1.6	1.9	2.3
Public revenues (percent of GDP)	24.7	23.7	26.2	26.3	27.4
Public expenditures (percent of GDP)	28.2	29.2	32.1	31.1	29.6
Of which:					
Wage bill (percent of GDP)	5.2	5.2	5.1	5.0	4.7
Social benefits (percent of GDP)	9.0	9.5	9.9	9.9	10.0
Capital expenditures (percent of GDP)	4.6	4.8	4.3	4.3	3.9
Fiscal balance (percent of GDP)	-3.5	-5.5	-5.9	-4.8	-2.5
Primary fiscal balance (percent of GDP)	-0.3	-1.7	-3.1	-2.2	0.3
Public and publicly guaranteed debt (percent of GDP)	62.0	70.4	71.8	71.9	70.7
Of which: External (percent of GDP)	26.9	26.6	29.6	33.5	34.6
Goods exports (percent of GDP)	15.9	18.2	9.3	8.0	7.5
Goods imports (percent of GDP)	36.8	36.1	30.8	28.7	29.1
Net services exports (percent of GDP)	2.2	-0.2	2.7	3.8	3.5
Trade balance (percent of GDP)	-18.7	-18.0	-18.8	-16.9	-18.1
Remittance inflows (percent of GDP)	9.2	7.1	7.2	6.9	6.7
Current account balance (percent of GDP)	-10.1	-10.7	-12.9	-11.4	-13.1
Foreign direct investment inflows (percent of GDP)	6.8	9.6	8.1	7	7.9
External debt (percent of GDP)	35.7	34.7	36.9	42.3	42.9
Real private credit growth (percent, period average)	4.6	-3.5	-1.4	0.6	0.9
Non-performing loans (percent of gross loans, end of period)	24	24.1	22.4	18.2	17.5
Unemployment rate (percent, period average)	13.4	16	17.5	17.1	16.8
Youth unemployment rate (percent, period average)	28.5	29.7	35.6	32.3	32
Labor force participation rate (percent, period average)	57.3	52.5	53.7	55.7	56
GDP per capita, PPP (current international $)	10,517.94	10,947.65	11,390.71	11,872.41	12,484.42
Poverty rate at US$5/day, PPP (percent of population)	47.5	47.2	46.7	46.2	45.5

Sources: Country authorities, World Bank estimates and projections.

Notes: Financial sector data for 2015 reflect year-to-date annual rolling averages unless otherwise stated. Youth unemployment rate is for labor force aged 15–29.

Bosnia and Herzegovina

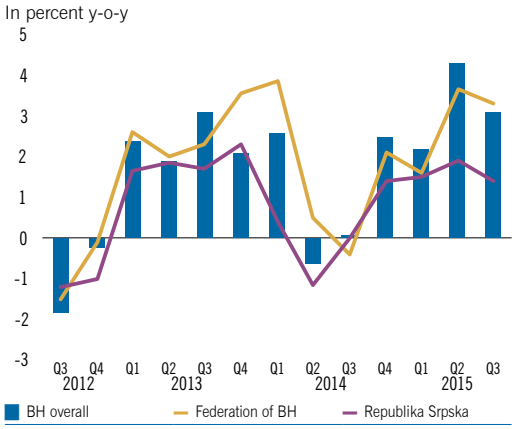
Growth in Bosnia and Herzegovina (BH) is likely to have reached 2.8 percent in 2015. Growth was higher than earlier expected with a supportive external environment boosting net exports and domestic activity rebounding from the impact of 2014 floods. Reforms are being advanced in a number of key areas, supported by the medium-term Reform Agenda that the authorities agreed on in mid-2015. Among them are major changes in labor laws, a new insolvency law recently adopted in one of the constituent entities, Republika Srpska (RS), and continuing pension and social assistance reforms in the Federation of Bosnia and Herzegovina (FBH). Adoption of the Reform Agenda and progress on realizing it are also the basis for the country's application for EU membership, which was submitted in mid-February 2016. However, the outlook for improved growth over the medium term is based on sustained implementation of long-standing reforms.

Recent developments

Economic growth was better than earlier expected in 2015, pushed up by a strong recovery from the impact of the previous year's floods. Net exports were the main driver of growth, with consumption also supportive and investment a drag on growth. Real GDP expanded by 4.3 percent year-on-year (y-o-y) in Q2—the highest rate in the last five years—and by 3.1 percent in Q3. On the production side, manufacturing and retail trade contributed around half the growth of real value added in the first three quarters of 2015. High frequency data suggest softening GDP dynamics in late 2015, and we projected growth to be 2.8 percent for 2015 as a whole.

The growth pick-up has not been reflected in labor market performance. Unemployment remains high, at 27.7 percent, with the number of persons in paid employment rising by only 1.9 percent y-o-y in November 2015. Net earnings were stagnant throughout 2015 across most sectors (up only 0.5 percent y-o-y in nominal terms).

Figure 1. Real GDP Growth, 2012–15



Source: Statistical offices.

Lower commodity prices, particularly for oil, continued to affect the economy of BH through a number of channels, most notably the trade balance and the impact on domestic

prices. Taken as a whole, the economic impact seems to be net positive because lower prices supported real disposable income, reduced real input costs, and reduced net imports. However, price deflation and minimal income growth raised the real burden of debt, with potential impact on household and corporate financial health.

Consumer price deflation persists, driven by lower prices for imported goods. The consumer price index (CPI) dropped by 1.3 percent y-o-y in December, the 13th consecutive month of declines, with the CPI now up only 3 percent from its 2010 average. The biggest drivers were falls in prices of imported goods and goods linked to the H2 2015 declines in euro-denominated oil prices, primarily food (down 1.5 percent y-o-y), clothing and footwear (down 8.3 percent), and transport (down 6.1 percent). Meanwhile alcohol and tobacco saw notable price rises, with smaller rises for education, health, housing, and utilities. Given the limited growth in nominal salaries, declining consumer prices provided some boost to real incomes. The net monthly salary in December 2015 averaged €421, down by 0.1 percent y-o-y in nominal terms.

The trade deficit continued to improve, though at just under 30 percent of GDP it is still significant. Lower oil prices brought down imports of related products, and improved external demand supported exports. Monthly data indicate that in 2015 imports fell by 2.1 percent y-o-y while exports, mainly to neighbors and the EU, increased by 3.5 percent, although growth fell late in the year. The trade deficit, valued in euros, fell by 8.7 percent, to €3.5 billion.

The reduction in the current account deficit (CAD) in 2015 was mainly the result of the declining trade deficit. The CAD is estimated to have narrowed from 7.8 percent in 2014 to 6.3 percent of GDP in 2015. This was driven by the reduction in the trade deficit for goods; in nominal US dollar terms, while the services surplus and remittances were relatively stable. In terms of net external financing, net FDI inflows are estimated to have dropped from 3 percent of GDP in 2014 to about 1.5 percent, leaving significant dependence on debt-creating inflows. This level of FDI does not provide much support for domestic investment rates (about 18 percent of GDP) or potential positive spillovers to economic growth.

Collections of gross revenue from indirect taxes went up in 2015. Collections increased by 1.7 percent y-o-y in 2015, led by higher excise tax collections, which contributed 1.1 percentage points (pp) to the growth in indirect tax revenue; of this 0.6 pp was due to the excise tax on petrol and 0.4 pp to the excise tax on tobacco.

The fiscal deficit is expected to remain little changed at 2 percent of GDP in 2016. Nonetheless, there are some positive signs of improvements in budgetary processes and steps toward much-needed improvements in the quality and structure of spending. For example, a moratorium on public employment was introduced for 2016, and pension reforms continue in FBH. Given previous delays in budget adoption, particularly following the need to form governments in 2015 for FBH and the BH Institutions, adoption in late 2015 of all three 2016 budgets is a positive early sign of how fiscal policy will be implemented this year.

Still, 2016 budget allocations are considerably higher than in 2015. Both Houses of the BH Parliament Assembly adopted the 2016 BH State Budget without amendments. That budget amounts to about €880 million (approximately 6 percent of estimated 2016 BH GDP), of which €486 million is for financing state institutions and €394 million for servicing foreign debt. While the former amount is the same level as in the four previous years, foreign debt servicing is about 29 percent higher than was budgeted for 2015. Furthermore, the Federation parliament adopted a budget with expenditures of €800 million (5.5 percent of estimated 2016 BH GDP), up 11 percent over the 2015 budget, with net lending of €155 million (1 percent of estimated 2016 BH GDP). In the RS the overall budget increased to €1.6 billion (11 percent of overall GDP), 40 percent higher than in 2015. The main difference is to the inclusion for the first time of the RS Pension and Disability Insurance Fund in the RS Budget and Treasury System. At €31 million, net lending is unchanged from 2015. The central government budgets do not cover spending by lower levels of government; general government spending for 2016 is projected at about 46 percent of GDP).

In Bosnia and Herzegovina monetary policy continues to be run through a currency board with the euro as the anchor currency. International reserves in 2015 were a comfortable 6 months or so of imports. Given its linkage to the euro, the BH convertible mark (BAM) has seen sustained depreciation against the dollar but nominal appreciation recently against the currencies of some trading partners. This contributed to some appreciation in both the nominal and the real effective exchange rate in late 2015, although in recent years the latter has been restrained due to weak price growth.

Financial sector support to economic activity has been constrained by deleveraging and by rising concerns about asset quality. While the banking sector remains stable and now relies less on foreign financing, many of the foreign-owned banks that dominate the banking system have been gradually deleveraging. This has contributed to falling credit growth, which averaged only 3.0 percent y-o-y from 2009 through December 2015; between 2003 and 2008 credit had grown by 24 percent a year. In addition, the share of nonperforming loans (NPL) in commercial bank portfolios was high, reaching 13.7 percent as 2015 ended. High provisioning for NPLs has caused some deterioration in bank profitability. Asset quality concerns make it hard to reestablish bank profitability, mainly because the country's corporate resolution and insolvency laws are inadequate. In a positive development, however, RS has recently adopted a new insolvency framework.

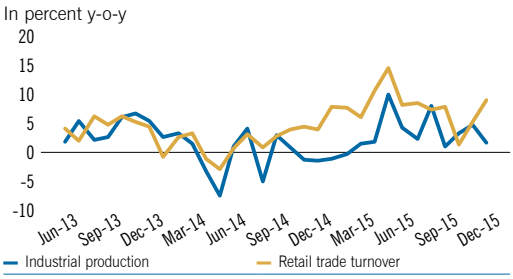
The entities have launched a number of reform initiatives as part of the Reform Agenda adopted in mid-2015. Both RS and FBH have new labor laws to address long-standing rigidities in their labor markets and to support job creation. However, the FBH constitutional court recently ruled that the FBH law needed to return to Parliament to have procedural violations resolved and in March the labor law in FBH is returned to Parliament procedure. Other reforms underway include reinforcing unemployment benefit systems and, in FBH, pension reforms. Addressing public sector arrears and reforming SOEs are also priorities. BH submitted its application for EU membership in mid-February 2016.

Outlook

Supported primarily by growth in consumption, medium-term economic growth is likely to strengthen to above 3 percent. Although the recovery in EU import demand will lead to a moderate rise in exports, given the relative strength of import demand, net external demand will continue to be a drag on growth. External conditions will, however, support a stable inflow of remittances, which, combined with sustained lower oil prices, will promote a gradual pick-up in consumption, keeping it a key driver of growth. Investments in energy and tourism will support growth in investment generally. As a result of these dynamics, real GDP growth is projected to strengthen gradually from 2.8 percent in 2015 to 3.5 percent in 2018. This projection depends, however, on sustained reforms, and the absence of adverse shocks to external trade and financial conditions.

