No. 8 ▪ Fall 2015

SOUTH EAST EUROPE

REGULAR ECONOMIC REPORT

Growth Recovers, Risks Heighten

WORLD BANK GROUP
Macroeconomics & Fiscal Management

Report No. 99668-ECA

South East Europe
Regular Economic Report No.8

Growth Recovers, Risks Heighten

Fall 2015

WORLD BANK GROUP
Macroeconomics & Fiscal Management

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), Anil Onal (lead author), Barbara Cunha (lead author), Ashley Taylor (lead author), Agim Demukaj, Aida Gjika, Sandra Hlivnjak, Sanja Madžarević-Šujster, Suzana Petrović, Lazar Šestović, Hilda Shijaku, and Bojan Shimbov. Maria Davalos, Trang Van Nguyen, Cesar A. Cancho, Alexandru Cojocaru, Monica Robayo and William Seitz prepared the regional poverty trends (Spotlight); Anil Onal (lead author) and Johannes Koettl the note on aging (Special Topic); Ilias Skamnelos, Johanna Jaeger, and Jane Bogoev contributed to the financial sector boxes; Anna Raggl and Pegi Yilli provided inputs on demographic and migration issues. Anne Grant provided assistance in editing, and Budy Wirasmo and Robert Waiharo in designing this report. Valentina Martinovic, Nejme Kotere, Samra Bajramovic, Ivana Bojic, Enkelejda Karaj, Hermina Vukovic Tasic, Jasminka Sopova, Boba Vukoslavovic, and Dragana Varezić assisted the team.

Dissemination of the report and external and media relations are managed by an External Communications team of Lundrim Aliu, Anita Božinovska, Paul A. Clare, Ana Gjokutaj, Jasmina Hadžić, Elena Karaban, Artem Kolesnikov, Andrew Kircher, Vesna Kostić, John Mackedon, Mirjana Popović, and Sanja Tanić.

The team is grateful to Ellen Goldstein (Country Director, South Eastern Europe), Satu Kähkönen (Director, Macroeconomics and Fiscal Management Global Practice), Ivailo Izvorski (Practice Manager, Macroeconomics and Fiscal Management Global Practice) and the South Eastern Europe Country Management team for their guidance in preparation of this report. The team is also thankful for comments on earlier drafts of this report received from SEE6 Central Banks and Ministries of Finance.

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

Contents

List of Figures

List of Figures (continued)

List of Figures (continued)

List of Tables

List of Boxes

Overview

Economic activity in the six South East European countries (SEE6) is picking up speed, and growth in the region is expected to average 1.8 percent for 2015.[1] The highest growth rates projected are 3.4 percent for Montenegro and 3.2 percent for FYR Macedonia; the lowest is Serbia's 0.5 percent. Although they trail the rest of the SEE6 region, Serbia and Bosnia and Herzegovina, which were hit heavily by floods in mid-2014, are recovering faster than expected. As 2015 progresses, a recovery in domestic demand is stimulating economic growth throughout the region. Private investment has become the main driver of growth. Developments in the global economy have also helped, especially lower oil prices and a pick-up in demand in the European Union (EU), a major market for the region.

While the recovery has encouraged job creation, unemployment is still very high, especially for the young. Employment throughout the region is slowly picking up, but it is above 2008 precrisis levels only in FYR Macedonia and Montenegro. In Serbia and FYR Macedonia, with growth firming up, the employment rate has moved up to 42 percent in Q2 2015, the highest level since Q2 2009 in each country. Despite these positive development, unemployment, which averaged 21.6 percent in Q2 2015, is still a central structural issue for the region. Real wages are rigid, limiting the flexibility of economies to respond to adverse shocks, while high and sticky unit labor costs jeopardize competitiveness. Informal labor markets are common. Only about 50 percent of working-age people are in the labor force; and at less than 40 percent, female labor force participation is even lower. Youth unemployment in the region is about 45 percent, which has not only near- and longer-term economic costs, but also social consequences.