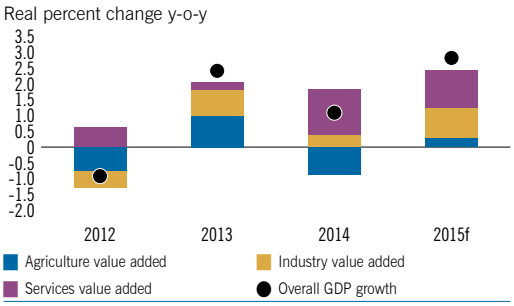
Achieving prudent, efficient, and effective fiscal policy within a highly decentralized fiscal system is central to BH's multi-dimensional reform agenda. Although deficits remain relatively moderate, the fiscal sector is still characterized by a high tax burden and inefficient patterns of spending. Fiscal consolidation will not be effective if structural rigidities on the expenditure side are not unaddressed, especially the large public wage bill and sizeable and poorly targeted social assistance. The proposed IMF program, and support from other partners like the World Bank, can help the authorities to deliver on their challenging agenda.

Figure 2. Growth in Industrial Production and Retail Trade



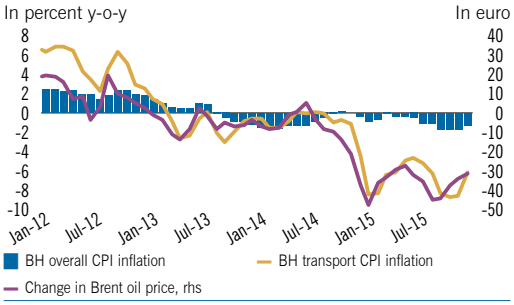
Source: BH Agency for Statistics.

Figure 3. GDP Growth on the Production Side, 2012–15



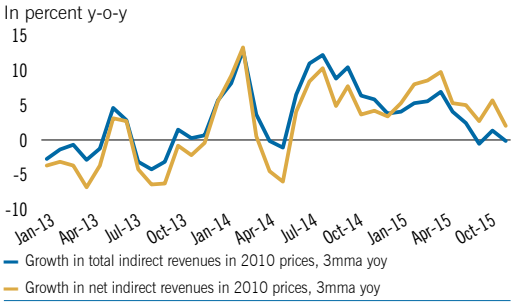
Source: BH Agency for Statistics, World Bank.

Figure 4. Consumer Price Inflation



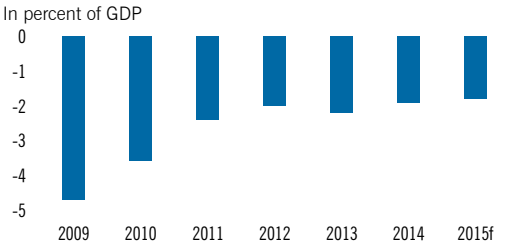
Source: BH Agency for Statistics.

Figure 5. Real Indirect Tax Revenues



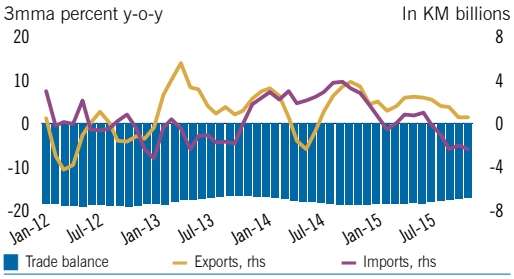
Source: Indirect Tax Office, World Bank.

Figure 6. General Government Fiscal Balance



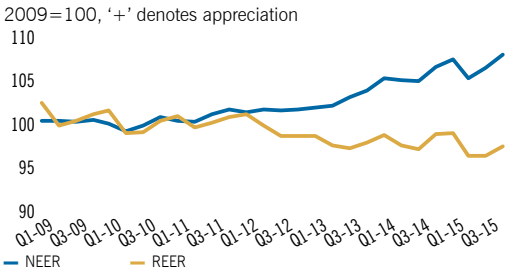
Source: Fiscal authorities, World Bank Staff est.
Note: f=forecast.

Figure 7. Growth in Exports and Imports, and the Goods Trade Balance



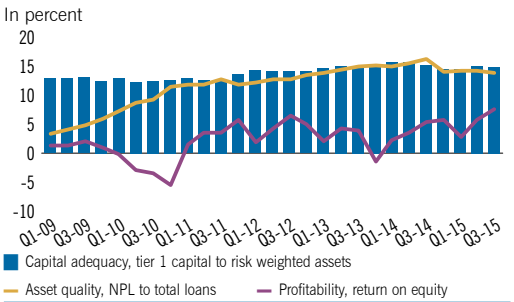
Source: BH Agency for Statistics, World Bank.

Figure 8. Real and Nominal Effective Exchange Rates



Source: Central Bank of BH, World Bank Staff calculations.

Figure 9. Banking Sector Performance Indicators



Source: Central Bank of BH, World Bank Staff calculations.

BOSNIA AND HERZEGOVINA	**2012**	**2013**	**2014**	**2015e**	**2016f**
Real GDP growth (percent)	-0.9	2.4	1.2	2.8	2.6
Composition (percentage points):					
Consumption				0.7	2.0
Investment				0.1	1.0
Net exports				2.0	-0.4
Exports				1.0	0.7
Imports (-)				0.9	-1.1
Consumer price inflation (percent, period average)	2.0	-0.1	-0.9	-1.0	-0.5
Public revenues (percent of GDP)	44.5	43.4	43.8	44.5	43.2
Public expenditures (percent of GDP)	46.6	45.6	45.8	46.3	45.2
Of which:					
Wage bill (percent of GDP)	12.9	12.5	12.0	11.7	11.4
Social benefits (percent of GDP)	17.1	16.8	17.1	17.1	16.9
Capital expenditures (percent of GDP)	3.2	4.0	4.3	4.4	4.4
Fiscal balance (percent of GDP)	-2.0	-2.2	-2.1	-1.8	-2.0
Primary fiscal balance (percent of GDP)	-1.5	-1.2	-1.3	-0.7	-1.0
Public debt (percent of GDP)	39.5	36.4	39.0	39.8	41.4
Public and publicly guaranteed debt (percent of GDP)	44.3	40.8	43.0	43.8	45.2
Of which: External (percent of GDP)	27.8	28.2	30.1	30.6	31.3
Goods exports (percent of GDP)	22.6	24.3	24.2	23.9	23.6
Goods imports (percent of GDP)	53.5	52.0	53.9	51.6	51.0
Net services exports (percent of GDP)	7.0	6.8	6.8	7.3	7.5
Trade balance (percent of GDP)	-24.0	-20.8	-22.9	-20.4	-19.9
Remittance inflows (percent of GDP)	8.1	8.1	8.5	8.4	8.3
Current account balance (percent of GDP)	-8.8	-5.7	-7.8	-6.3	-6.4
Foreign direct investment inflows (percent of GDP)	2.0	1.7	2.6	1.4	1.7
External debt (percent of GDP)	52.8	53.9	50.8	54.0	55.1
Real private credit growth (percent, period average)	1.0	1.9	4.0	2.2	2.5
Non-performing loans (percent of gross loans, end of period)	13.5	15.1	14.2	14.1	14.0
Unemployment rate (percent, period average)	28.1	27.5	27.5	27.7	27.5
Youth unemployment rate (percent, period average)	63.3	58.8	62.9	62.3	62.1
Labor force participation rate (percent, period average)	44.0	43.6	43.7	44.1	44.3
GDP per capita, PPP (current international $)	9,214.0	9,562.8	9,808.0	10,359.6	10,500.0
Poverty rate at US$5/day, PPP (percent of population)					

Sources: Country authorities, World Bank estimates and projections.

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

Kosovo

Fueled by domestic demand, real economic growth reached an estimated 3.6 percent in 2015 and is projected to remain little changed in 2016. Consumption and investment contributed positively to growth, but the contribution of net exports was negative due to weaker trade revenue in the last quarter driven by a fall in export of base metals, Kosovo's main commodity. Foreign direct investment went up by 150 percent in 2015, with more originating in the EU after Kosovo signed the Stability Association Agreement. Despite solid revenue growth of 9.4 percent, fiscal adjustment was needed so that Kosovo could honor its fiscal rule that, with few exceptions, caps budget deficits at 2 percent of GDP. The IMF approved a 22-month, €184-million Stand-by Arrangement (SBA) on July 29, 2015. The first SBA review was concluded positively in January 2016. The country's economic performance will be similar in 2016 subject to political stability and a successful start of FDI in the Brezovica Ski Resort.

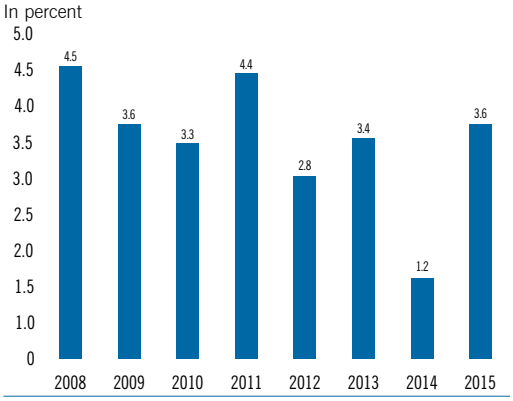
Recent developments

Despite political instability, the Kosovo economy performed well in 2015. Growth for the year is estimated at 3.6 percent, driven by domestic demand. Investment contributed 4.1 percentage points (pp) to growth. Private investment was boosted by more foreign direct investment (FDI) and greater access to mortgage loans; public investment also intensified at the end of the year. Private consumption added an estimated 0.9 pp, fueled by an increase of 9 percent in remittances and by higher wages and pensions since 2014. Net exports had a negative 1.3 pp contribution to growth as exports fell in the last quarter. Exports of goods contributed only 0.1 pp to growth for the year and the contribution of imports was negative by 1.4 pp. On the production side, services were the main contributor to growth with 1.3 pp, mainly from private investment and public highway construction. Agriculture, forestry, and fishing together added 0.7 pp, and industry contributed 0.4 pp, mainly, as was expected, from significant growth in electricity production in 2015—a leveling effect after production was interrupted in 2014 by an explosion near the Kosovo A power plant. Public administration continued to have a negative effect on growth.

External imbalances widened in 2015. The current account deficit went from 7.9 percent of GDP in 2014 to 9.4 percent because of large profits of foreign-invested companies, and as the accelerated construction of the highway to FYR Macedonia (more funding was allocated during the fiscal year) required more imports of investment goods that pushed up transport services by 47.3 percent. More Kosovars traveled abroad, although visa liberalization has not yet been granted for Schengen countries, so that imports of travel services went up 7 percent. Exports of goods and services lost their initial steam (11.3 percent growth y-o-y was recorded through June) and were flat

by yearend compared to a year before. The slowdown in China brought down the prices of base metals, Kosovo's main commodity export, and slashed exports of goods late in the year. Exports of telecommunication services were depressed by 30 percent because of the spread of new technologies.

Figure 1. Real GDP Annual Growth Rates, Kosovo, 2008–15



Source: Kosovo Agency of Statistics (SAK) data.
Note: 2015 growth is an estimate based on data for Q1–Q3 from SAK.