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

Table 0.1: Expectations for sustained recovery of growth sustained through 2017

Real GDP Growth, 2014–17

	2014	2015f	2016f	2017f
Albania	2.1	2.7	3.4	3.5
Bosnia and Herzegovina	0.8	1.9	2.3	3.1
Kosovo	1.0	3.0	3.5	3.7
Macedonia, FYR	3.8	3.2	3.4	3.7
Montenegro	1.5	3.4	2.9	3.0
Serbia	-1.8	0.5	1.5	2.0
SEE6*	**0.3**	**1.8**	**2.4**	**2.8**

Source: National statistical offices and World Economic Outlook (2015).
Note: *This is a weighted average.

With few jobs being created and high rates of informality, poverty reduction throughout the SEE6 has been lackluster since 2008. Households rely heavily on pensions, social assistance, and transfers, which constitute half of their incomes. The fiscal costs of social spending are significant, averaging 13.4 of GDP. At the same time, considerable opportunities exist for making current programs more efficient, mainly by targeting benefits more effectively, and reallocating funding to new programs or more pressing needs.

SEE6 medium-term growth prospects are positive. The regional growth rate is forecast to rise to an average 2.6 percent in 2016–17, stimulated by recovering domestic demand and low oil prices, but moderated by tightening global financing conditions and a slowing global growth trajectory. Within the aggregate SEE growth picture, country diversity is marked, with the Serbian economy growing more slowly than the others in the near term. As discussed in the Spotlight on poverty trends, with the return of economic growth, poverty is expected to decline. Overcoming structural weaknesses in the labor market of SEE6 will help sustain poverty reduction in the region

There are risks to this overall positive outlook in both directions. In the near term, lower oil prices are expected to continue to support emerging growth in the EU economies. In the medium term, moderate global demand and tighter financing conditions are expected to slow the region's growth trajectory relative to the period leading up to 2008. Moreover, international financial markets remain turbulent, though concern has shifted from the mid-year heightening of the crisis in Greece, which had limited spillovers to the region, to the timing of U.S. interest rate rise and the outlook for China's economy. Attention of policymakers in the region, and in the EU, has also turned to the challenge of rising transit migration through the region to the EU. Domestically, political cycles and the realization of planned structural and fiscal reforms may have both upside and downside effects on the outlook.

Carefully prioritizing economic policies is essential to manage these risks. At close to 4 percent on average, fiscal deficits are worrisome when public debt is rising rapidly. Sustained reforms are needed to ensure macrofiscal sustainability, particularly as financing conditions tighten, and to expand the space for using fiscal policy to mitigate future shocks. Among other goals, reform efforts should continue to: address structural budget rigidities; prioritize and rationalize expenditures toward productive investments and raising the quality of public services; clear public arrears; improve revenue collection; broaden the tax base; and reduce the labor tax wedge. With regional inflation low and output gaps evident in almost all SEE6 economies, there is some scope for short-term monetary easing, especially in countries where fiscal deficits have begun to decline. However, care must be taken to ensure consistency with external balances to avoid the risk of adverse currency movements, which could put pressure on corporate, household, and public balance sheets, particularly where much debt is denominated in foreign currencies. Addressing high nonperforming loans (NPLs)—at 16 percent of total loans on average—is critical to ultimately release the flow of credit to support business and job creation. During the summer proactive financial sector regulations and communications inoculated the SEE6 against contagion from the Greek financial crisis. The possibility of further deleveraging and of more adverse swings in international financing conditions calls for sustained efforts to keep national finances stable.

While macroeconomic stability is necessary for sustained income growth, it is not sufficient; structural issues must be tackled so that the SEE6 countries can accelerate growth and restart their EU convergence process. From 2000 to 2007, growth in the SEE6 moved average income per capita up from 23 percent of the EU average to 31 percent on a purchasing power parity (PPP) basis. However, the rate of convergence has since stagnated. SEE6 income has on average grown by only 1 percent annually since the global financial crisis crested.

Vigorous structural reforms will be needed to broaden the SEE6 growth outlook. Like the macrofiscal policy agenda, the structural reform agenda is multipronged: stimulate employment by eliminating disincentives and barriers to formal jobs, support investment by improving governance and the business environment, and deepen international integration and connectivity. It also requires that public services and social protection systems be made more efficient and more equitable. Resilience can also be promoted by sustainable use of energy and natural resources and by careful stewardship of the environment.

Over time growth in the region will continue to be affected by such demographic factors as the aging and shrinking of societies across the region. Today, the average inhabitant is already 13.5 years older than the global average and the United Nations projects that the difference will widen to 21.1 years in the next 50 years. Today, on average in SEE6 there are 2 old-age dependents for every 10 working-age people; by 2060, the projection is for 7.6 dependents per 10 working-age people. The UN also projects that the population will have shrunk by 25 percent. As productive capacity similarly shrinks, the demographic transformations may hurt growth and are likely to intensify pressure on public finances. However, it is possible to mitigate part of the negative effects with responsive policies and with adjustments in the behavior of individuals and firms. And opportunities may well arise from incentives, for example, to increase labor force participation, invest more in building human capital across the region and slowing the trends of emigration. Creating income generating opportunities provides incentives for young individuals to stay or return home from abroad, attenuating not only the effects of aging, but also positively contributing to the quality and quantity of human capital in SEE6 and ultimately increasing potential growth of the region.

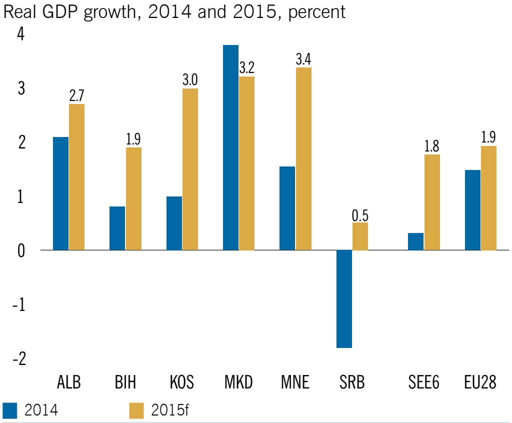
1. Strengthening Economic Recovery

Investment Boost to Growth

As economic activity picks up in the six South East European countries (SEE6) growth in the region is expected to average 1.8 percent for 2015.[2] The highest growth rates expected are 3.4 percent for Montenegro and 3.2 percent for FYR Macedonia; the lowest is the projected 0.5 percent for Serbia. Although trailing the rest of the SEE6 region, Serbia and Bosnia and Herzegovina, are recovering faster than expected from the floods of 2014. This publication's regional growth projections for 2015 have been revised upwards (from the 1.3 percent expected in the January 2015 RER to 1.8 percent), mainly because domestic demand has been higher than was expected.

Figure 1.1: After a year of stagnation, the economies of SEE6 are recovering in 2015

Real GDP growth, 2014 and 2015, percent



Source: World Bank staff estimates based on data from national statistical offices and Eurostat (2015).

Domestic investment is driving growth in 2015. Starting in the second half of 2014, growth has been primarily driven by domestic demand, both consumption (especially in Bosnia and Herzegovina and Kosovo) and investment throughout SEE6. Private investment has been picking up across the region as credit growth recovers and more retained earnings are invested. In every SEE6 country private investment has been contributing to growth. The pace of public investment has also picked up as governments carry out capital projects, often financed by international financial institutions (IFIs). However, fiscal restraints on current public spending and continuing labor market weakness are suppressing consumption growth throughout the region.