Financial account balances went up by 180 percent in 2015, with inflows of FDI recovering. Net FDI inflow in 2015 more than doubled to about 5.3 percent, reflecting in substantial part reinvested earnings by foreign-invested companies (this is part of the negative amount recorded in the current account deficit). Most FDI originates in the EU but in 2015 a significant amount came from Turkey. This is a very positive development that complements progress toward EU accession with the signing of the Stabilization Association Agreement in 2015. Real estate, rentals, and business activities continued to attract most of the FDI.

The 2015 fiscal deficit was 1.9 percent of GDP (below the 2 percent fiscal rule cap), thanks to healthier revenues and a timely fiscal adjustment. The initial budget, which had been based on overoptimistic revenue projections, was corrected through a fiscal consolidation in the mid-year budget review. Among the revenue measures adopted were an increase in the VAT rate from 16 to 18 percent and improvements in tax collection, which produced 0.8 pp of GDP. Also helpful were lower execution of the original budget (cuts on goods and services, the wage bill, and war veteran benefits) by about 1 pp of GDP. Better tax collection was a major factor in the generation of 9.4 percent more revenue than in 2014. One-off revenues of 1.1 percent of GDP from partial liquidation of privatization fund increased Kosovo's yearend bank balances. Spending grew by 8.5 percent, mainly due to higher current spending on wages and pensions. Almost half of public investment spending was executed in the last quarter. At yearend Kosovo was able to allocate more funding than originally budgeted for the highway to Macedonia by transferring resources scheduled for nonperforming capital projects. This will also reduce the highway financing burden in coming years.

Deflation of 0.5 percent was recorded in 2015. Kosovo, a price taker, benefited from falling global fuel prices. The decline in global prices for transportation fuel that began in the second half of 2014 continued, leading to deflation in Kosovo throughout 2015. The costs of higher education and accommodation services also plunged. A slight decline in food prices in the second half of the year helped to mitigate poverty very slightly.

In 2015 Kosovo's financial sector was profitable and credit grew 7.3 percent. Commercial bank profits shot up by 56.5 percent y-o-y, driven by spending cuts.

Though improving, financial intermediation in Kosovo is still underdeveloped. As rates fell, interest rate spreads narrowed by an average of 2.9 pp to 7.1 percent. Lower interest rates heightened private credit by 7.3 percent (y-o-y) with credit growing faster to households (10.6 percent, y-o-y) than to businesses (5.7 percent). Meanwhile, deposits grew 6.4 percent. Transferable deposits, which are 60 percent of the total, grew more (23 percent); time deposits declined by 8.4 percent for households but went up 8.1 percent for corporations.

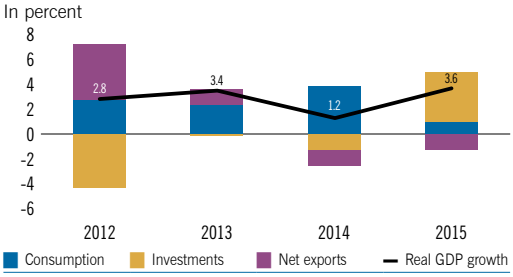
Nonperforming loans (NPLs) are coming down. After peaking at 8.8 percent in February 2014, by January 2016 they were down to just 6.2 percent of total loans, with the trend continuing in the right direction. NPLs are now lower in Kosovo than in the other SEE6 countries. Both corporate and household NPLs are dropping, mainly due to the successful work of private enforcement agents.

Outlook

Economic growth in Kosovo is expected to remain little changed in 2016 and 2017, assuming sustained consumption growth, rising exports, and starting investments of the FDI-financed Brezovica Ski Resort. Domestic demand is expected to drive positive growth but net exports will continue to be negative. Consumption is expected to contribute 2.4 pp to growth; private consumption should be up 2.6 pp, but public consumption will go down by 0.2 pp. Investments will add 1.4 percentage points to growth. Private investments will continue to be fueled by FDI, such as that for Brezovica. The public investments will benefit from higher spending on the highway to Macedonia. Net exports will continue to reduce growth by 0.3 pp because, although both will increase, imports will have a larger base than exports. The near-term outlook assumes no further political disruptions and preservation of 2015's positive trend in FDI inflows. The countries economic performance will be similar in 2016 subject to political stability and successful start of FDI in the Brezovica Ski Resort.

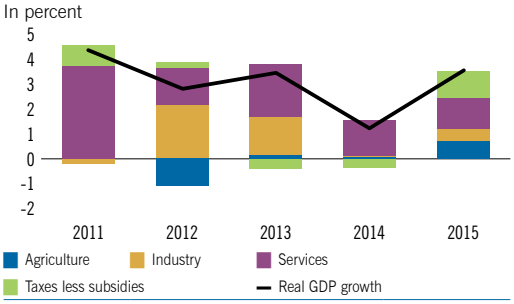
The fiscal stability achieved by the consolidation efforts in mid-2015 is expected to be preserved in the near term. The 2016 draft budget is in line with the IMF program, which should reinforce fiscal stability. The recent approval of the investment amendment to the current fiscal rule will both open up additional fiscal room for productive investments in strategic sectors and boost public investments and economic growth in coming years.

Figure 2. Growth in Aggregate Demand, 2012–15



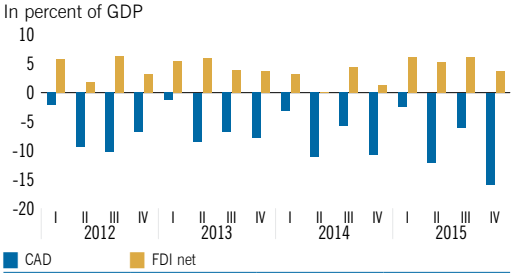
Source: Statistics Agency of Kosovo and World Bank.

Figure 3. Growth in the Economy by Sector, 2010–14



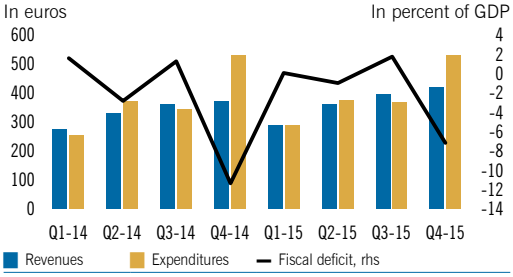
Source: Statistics Agency of Kosovo and World Bank.

Figure 4. Current Account Balance and FDI, 2011–15



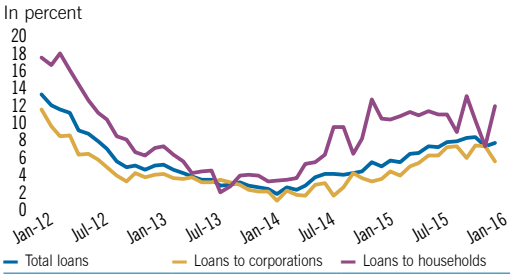
Source: Central Bank of the Republic of Kosovo and World Bank.

Figure 5. General Government Deficit, by Quarter, 2013–15



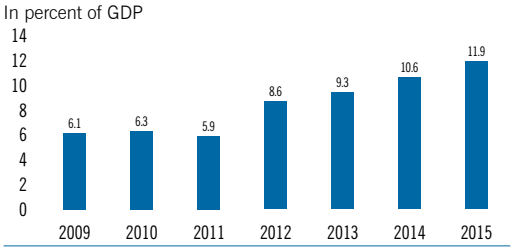
Source: Ministry of Finance and World Bank.

Figure 6. Annual Growth in Loans, 2012–15



Source: Central Bank of the Republic of Kosovo.

Figure 7. General Government Debt, 2008–15

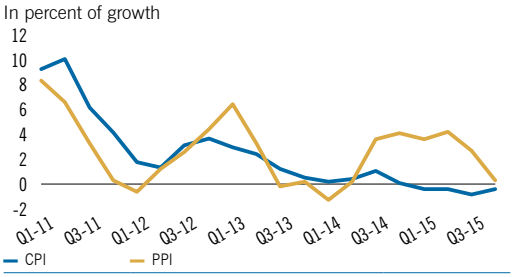


Source: Ministry of Finance.

Figure 8. Nonperforming Loans, 2008–15

Source: Central Bank of the Republic of Kosovo.

Figure 9. CPI and PPI, 2011–14



Source: Statistics Agency of Kosovo.

KOSOVO	2012	2013	2014	2015e	2016f
Real GDP growth (percent)	2.8	3.4	1.2	3.6	3.6
Composition (percentage points):					
Consumption	2.7	2.3	3.8	0.9	2.4
Investment	-4.4	-0.1	-1.4	4.1	1.4
Net exports	4.5	1.2	-1.2	-1.3	-0.3
Exports	0.1	0.4	3.0	0.1	0.3
Imports (-)	4.4	0.8	-4.2	-1.4	-0.7
Consumer price inflation (percent, period average)	2.5	1.8	0.4	-0.5	0.5
Public revenues (percent of GDP)	25.9	25.2	24.4	25.4	26.6
Public expenditures (percent of GDP)	28.5	28.1	27.0	27.3	28.4
Of which:					
Wage bill (percent of GDP)	8.1	7.9	9.1	9.3	9.2
Social benefits (percent of GDP)	3.7	4.2	6.1	6.9	7.4
Capital expenditures (percent of GDP)	10.8	10.1	7.5	7.4	7.8
Fiscal balance (percent of GDP)	-2.6	-2.9	-2.6	-1.9	-1.8
Primary fiscal balance (percent of GDP)	-2.4	-2.5	-2.4	-1.6	-1.5
Public debt (percent of GDP)	8.2	9.0	10.6	11.9	15.2
Of which: External (percent of GDP)	6.7	6.1	6.0	6.4	7.5
Goods exports (percent of GDP)	5.6	5.5	5.9	5.6	5.7
Goods imports (percent of GDP)	46.3	43.1	43.5	42.3	41.7
Net services exports (percent of GDP)	6.4	5.9	6.1	5.6	5.6
Trade balance (percent of GDP)	-34.3	-31.8	-31.5	-31.2	-30.4
Remittance inflows (percent of GDP)	12.0	11.7	12.7	13.2	13.5
Current account balance (percent of GDP)	-7.5	-6.9	-8.1	-9.4	-9.6
Foreign direct investment inflows (percent of GDP)	4.2	4.7	2.8	5.2	5.5
External debt (percent of GDP)	7.3	6.5	6.4	6.5	7.4
Real private credit growth (percent, period average)	5.8	1.9	3.0	7.3	
Nonperforming loans (percent of gross loans, end of period)	7.5	8.7	8.5	6.2	
Unemployment rate (percent, period average)	30.9	30.0	35.3	33.3	
Youth unemployment rate (percent, period average)	55.3	55.9	61.0	60.0	
Labor force participation rate (percent, period average)	36.9	40.5	41.6	42.6	
GDP per capita (US$)	3,600.7	3,877.2	4,052.7	3,551.0	3,629.0

Sources: Country authorities, World Bank estimates and projections.
Notes: Credit growth for 2015 reflects year-to-date annual rolling averages. Non-performing loans show year-to-date actuals.

FYR Macedonia

FYR Macedonia's economic growth remained robust at 3.7 percent in 2015, despite the political turmoil. Growth was driven by rising private consumption and higher public spending. Net exports made a small contribution to growth. The trade deficit narrowed in 2015, but net FDI inflows declined. The fiscal deficit was slightly lower than the budget had projected but still higher than that in the Medium Term Fiscal Strategy. Growth is expected to accelerate gradually in the medium term, but a prolonged political turmoil would affect this outlook negatively.

GDP growth remained robust in 2015, despite the political turmoil. Preliminary data indicate that FYR Macedonia's economy expanded by 3.7 percent in 2015. Growth was largely driven by construction (16.8 percent), wholesale and retail trade (7.3 percent) and services (3.4 percent), particularly real estate, fueled by buoyant credit growth. Manufacturing output contracted by 2 percent as the recovery in the second half of 2015, partially compensating for the slowdown earlier in the year. Finally, agriculture production has slowed down, despite receiving increasing subsidizes.

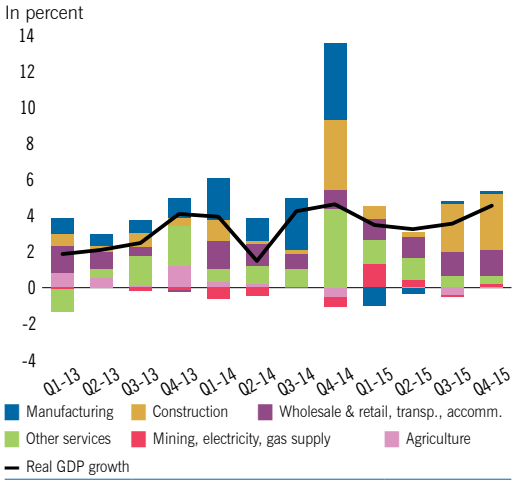
On the demand side, growth was largely driven by consumption, both private and public. Increasing employment combined with higher real wages, pensions, and social transfers, led to a 3.2 percent increase in private consumption in 2015. Government consumption also increased sharply in 2015 (4.6 percent), especially in the second half of the year. Gross investment rebounded in the third quarter, propelled by increased public outlays on highway construction. Growth in long-term credit to firms suggests that private investment also picked up toward the end of 2015. Exports (mostly FDI related) continued to perform well growing by 4.6 percent y-o-y. Imports growth was almost flat in the first three quarters, but a significant increase in FDI related imports in the last quarter propelled imports growth to 2.4 percent for the full year. Net external demand contributed favorably (although modestly) to GDP growth (0.7 percent y-o-y).

Deflation persisted in 2015. Falling global food and oil prices influenced domestic price movements and led to a general price decline of 0.3 percent. Meanwhile, core inflation went up slightly, by 0.5 percent, driven by higher prices for pharmaceuticals and IT equipment.

Widespread job creation caused unemployment to fall further in 2015. Employment rose by nearly 1 percent in 2015, due to new hires in manufacturing, public administration and services (especially accommodations and financial and real estates). Labor force participation remained stable at 57.2 percent. Unemployment dropped to an average of 26.1 percent in 2015, from 28.1 percent in 2014. Youth unemployment

also eased significantly, from 53.1 percent in 2014 to 47.3 percent in 2015, helped by costly youth employment programs. Still, long-term unemployment remains a problem: 61 percent of the registered unemployed report having been without a job for more than a year.

Figure 1. GDP Growth by Sector



Source: State Statistics Office data.

Exports grew faster than imports in 2015, narrowing the trade deficit. Exports increased by 9.0 percent (y-o-y) in euro terms in 2015, though they declined by the same amount in US dollar terms as the denar, which is pegged to the euro, depreciated against the dollar. Most of the growth was driven by FDI-related exports, which account for almost 40 percent of total exports. Exports from traditional segments, such as iron and steel, ores and slag, and tobacco, declined. Export destinations became more concentrated: 44 percent of exports (mainly parts and components related to the automobile sector) went to Germany, up from 41 percent in 2014. After declining in the third quarter, imports rebounded as the year ended, leading to 2015 growth of 5.5 percent (y-o-y). As a result, the trade deficit narrowed by 19 percent (y-o-y), to about 17 percent of GDP.

The current account deficit widened slightly in 2015, and net FDI inflows declined. Private transfers, though slightly lower than in 2014, were still enough to cover the trade deficit, alleviating external financing pressures. The current account deficit widened to 1.4 percent of GDP, up from 0.8 percent in 2014. The deficit is mainly financed by FDI. Net FDI decreased by 14 percent (y-o-y) in 2015, falling to 1.9 percent of GDP from 2.3 percent in 2014. This was largely due to capital outflows in May 2015 (the height of the political uncertainties in the country and the Greek crises) and later in September and November. As in 2014, reserves covered 4.6 months of imports.

Credit continued to expand and the financial sector is sound. Non-performing loans (NPLs) fell to 10.6 percent in December, thanks to a decline in corporate NPLs. The banking sector remains highly liquid (28.5 percent on average in Jan-Sep 2015). Profitability increased in the first three quarters of 2015, and the capital adequacy ratio held at 16 percent, well above the mandated 8 percent. Credit growth reached 9.5 percent (y-o-y) in 2015, slightly below the 9.8 percent in 2014; household lending accounted for 57 percent of the expansion.

The fiscal deficit narrowed in 2015, in part due to some payments that were deferred to 2016. Total revenues amounted to 28.8 percent of GDP in 2015, up from 27.8 percent in 2014. The increase was driven by reintroduction of a profit tax on non-reinvested earnings (not collected since 2009), and by higher social contributions linked to the improved labor market. VAT, which accounts for almost one-third of tax revenues, underperformed despite

higher growth and consumption. This result is probably due to a combination of factors, among them declining oil prices, weaknesses in revenue collection, and a growing VAT-exempt FDI segment. Expenditures increased less than revenues in 2015, but at 32.3 percent of GDP, this represents an increase from 32 percent in 2014. This increase largely reflects higher public wages, pensions, social transfers, and spending on goods and services, especially in the second half of 2015. The central government under-executed capital spending despite increases projected in the mid-year budget revision. However, capital spending by nongovernment public agencies compensated for government underperformance. The central government deficit reached 3.5 percent of GDP in 2015, lower than the revised budget (3.7 percent) and the result of 2014 (4.2 percent). The difference between actual and projected deficits mainly reflects transfers of contributions by the state-funded pension fund to private funds (about 0.1 percent of GDP) that were related to 2015 but deferred to January 2016.

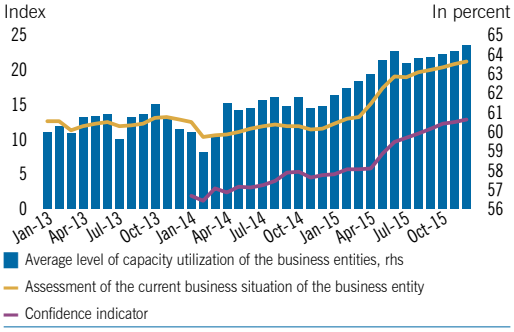
After declining in the first half of the year, public debt rose in the second half to a level higher than a year earlier. Public debt fell from 46 percent of GDP in December 2014 to 43.7 percent in July 2015 following prepayment of debt to the IMF (€154 million). Government issuance of a €270 million Eurobond and increased domestic net borrowing by € 94 million caused debt to rise in 2015. State guarantees associated with large investment projects, including two highways, added another 0.8 percent of GDP, which by year-end brought total public debt to 46.4 percent of GDP. Debt is expected to continue to expand in 2016 driven by increasing financing needs for the still high deficit level and the sizable State Owned Enterprises investment portfolio; in the first two months, €57 million in new domestic debt was issued.

Outlook

Growth is expected to remain robust at 3.7 percent in 2016 and increase to 4 percent in 2017. Public investment will continue to be an important driver of growth as the construction of the two highways is scheduled to end by 2018. Private consumption should continue to be strong, supported by increasing employment and possibly higher public wages, pensions, and social transfers. FDI exports are expected to continue increasing as the EU market gradually recovers, but the contribution of net external demand will continue to be modest.

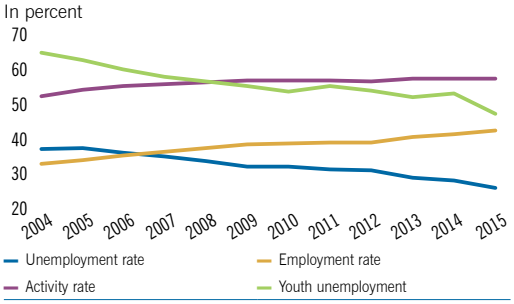
The political uncertainty and refugee crises are the primary risks to the economy over the coming year. General elections are currently scheduled for June 5, 2016, subject to satisfactory resolution of issues related to the voters registry, and the law on media. Prolonged political uncertainties could affect investment decisions and slow economic activity. Escalation of the current refugee crises may also be a risk, especially if the EU decides to close its borders or significantly limit the inflow.

Figure 2. Business Tendencies in Manufacturing



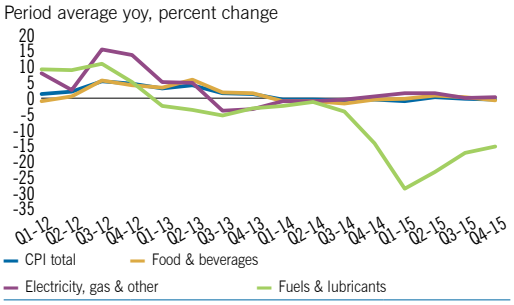
Source: State Statistics Office data.

Figure 3. Labor Market Developments, 2004–15



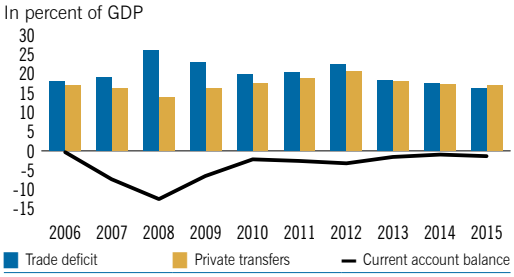
Source: State Statistics Office (Labor Force Survey).

Figure 4. The Main Components of the CPI, 2012–15



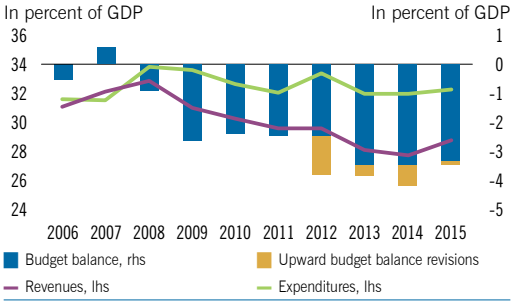
Source: State Statistics Office data.

Figure 5. Current Account Balance, Trade Deficit and Private Transfers, 2006–15



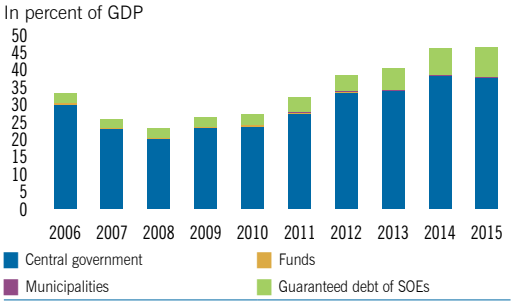
Source: National Bank data.

Figure 6. Central Government Budget Execution, 2006–15



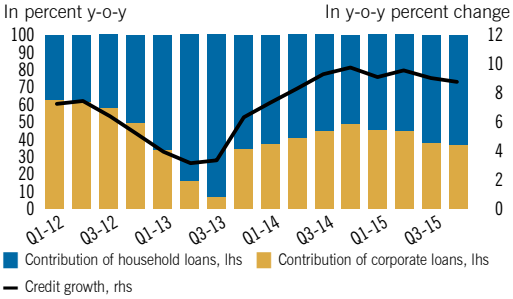
Source: Ministry of Finance and WB staff estimates.