Low energy prices, weaker currencies, and tepid economic prospects in Europe are also supporting growth in SEE6. Albeit from a lower base, exports continue to grow faster than imports on average. Goods exports as a share of GDP are expected to go up by 2.9 percentage points in Serbia and 1.3 percentage points in FYR Macedonia. Exports in these two countries are growing on the back of strong FDI-supported industrial products (automobiles and electrical machinery) as well as domestically-owned steel and food exports in Serbia. Growth prospects in the EU28, a key export partner for the SEE6, are showing a slight pickup from 1.5 percent in 2014 to 1.9 percent this year. Low oil prices and consequently reduced import bills, are helping narrow external imbalances throughout the region except for Albania, where oil exports amount to about a quarter of total goods exports. However, adverse weather conditions (floods in 2014 and

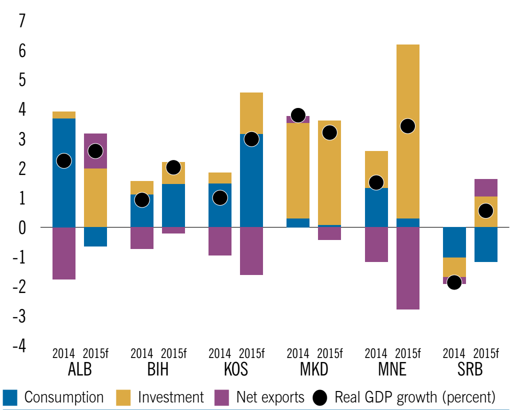
2 The SEE6 are Albania, Bosnia and Herzegovina, Kosovo, FYR Macedonia, Montenegro, and Serbia.

droughts in 2015) have reduced 2015 agricultural, and to a lesser extent energy, exports across the region, limiting the contribution of exports to growth.

The SEE6 labor markets are gradually recovering. Employment numbers are slowly picking up across the region. Employment is already above precrisis levels in FYR Macedonia and Montenegro. In Q2 2015, Serbian employment moved up to 42.3 percent and the FYR Macedonian employment to 41.7 percent, the highest level in each country since Q2 2009. Unemployment is also slowly falling; the regional average is down from 22.9 percent in Q2 2014 to 21.6 percent in Q2 2015. The largest improvement over this period, 2.6 percentage points, has been in Serbia. What is notable is that most of the jobs were created in the formal private sector, while government continued its fiscal consolidation and restructuring of state-owned enterprises (SOEs).

Figure 1.2: While recovering investment drives growth…

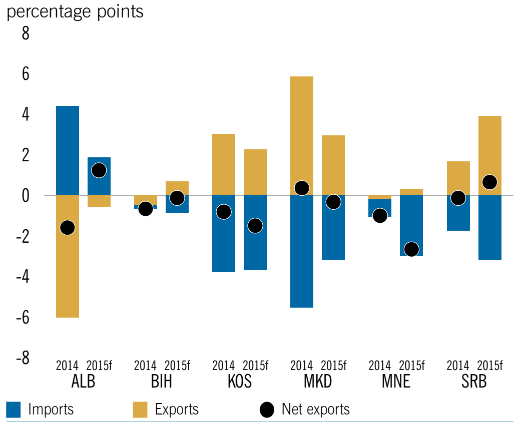
Decomposition of real GDP growth, 2014–15, percentage points



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

Figure 1.3: …the contribution of net exports remains limited

Contribution of net exports to real GDP growth, 2014–15, percentage points



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

Despite the positive development, the slow pace of adjustment reflects structural problems in SEE6 labor markets. Despite variations by country and sector, real wage rigidities mean that changes in employment are the main channel for labor market adjustment to shocks. Sticky unit labor costs have undermined competitiveness, and informal labor markets are common. Despite a slight pickup of 0.6 percentage points in 2014, regional labor force participation rates are low by international standards: only 50 percent of working-age individuals are active. At less than 39.1 percent, female participation is even lower. The gender gap also helps to explain lagging income per capita in SEE6 (see Box 1.1). Youth unemployment is about 45 percent for the region; the result is both near- and longer-term economic costs and social consequences.