Figure 7. Public Debt by Government Level, 2006–15



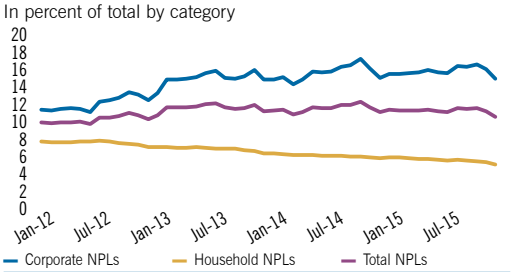
Source: National Bank data.

Figure 8. Credit Growth and Contribution to Credit Growth, 2012–15



Source: National Bank data.

Figure 9. Nonperforming Loans, 1/2012–12/2015



Source: National Bank data.

MACEDONIA, FYR	2012	2013	2014	2015e	2016f
Real GDP growth (percent)	-0.5	2.9	3.5	3.7	3.7
Composition (percentage points):					
Consumption	1.4	1.4	1.6	3.0	1.7
Investment	3.0	0.1	3.8	0.0	1.7
Net exports	-4.2	1.3	-1.7	0.7	0.3
Exports	0.9	2.6	8.0	2.3	2.2
Imports (-)	-5.1	-1.3	-9.7	-1.6	-1.9
Consumer price inflation (percent, period average)	3.3	2.8	-0.3	-0.3	0.9
Public revenues (percent of GDP)	32.1	30.2	29.8	30.9	31.1
Public expenditures (percent of GDP)	36.0	34.2	34.0	34.4	34.5
Of which:					
Wage bill (percent of GDP)	7.7	7.2	7.0	6.9	6.8
Social benefits (percent of GDP)	16.6	17.5	17.3	17.5	17.7
Capital expenditures (percent of GDP)	5.2	4.4	4.3	4.4	4.1
Fiscal balance (percent of GDP)	-3.8	-3.9	-4.2	-3.5	-3.4
Primary fiscal balance (percent of GDP)	-2.9	-2.9	-3.2	-2.3	-2.3
Government debt (percent of GDP)	33.7	34.2	38.2	37.9	39.6
Public and publicly guaranteed debt (percent of GDP)	38.3	40.5	45.9	46.4	48.9
Of which: External (percent of GDP)	25.6	25.6	31.9	31.2	33.0
Goods exports (percent of GDP)	30.4	29.1	32.5	33.5	34.4
Goods imports (percent of GDP)	56.9	51.9	54.2	53.4	54.1
Net services exports (percent of GDP)	4.1	4.6	4.2	3.8	4.0
Trade balance (percent of GDP)	-22.4	-18.2	-17.5	-16.3	-15.7
Remittance inflows (percent of GDP)	2.4	2.2	2.2	2.1	2.1
Current account balance (percent of GDP)	-3.2	-1.6	-0.8	-1.4	-1.7
Foreign direct investment inflows (percent of GDP)	1.7	2.8	2.3	1.9	2.1
External debt (percent of GDP)	66.1	64.0	69.8	69.7	70.1
Real private credit growth (percent, period average)	3.7	1.0	8.5	9.4	9.6
Non-performing loans (percent of gross loans, end of period)	10.3	11.3	11.1	10.6	10.3
Unemployment rate (percent, period average)	31.0	29.0	28.0	26.1	25.2
Youth unemployment rate (percent, period average)	54.0	51.9	53.1	47.3	46.0
Labor force participation rate (percent, period average)	56.5	57.3	57.5	57.2	57.4
GDP per capita, PPP (current international $)	11,874	12,468	12,938	13,330	13,797
Poverty rate at US$5/day, PPP (percent of population)	19.2	19.1	18.7	17.3	16.4

Sources: Country authorities, World Bank estimates and projections.

Notes: Labor market indicators and credit growth for 2015 reflect year-to-date annual rolling averages. Non-performing loans show year-to-date actuals. Poverty rates are based on FYR Macedonia survey on income and living conditions (SILC).

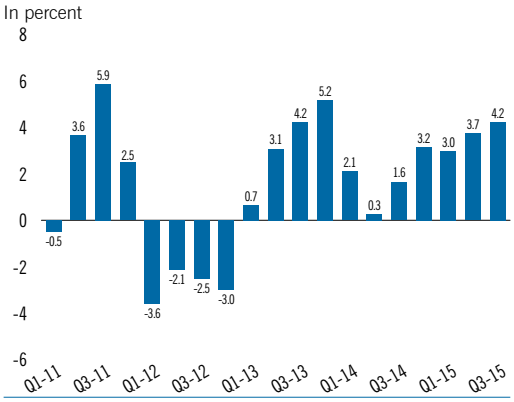
Montenegro

Economic growth is likely to have nearly doubled to 3.4 percent in 2015, fueled by investment—especially of the Bar-Boljare highway—and exports of tourism services. Although activity and employment rates reached historical highs, unemployment was also high at 17.6 percent. Stronger tourism receipts also helped narrow external imbalances, despite struggling goods exports, lower metal prices and Russian trade sanctions. After consolidation measures reduced the fiscal deficit to 3.1 percent of GDP in 2014, a rise in highway-related capital expenditures and revenue underperformance in 2015 pushed the general government deficit back up to 7 percent. As a result, public debt headed up toward 68 percent of GDP.

Highway construction and tourism underpinned economic recovery in 2015. After growing 1.8 percent in 2014, real GDP expanded by an estimated 3.4 percent in 2015 (ESA2010 methodology). Growth was supported by investment, both public and private, especially in the second half of the year as tourism projects and construction of a priority motorway section took off. Healthy growth in exports of services, particularly tourism, supported the economy: tourist arrivals expanded by 12.9 percent and overnight stays by 15.7 percent. Government consumption also grew, and higher household consumption boosted retail trade, which surged by 2 percent in 2015.

A recovery of domestic demand spurred inflation in 2015. After increasing throughout 2015, 12-month consumer prices grew by 1.4 percent in December. On average, although oil prices continued to drop, annual inflation amounted to 1.5 percent, up from negative 0.7 percent in 2014, driven by higher prices for food and clothes.

Figure 1. Real GDP Growth, 2011–15



Source: MONSTAT.

Although growth recovered, the labor market response was sluggish. Survey data pointed to 1 percent fewer unemployed by September compared to the same period of 2014; agriculture and service-related activities helped increase employment by 2.7 percent year-on-year (y-o-y). As a result, the four-quarter unemployment rate dropped to 17.6 percent though that was still high. Administrative employment data in the last quarter of 2015 showed a decline, and unemployment increased again, pushing the year-end unemployment

rate to 18.8 percent—1.9 percentage points more than in December 2014.

Labor inactivity remains high. The activity rate rose to 53.5 percent and the employment rate to 44.1 percent, but both are very low compared to EU peers. A new law introduced a limited quota of work permits for foreign workers, with the strict requirement to employ those available through the local unemployment bureau. Further, amendments to the Law on Social and Child Care introduced lifetime benefits for women giving birth to three or more children in the amount of 70 percent of the average net wage. Women qualifying are also entitled to health insurance (with a condition of having 25 years of service for mothers of three or 15 years of service for mothers of four or more children). The right cannot be exercised during active employment or while exercising pension rights; early developments suggest that around 15,000 women have applied for this entitlement, resulting in the withdrawals from the labor market.

Tourism helped narrow the external imbalance in 2015. The current account deficit declined to 13.4 percent of GDP in 2015, compared to 15.2 percent for the same period in 2014. The drop was led by a historically high current account surplus, pushed up by surging tourism revenues (19.1 percent y-o-y). Another positive contribution came from the improved income balance underpinned by increase in workers' remittances, reduced interest and dividend payouts. On the other hand, goods exports again struggled, especially meat exports suppressed by Russian trade sanctions, and led to a rise in the trade deficit to 40.6 percent of GDP.

Net FDI surged in 2015. Net FDI amounted to 17.2 percent of GDP largely because of surge in investments in companies and banks, mostly from Austria and Ukraine. Two more banks were given licenses during the course of 2015, with one more becoming operational in early 2016, resulting in a total of 15 banks for a small market of 620 thousand citizens.

Lending gradually recovered in 2015. After falling by 1.9 percent in 2014, total lending grew by 0.8 percent in 2015. While corporate and household borrowing grew by 3 percent, government and financial institutions reduced their borrowing from the banking sector. With total deposits surging by 13.7 percent annually, driven mostly by corporate savings, the loan-to-deposit ratio reached 90.9 percent by end-2015—the lowest level since 2007. As lending grew, the share of non-performing loans dropped from 15.9 percent at the end of 2014 to 12.5 percent.

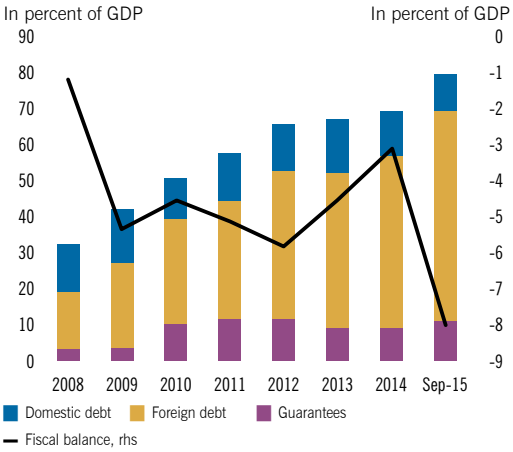
In 2015, the general government deficit grew to a preliminary 7 percent of GDP. The central government cash deficit reached 8 percent of GDP, against a budgeted 6.7 percent. The rise in capital spending (advances for construction of the Bar-Boljare highway) and repayment of arrears amounting to 2.2 percent of GDP (pension debt, resolution of court cases, and utilities) led to a surge in expenditures (10.9 percent y-o-y). Meanwhile, revenues dropped by 1.9 percent y-o-y, especially from VAT, as tax relief authorized for new investments eroded the tax base.

Public debt is estimated to head up to 68 percent of GDP in 2015. By September 2015, public debt already reached 67.9 percent of GDP, and grew 18 percent in nominal terms from the end of 2014. With guarantees

included, it reached 78.8 percent of GDP. The main impetus for the rise in public debt was external: the €500 million Eurobond and the €169 million Chinese EXIM Bank disbursement.

In November, Standard & Poor's (S&P) affirmed Montenegro's long-term and short-term B+/B ratings with stable outlook. S&P estimated annual average economic growth of 3.1 percent for 2015–18, supported by higher investment, predominantly in tourism and energy. However, the rating was tentative because the high deficit and public and external debt, especially for highway construction, raise risks to public finances.

Figure 2. Fiscal Balance and Public Debt, 2008–15



Source: Ministry of Finance (MoF) and MONSTAT data.

Fiscal policy will continue to be expansionary in 2016–18. The 2016 general government deficit is budgeted at 6.2 percent of GDP, with the expectation that growth will reach 4.1 percent. The government plans to allocate as much as €334.9 million for capital investments, with public debt expected to rise to 72.3 percent of GDP. The borrowing requirement in 2016 will be about 18 percent of GDP to repay €390 million in Eurobonds, allocate €255 million for the highway, finance the budget cash deficit, and settle health fund arrears. In early March, the government issued a €300 million 5-year Eurobond with a coupon of 5.75 percent—some two percentage points above the last year's issue.

The authorities have revised up the fiscal deficits for 2017–18 from the estimates presented in the September 2015 Fiscal Guidelines. The Guidelines shelved plans to get rid of the primary deficit by 2018. In November 2015, Albania and Montenegro signed a Memorandum of Understanding with a private Chinese company, Pacific, to start preparing the construction project for the Adriatic–Ionian Highway to connect the two countries along the coast. The estimated cost to Montenegro is €550 million, or 14.5 percent of GDP, which will further strain public finances. The January 2016 amendments to the Law on Pension and Disability Insurance will increase all pensions by at least 3 percent in July 2016, and the lowest pensions will be 20 percent higher. Added to the new social spending on lifetime benefits for mothers of three and more children this means spending of another 1.5 percent of GDP in 2016 alone. The savings from the planned staff rationalization, given the severance pays that would add to the costs in the near term, would hardly offset wage rise expected from the new Law on civil service wages.

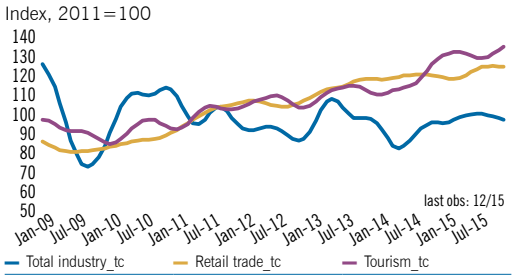
EU accession negotiations with Montenegro have advanced. In 2015, the EU opened six new chapters; so far, 22 of 35 negotiating chapters have been opened. However, if the negotiation process is to advance further, according to the 2015 EC Report on Montenegro and

Enlargement Strategy, the entire rule of law system of Montenegro needs to deliver results, in particular establish a track record in the fight against corruption and organized crime and complete implementation of the new electoral legislation. In terms of economic criteria, Montenegro is assessed as moderately prepared in developing a functioning market economy. Its public debt needs to be reduced and the competitiveness of industrial production and agriculture improved.

In January 2016, the Montenegrin parliament passed a vote of confidence in the government. The government was backed by members of leading party DPS, ethnic minority parties, Positive Montenegro, and the Social Democrats of Montenegro. The vote came after Prime Minister Djukanovic invited all opposition parties to join his government, offering the posts of ministers or assistant ministers of interior, finance, social welfare, and agriculture.

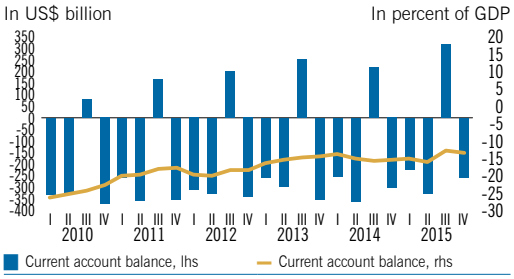
Economic growth is projected to continue at the same pace in 2016 and 2017, with investment in public infrastructure and tourism as the main drivers of economic activity. However, the risks to the outlook are again tilted to the downside. Slowing or stagnating growth in the Euro Area and globally and volatility in financial markets affected by gradual monetary tightening are the main external risks for budget financing and growth prospects. Montenegro's debt exposure to the US dollar (a highway loan amounting to €688 million in 2014) and borrowing needs over the medium term that exceed 17 percent of GDP present substantial risks to public finances. Risks on the domestic side include not only still high NPLs and delays in the structural reforms necessary to stabilize finances and increase competitiveness but also instability in domestic politics, which could reduce the confidence of foreign investors and cause them to pull back on their investments in Montenegro.

Figure 3. High Frequency Data, Trend-Cycle Adjusted Series, 2009–15



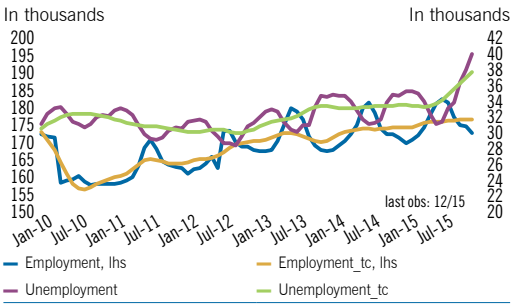
Source: MONSTAT and WB staff calculations.

Figure 4. Current Account Balance



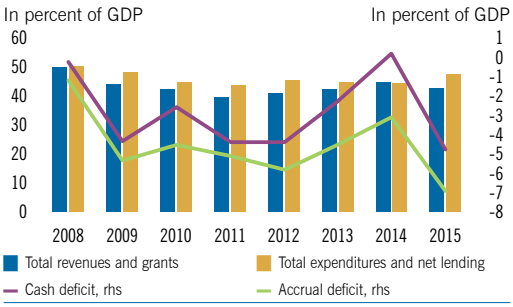
Source: CBCG and MONSTAT data.

Figure 5. Labor Market, Administrative Data



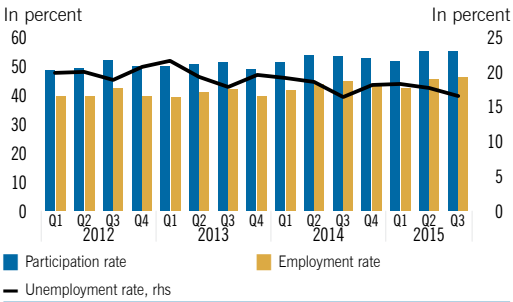
Source: MONSTAT and WB staff calculations.

Figure 6. General Government Deficit



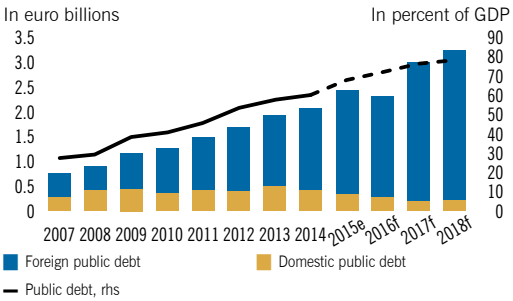
Source: MoF and MONSTAT data.

Figure 7. Labor Market, Survey-based Data, 2012–15



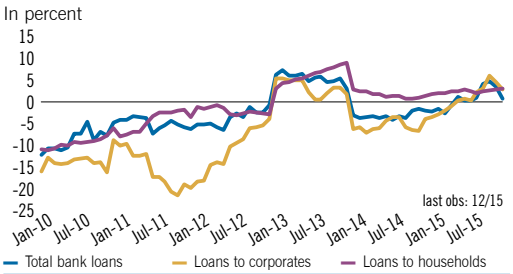
Source: MONSTAT data.

Figure 8. General Government Debt, 2007–18



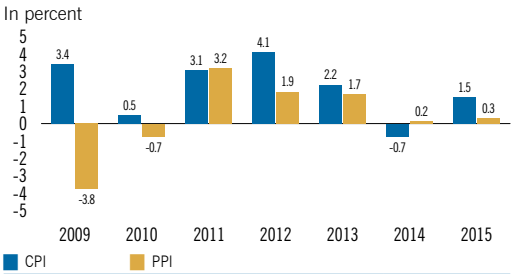
Source: MoF and MONSTAT data.

Figure 9. Loans: Annual Growth Rates, 2010–15



Source: CBCG data.

Figure 10. CPI and PPI, Annual Growth Rates, 2009–15



Source: MoF and MONSTAT data.

MONTENEGRO	2012	2013	2014	2015e	2016f
Real GDP growth (percent)	-2.7	3.5	1.8	3.4	3.7
Composition (percentage points):					
Consumption	-2.7	1.6	2.6	0.6	1.5
Investment	0.5	0.5	0.5	1.6	3.0
Net exports	-0.5	1.5	-1.2	1.2	-0.8
Exports	-0.1	-0.5	-0.3	2.4	0.6
Imports (-)	-0.4	2.0	-1.0	-1.2	-1.4
Consumer price inflation (percent, period average)	4.1	2.2	-0.7	1.5	1.9
Public revenues (percent of GDP)	40.9	42.3	44.6	42.4	43.7
Public expenditures (percent of GDP)	46.8	46.9	47.7	49.4	49.9
Of which:					
Wage bill (percent of GDP)	13.2	12.4	12.7	12.2	12.4
Social benefits (percent of GDP)	15.2	14.4	14.3	13.9	14.1
Capital expenditures (percent of GDP)	4.3	3.6	5.3	8.5	11.1
Fiscal balance (percent of GDP)	-5.8	-4.6	-3.1	-7.0	-6.2
Primary fiscal balance (percent of GDP)	-4.0	-2.4	-0.8	-4.8	-4.1
Public debt (percent of GDP)	53.4	57.5	59.9	68.0	72.3
Public and publicly guaranteed debt (percent of GDP)	65.4	66.8	68.8	78.8	82.6
Of which: External (percent of GDP)	49.8	49.5	56.0	68.2	74.7
Goods exports (percent of GDP)	12.3	11.8	10.3	9.0	8.8
Goods imports (percent of GDP)	56.0	51.3	50.1	49.7	49.5
Net services exports (percent of GDP)	19.2	19.4	20.0	21.9	21.5
Trade and services balance (percent of GDP)	-24.4	-20.1	-19.8	-18.7	-19.2
Remittance inflows (percent of GDP)	2.3	2.4	2.3	2.3	2.3
Current account balance (percent of GDP)	-18.5	-14.5	-15.2	-13.4	-14.2
Foreign direct investment inflows (percent of GDP)	14.5	9.6	10.2	17.2	11.0
External debt (percent of GDP)	144.8	142.3	145.2	147.7	149.2
Real private credit growth (percent, period average)	-9.3	2.6	-2.5	1.2	1.4
Non-performing loans (percent of gross loans, end of period)	16.5	17.5	15.9	12.5	11.8
Unemployment rate (percent, period average)	19.8	19.5	18.0	17.6	17.3
Youth unemployment rate (percent, period average)	42.6	41.7	36.3	38.5	38.1
Labor force participation rate (percent, period average)	49.8	50.1	52.7	53.5	54.0
GDP per capita, PPP (current international $)	13,729.7	14,286.0	14,338.0	14,395.4	14,524.9
Poverty rate at US$5/day, PPP (percent of population)	19.3	18.7	13.3	11.9	11.1

Sources: Country authorities, World Bank estimates and projections.

Notes: Labor market indicators and credit growth for 2015 reflect year-to-date annual rolling averages. Non-performing loans show year-to-date actuals.

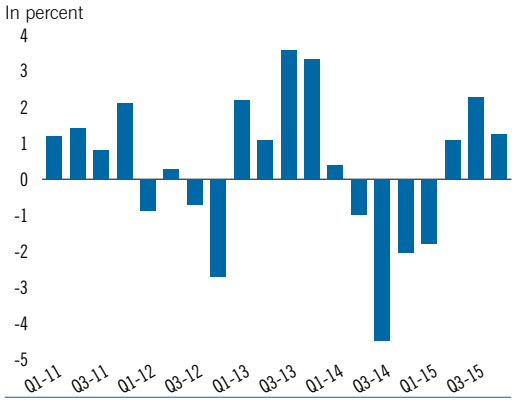
Serbia

In 2015 Serbia's economy returned to growth and unemployment declined, despite fiscal consolidation that reduced the fiscal deficit by more than earlier expected. Fiscal and structural reforms continued to make progress, the IMF program stayed on track, and there was a major breakthrough in the EU accession process so that the first negotiation chapters opened in early 2016. Continued work on structural reforms and fiscal discipline through this period are crucial to support growth and ensure that public debt stays sustainable.