Modest improvements in labor market performance are only slowly rising living standards in the SEE6, which remain below precrisis levels. Some countries in the region

Box 1.1: The Economic Cost of Gender Gaps in SEE6

Labor force participation rates in SEE6 are less than 50 percent, about 10 percentage points lower than the EU average. Participation is particularly low among women at participation rates averaging just 40 percent, compared to close to 60 percent for men. The gender gap in the region is largest in Kosovo, where only 21.4 percent of women were active in the labor market in 2014.

The gender gaps in labor participation and entrepreneurship represent a missed opportunity for lifting income per capita in SEE6. Cuberes and Teignier (2015) estimate that the magnitude of "lost" income per capita due to gender differences in SEE6 averages about 17 percent, with the income loss highest in Kosovo at over 28 percent. These SEE6 income losses have widened since the global financial crisis. The estimated average loss in income per capita in SEE6 due to gender gaps is significantly higher than the 10.5 percent estimate for the EU. About a third of the estimated lost income per capita is due to distortions in the occupational choices for women and men; the rest is due to costs associated with gender inequalities in labor force participation.

Though gender gaps are prevalent in all groups, gaps by age vary within SEE6 (World Bank 2012) and have implications for the evolution of the labor market. In SEE6, Cuberes and Teignier (2015) calculated that income losses in SEE6 because of gender gaps are highest among those aged 36–50 and the minimal labor market activity of women in that group are largely responsible for the missed income opportunities due to labor market gender inequalities.

Figure B1.1: Gender Gaps and Income per Capita

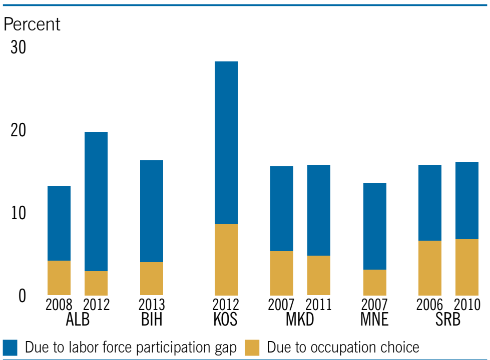
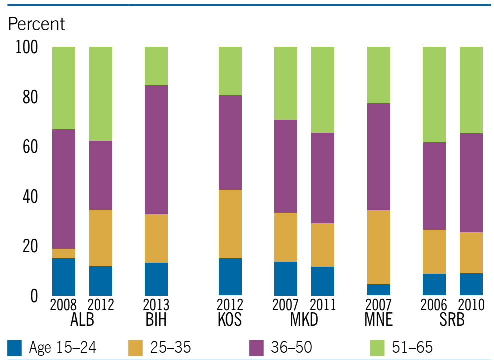


Figure B1.2: Income per Capita by Age Group



Source: Cuberes and Teignier 2015.

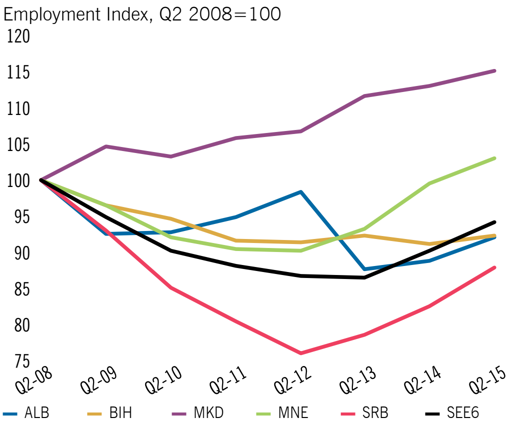
Note: A counterfactual set of gender gaps for each age group is calculated. To get the fraction of income loss for each age group, the aggregate gender gap is computed as if all the gender gaps were zero except for that particular age group.