Growth in 2015 turned out to be much better than had been earlier projected. After rebounding in Q3 to 2.3 percent y-o-y, initial estimates of real GDP growth in Q4 were 1.2 percent y-o-y. Growth for 2015 as a whole was an estimated 0.8 percent, considerably above the contraction of 0.5 percent expected earlier in the year. If not for drought, growth could have been even better. Agricultural output (accounting for 8 percent of GDP) declined by an estimated 8 percent y-o-y in real terms in 2015. With services value-added posting a small decline (0.2 percent y-o-y), the main driver of the growth recovery was industry, where real value-added grew by 5.8 percent y-o-y, supported by improving external conditions and recovery from the disruption of the floods. Consumption fell less than had been projected as private sector wages began to head upward. Investment also did well, up 8.4 percent, contributing 1.6 percentage points (pp) to growth, and construction was boosted by reforms to the permitting procedure. Export growth reached 8.2 percent in real terms, y-o-y.

As growth returned, unemployment fell but picked up slightly towards the end of 2015. Having peaked at 24 percent in 2012, unemployment has since declined. On average, compared to 2014 the number of employed rose by 0.6 percent in 2015, slightly below real GDP growth for the year. Importantly, the net increase in the number of employees came from the private, formal sector; the government hiring freeze continued and state-owned enterprises (SOEs) released about 15,000 people. As a result, employment in 2015 averaged 42.2 percent, the highest level since Q3 2008. During the year, the most significant improvement in the labor market was in Q3, when unemployment hit 16.7 percent. However, in Q4 it turned around and reached 17.9 percent (it had been 17.3 percent in Q4 2014). Aggregate real wages continued to slip in 2015, down 2 percent, following falls of 1.5 percent in 2013 and 0.8 percent in 2014. However, according to the most recent aggregate data, real wage growth y-o-y was 1.5 percent in December 2015 and 0.6 percent in January 2016. The latest data for public and private wages suggest that nominal public sector wages in 2015 were down by 5.5 percent y-o-y, while private sector wages went up by 3 percent.

Figure 1. Real GDP Growth, 2011–15

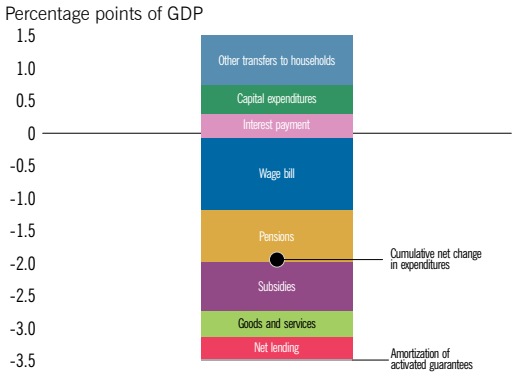


Source: Statistics Office.

Inflation continues to undershoot the target band due to lower oil prices and lack of domestic demand. Despite substantial monetary easing, consumer price inflation averaged 1.9 percent for 2015, below the National Bank of Serbia (NBS) target band of 4 ± 1.5 percent. After picking up in August to 2.1 percent y-o-y, primarily as a result of the electricity price increase, inflation held at about 1.4 percent for the rest of the year. With inflation low, since May 2013 the NBS has lowered its policy rate continuously, cutting rates seven times in 2015 alone, from 8.0 to 4.5 percent between January and October. In February 2016, in a surprise move, the policy rate was cut another 0.25 percentage points, because of minimal inflation pressures both domestically and from global developments. In January inflation reached 2.4 percent y-o-y, pushed up by higher food prices, but it went down to 1.5 percent in February.

Fiscal consolidation activities, along with one-off revenue gains, managed to reduce the general government fiscal deficit from 6.7 percent of GDP in 2014 to 3.7 percent in 2015. In the government's fiscal plan, as supported by the IMF program, three-quarters of the necessary structural adjustment through 2017 comes from wage and pension reforms and the rest from lower subsidies and additional revenues. The deficit was reduced in 2015 by both restrained spending (down 1.9 percent y-o-y in nominal terms) and higher revenues (up 4.6 percent). Additional tax revenues of 1.7 percent were almost entirely the result of higher excise income, an excise tax on electricity having been introduced in August 2015. Nominal expenditures were reduced by major savings from wage bill and pension reforms. Partially offsetting the savings (see Figure 2), spending on several categories increased, especially social assistance, investments and interest payments. Despite lower net financing needs, over 2015 general government debt, including guarantees, still shot up, from 72.3 percent of GDP at the end of 2014 to 76.8 percent, in part because of valuation effects from the appreciation of the US dollar against the dinar.

Figure 2. Net Reduction of General Government Spending by Category, 2014–15



Source: Ministry of Finance.

In euro terms, in 2015 Serbia's exports rose by 6.6 percent y-o-y and imports by 4.1 percent. The goods trade deficit at €4 billion declined slightly compared to 2014

and accounted for 12.1 percent of GDP. The current account deficit of €1.6 billion, 4.8 percent of GDP, was 21 percent lower than in 2014, due mainly to an improved services balance but also to higher net transfers. For the same period net foreign direct investment (FDI) was up 46 percent y-o-y in euro terms. Net FDI reached €1.6 billion, which more than covered the current account deficit. One-third of total FDI went to automotive and related industries. By the end of September 2015, external debt stood at €26.3 billion (79.5 percent of GDP). Banks and businesses continued to reduce their external debt but the government's rose by €728 million in the year through September.

After a period of stability in the second half of 2015, the exchange rate came under pressure in early 2016 as international markets became more turbulent. In 2015 improvement in the current account supported the dinar against the euro, and the National Bank of Serbia (NBS) became a net purchaser of euros to prevent appreciation of the dinar. While flat against the euro, in 2015 the dinar depreciated significantly against the US dollar, particularly early in the year, and by December it was down by 11.8 percent. In January 2016 the dinar again depreciated by 1.3 percent against the euro despite significant and frequent NBS foreign exchange market interventions. In February and early March the exchange rate stayed relatively flat against the euro. Official reserves were €9.9 billion at the end of February 2015, down €526 million since December.

The financial system seems to be stable, although asset quality remains a concern and some state-owned banks are problematic. The Serbian financial system weathered the global financial crisis and successive recessions relatively well, but not without consequences for the banking sector: nonperforming loans (NPLs) had gone up from 11.3 percent in 2008 to 22.3 percent by November 2015 and bank profitability had fallen. True NPLs may be higher: a recent NBS Asset Quality Review of 14 major banks led to upward revision of their estimated NPLs as of Q1 2015 from 22.6 to 27.4 percent. The NBS has also moved to intensify oversight of banks and has been more active in resolving the longstanding NPL problem thanks to the Action Plan for NPL Resolution approved in August 2015.

Credit activity, though recovering, is still tentative. Lending rates have declined, tracking the trend in policy rate changes but at a slower pace. On average, interest rates on new business loans declined by 192 bps in 2015, and on new loans to households by 224 bps. By year-end 2015 loans to the private sector were up 3 percent y-o-y (not adjusted for currency movements). Loans to enterprises, both private and SOEs, were up 2 percent, supported by the recovery in investment as well as the lower interest rates. While growth in loans to private enterprises had turned positive by yearend, for most of the year they were declining. Loans to households were up 4.7 percent in December (y-o-y), although growth has been slowing in recent months.

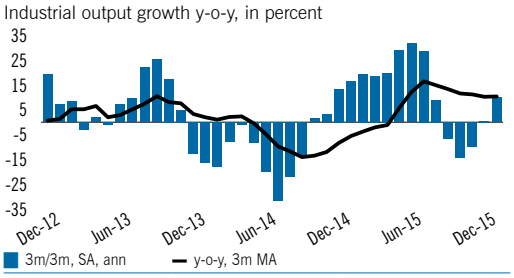
Outlook

Growth in Serbia is projected to rise from 0.8 percent in 2015 to 1.8 percent in 2016 and to 3.5 percent by 2017, based on rising investment, a gradual recovery of consumption, and growing external demand. Fiscal consolidation will continue to limit near-term domestic demand but will benefit Serbia in the medium term by supporting investment

and enhancing the business climate. The main domestic risk to growth is delays in structural reforms, due for example to the impact of the early elections, which may also deter foreign investors. Another risk to growth in 2016 are the effects of recent floods; their impact has yet to be estimated. With domestic demand recovering only gradually and import prices low, inflation is expected to return to the target band only in mid-2016.

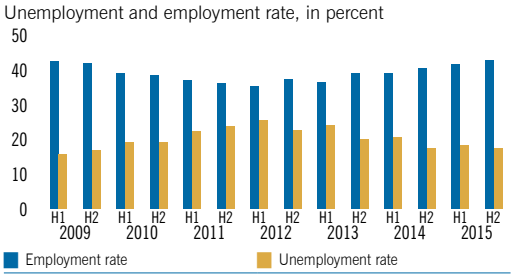
The current fiscal consolidation program is expected to put the public debt-to-GDP ratio on a downward trajectory by 2017. Over the medium term, government spending is expected to contract from 46 percent of GDP in 2014 to 42 percent by 2017, mostly from cutting recurrent spending. The 2016 budget as approved aims to consolidate further the significant fiscal adjustments made in 2015. Debt sustainability analysis, in a baseline scenario, projects that the public debt-to-GDP ratio will peak at 78.6 percent in 2016, after which it will begin to edge down. Early elections, possible delays in resolution of SOEs, and public sector rightsizing might put additional pressure on the 2016 budget. A more significant depreciation of the dinar could add further risks to debt sustainability.

Figure 3. Strong growth of industrial output helped Serbia's economy exit recession…



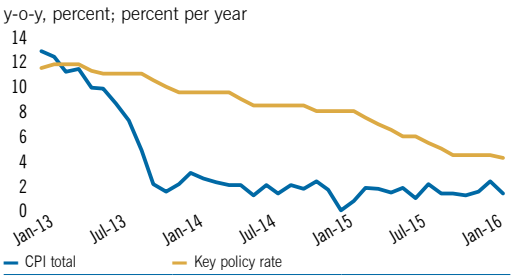
Source: Statistics Office.

Figure 4. …with the recovery reflected in labor market conditions



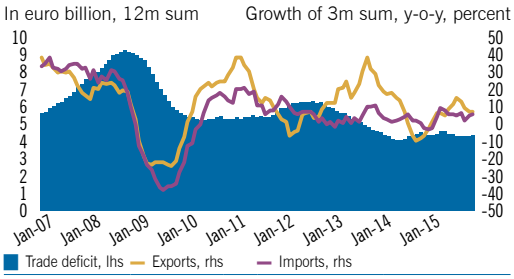
Source: LFS, Statistics Office.

Figure 5. Inflation remains low, despite the continued easing of the key monetary policy rate



Source: National Bank of Serbia.

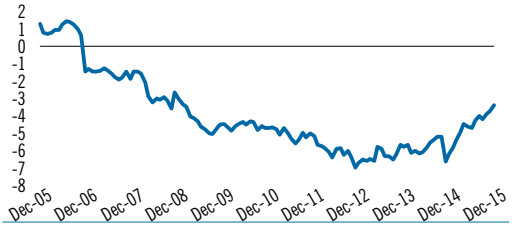
Figure 6. Exports were growing throughout 2015, but imports started picking up as well



Source: Statistics Office.

Figure 7. The fiscal deficit declined significantly in 2015…

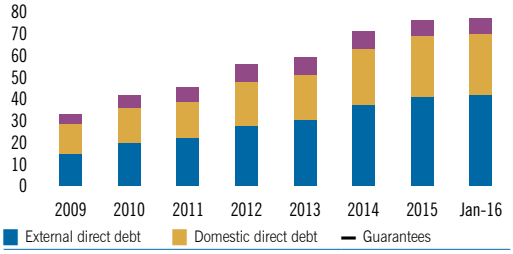
Fiscal balance as percent of annual GDP, 12-month sum



Source: Ministry of Finance.

Figure 8. …although general government debt-to-GDP moved up notably, in part due to currency movements

Government debt-to-GDP, percent



Source: Ministry of Finance – Public Debt Administration.

SERBIA	2012	2013	2014	2015e	2016f
Real GDP growth (percent)	-1.0	2.6	-1.8	0.8	1.8
Composition (percentage points):					
Consumption	-1.2	-0.6	-1.1	-0.9	0.3
Investment	0.6	-1.5	-0.1	1.7	1.5
Net exports	-0.4	4.8	-0.6	0.1	0.0
Exports	0.3	7.4	2.3	3.6	3.7
Imports (-)	-0.7	-2.6	-3.0	-3.5	-3.6
Consumer price inflation (percent, period average)	7.3	7.7	2.1	1.9	2.2
Public revenues (percent of GDP)	39.4	37.9	39.7	40.9	40.0
Public expenditures (percent of GDP)	46.6	43.5	46.3	44.6	43.6
Of which:					
Wage bill (percent of GDP)	10.5	10.1	10.0	8.9	8.9
Social benefits (percent of GDP)	18.1	17.7	17.8	17.8	17.2
Capital expenditures (percent of GDP)	3.3	2.1	2.5	2.9	2.9
Fiscal balance (percent of GDP)	-7.2	-5.6	-6.6	-3.7	-3.6
Primary fiscal balance (percent of GDP)	-5.3	-3.2	-3.7	-0.5	-0.1
Public debt (percent of GDP)	49.2	52.6	64.6	69.5	73.2
Public and publicly guaranteed debt (percent of GDP)	57.4	60.9	72.3	76.8	78.6
Of which: External (percent of GDP)	33.2	35.7	43.1	45.8	49.2
Goods exports (percent of GDP)	26.5	30.7	31.9	34.3	36.0
Goods imports (percent of GDP)	44.3	42.8	44.3	46.4	47.3
Net services exports (percent of GDP)	0.4	0.9	1.4	2.2	2.6
Trade balance (percent of GDP)	-17.5	-11.2	-10.9	-9.9	-8.7
Remittance inflows (percent of GDP)	6.1	6.3	5.6	6.3	6.2
Current account balance (percent of GDP)	-11.6	-6.1	-6.0	-4.8	-4.6
Foreign direct investment inflows (percent of GDP)	2.4	3.8	3.7	4.8	4.7
External debt (percent of GDP)	81.2	75.1	78.4	83.4	83.3
Real private credit growth (percent, period average)	6.3	-9.2	-4.0	-2.2	-0.7
Non-performing loans (percent of gross loans, end of period)	18.6	21.4	23.0	22.8	22.0
Unemployment rate (percent, period average)	24.0	22.1	19.4	17.9	17.5
Youth unemployment rate (percent, period average)	51.0	49.4	47.0	42.9	42.0
Labor force participation rate (percent, period average)	47.7	48.4	51.8	51.4	52.0
GDP per capita, PPP (current international $)	12,790.8	13,404.8	13,378.0	13,576.8	13,944.3
Poverty rate at US$5/day, PPP (percent of population)	14.8	14.5	14.7	14.4	14.0

Sources: Country authorities, World Bank estimates and projections.

Notes: Labor market indicators and credit growth for 2015 reflect year-to-date annual rolling averages. Non-performing loans show year-to-date actuals.

6. SEE6: Key Economic Indicators

SEE6: Key Economic Indicators

	2012	2013	2014	2015e	2016f	2017f
			Real GDP growth (percent)			
Albania	1.6	1.1	2.0	2.6	3.2	3.5
Bosnia and Herzegovina	-0.9	2.4	1.1	2.8	2.6	3.1
Kosovo	2.8	3.4	1.2	3.6	3.6	4.0
Macedonia, FYR	-0.5	2.9	3.5	3.7	3.7	4.0
Montenegro	-2.7	3.5	1.8	3.4	3.7	3.1
Serbia	-1.0	2.6	-1.8	0.8	1.8	2.3
SEE6	*-0.3*	*2.5*	*0.3*	*2.1*	*2.6*	*3.0*
			Consumer price inflation (percent, end of period)			
Albania	2.4	1.9	0.7	1.9		
Bosnia and Herzegovina	1.7	-1.4	-0.5	-1.2		
Kosovo	3.7	0.5	-0.4	-0.3		
Macedonia, FYR	4.7	1.4	-0.3	-0.3		
Montenegro	5.1	0.3	-0.3	1.4		
Serbia	12.2	2.2	1.7	1.5		
SEE6	*7.0*	*1.2*	*0.7*	*0.7*		
			Public expenditures (percent of GDP)			
Albania	28.2	29.2	32.1	31.1	29.6	28.4
Bosnia and Herzegovina	46.6	45.6	45.8	46.3	45.2	44.1
Kosovo	28.5	28.1	27.0	27.3	28.4	28.2
Macedonia, FYR	36.0	34.2	34.0	34.4	34.5	34.0
Montenegro	46.8	46.9	47.7	49.4	49.9	48.4
Serbia	46.6	43.5	46.3	44.6	43.6	41.8
SEE6	*38.8*	*37.9*	*38.8*	*38.8*	*38.5*	*37.5*
			Public revenues (percent of GDP)			
Albania	24.7	23.7	26.2	26.3	27.4	27.3
Bosnia and Herzegovina	44.5	43.4	43.8	44.5	43.2	42.1
Kosovo	25.9	25.2	24.4	25.4	26.6	26.3
Macedonia, FYR	32.1	30.2	29.8	30.9	31.1	31.2
Montenegro	40.9	42.3	44.6	42.4	43.7	42.1
Serbia	39.4	37.9	39.7	40.9	40.0	39.1
SEE6	*34.6*	*33.8*	*34.7*	*35.0*	*35.3*	*34.7*

SEE6: Key Economic Indicators

	2012	2013	2014	2015e	2016f	2017f
			Fiscal balance (percent of GDP)			
Albania	-3.5	-5.5	-5.9	-4.8	-2.2	-1.1
Bosnia and Herzegovina	-2.0	-2.2	-2.1	-1.8	-2.0	-2.0
Kosovo	-2.6	-2.9	-2.6	-1.9	-1.8	-1.9
Macedonia, FYR	-3.8	-3.9	-4.2	-3.5	-3.4	-3.0
Montenegro	-5.8	-4.6	-3.1	-7.0	-6.2	-6.4
Serbia	-7.2	-5.6	-6.6	-3.7	-3.6	-2.6
SEE6	*-4.2*	*-4.1*	*-4.1*	*-3.8*	*-3.2*	*-2.8*
			Public debt (percent of GDP)			
Albania	58.0	66.6	67.7	67.8	65.8	62.9
Bosnia and Herzegovina	39.5	36.4	39.0	39.8	41.4	42.0
Kosovo	8.2	9.0	10.6	13.0	14.9	16.3
Macedonia, FYR	33.7	34.2	38.3	37.9	39.5	40.3
Montenegro	53.4	57.5	59.9	68.0	72.3	76.4
Serbia	49.2	52.6	64.6	69.5	73.2	73.3
SEE6	*40.3*	*42.7*	*46.7*	*49.3*	*51.2*	*51.9*
			Public and publicly guaranteed debt (percent of GDP)			
Albania	62.0	70.4	71.8	71.9	70.7	68.1
Bosnia and Herzegovina	44.3	40.8	43.0	43.8	45.2	45.6
Kosovo	8.2	9.0	10.6	13.0	15.2	16.7
Macedonia, FYR	38.3	40.5	46.0	46.4	48.9	50.3
Montenegro	65.4	66.8	68.8	78.8	82.6	86.3
Serbia	57.4	60.9	72.3	76.8	78.6	77.6
SEE6	*45.9*	*48.1*	*52.1*	*55.1*	*56.9*	*57.4*
			Goods exports (percent of GDP)			
Albania	15.9	18.2	9.3	8.0		
Bosnia and Herzegovina	22.6	24.3	24.2	23.9		
Kosovo	5.6	5.5	5.8	5.6		
Macedonia, FYR	30.4	29.2	32.5	34.4		
Montenegro	12.3	11.8	10.3	9.0		
Serbia	26.5	30.7	31.9	34.3		
SEE6	*22.5*	*24.7*	*24.2*	*25.0*		

SEE6: Key Economic Indicators

	2012	2013	2014	2015e	2016f	2017f
			Trade balance (percent of GDP)			
Albania	-18.7	-18.0	-18.8	-16.9		
Bosnia and Herzegovina	-24.0	-20.8	-22.9	-20.4		
Kosovo	-34.1	-31.6	-31.0	-31.1		
Macedonia, FYR	-22.5	-18.5	-17.6	-16.8		
Montenegro	-24.4	-20.1	-19.8	-18.7		
Serbia	-17.5	-11.2	-10.9	-9.9		
SEE6	*-21.1*	*-16.9*	*-17.2*	*-15.9*		
			Current account balance (percent of GDP)			
Albania	-10.1	-10.7	-12.9	-11.4	-13.1	-12.6
Bosnia and Herzegovina	-8.8	-5.7	-7.8	-6.3	-6.4	-7.1
Kosovo	-7.5	-6.9	-7.9	-9.4	-9.6	-9.8
Macedonia, FYR	-3.3	-1.6	-0.9	-1.4	-1.7	-2.2
Montenegro	-18.5	-14.5	-15.2	-13.4	-14.2	-14.9
Serbia	-11.6	-6.1	-6.0	-4.8	-4.6	-4.5
SEE6	*-9.8*	*-6.6*	*-7.2*	*-6.3*	*-6.6*	*-6.8*
			External debt (percent of GDP)			
Albania	35.7	34.7	36.9	42.3	42.9	42.2
Bosnia and Herzegovina	52.8	53.9	50.8	54.0	55.1	54.3
Kosovo	7.3	6.5	6.4	6.5	7.4	7.3
Macedonia, FYR	66.1	64.0	69.8	69.7	70.1	69.8
Montenegro	144.8	142.3	145.2	147.7	149.2	149.6
Serbia	81.2	75.1	78.4	83.4	83.3	82.9
SEE6	*64.6*	*62.8*	*64.6*	*67.3*	*68.0*	*67.7*
			Unemployment rate (period average, percent)			
Albania	13.4	16.0	17.5	17.1		
Bosnia and Herzegovina	28.1	27.4	27.5	27.7		
Kosovo	30.9	30.0	35.3	35.3		
Macedonia, FYR	31.0	29.0	28.0	27.4		
Montenegro	19.8	19.5	18.0	17.6		
Serbia	24.0	22.1	19.4	17.9		
SEE6	*23.9*	*23.3*	*22.5*	*21.7*		

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

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