References:
Cuberes, David and Marc Teignier. 2015. "How Costly Are Labor Gender Gaps? Estimates for the Balkans and Turkey. World Bank Policy Research Working Paper Series (forthcoming). Washington, DC.
World Bank. 2012. "World Development Report 2012: Gender Equality and Development." Washington, DC.

are tentatively resuming poverty reduction, but the effects of the 2008 global financial crisis and subsequent recessions in the region have yet to fade (see Spotlight). As recovery picks up, poverty is expected to decline slowly. Growth will help SEE6 to return to the precrisis levels and pace of poverty reduction.

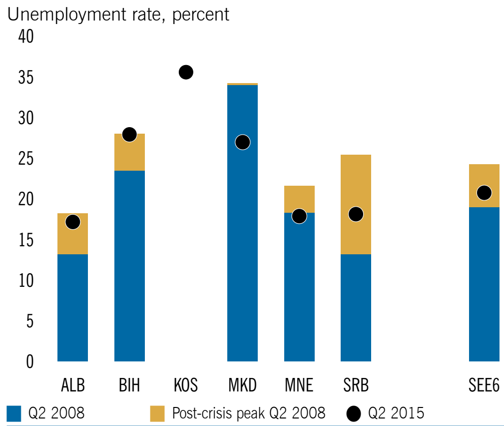
Weak growth in the SEE6 since the 2008 global financial crisis has stalled income convergence of its incomes with the EU. SEE6 income has had average annual growth of just 1 percent since 2008. While average growth in the region is still better than in the EU, there are significant differences within it. Growth in

Figure 1.4: In most of the SEE6, employment, while improving, remains below pre-crisis levels…



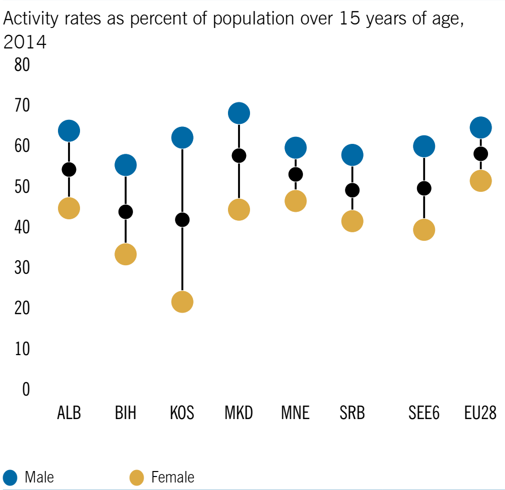
Sources: World Bank staff calculations based on national statistical offices.
Note: The regional total excludes Kosovo.

Figure 1.5: …and the unemployment rate is stubbornly high



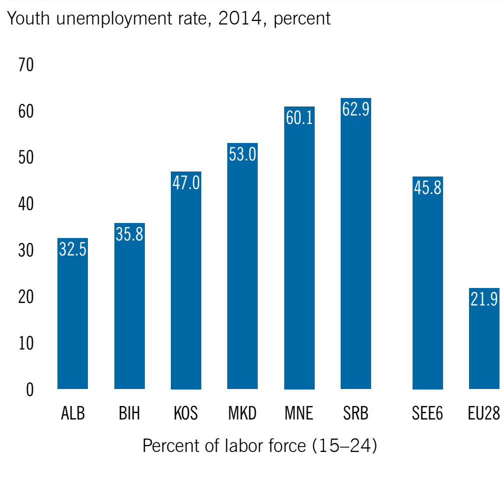
Sources: World Bank staff calculations based on national statistical offices.
Note: Kosovo is as of 2014. Regional average is weighted and excludes Kosovo.

Figure 1.6: Labor market participation is low, especially for women…



Sources: National statistical offices and Eurostat 2015 data.
Note: Kosovo data is for population aged 15–64.

Figure 1.7: …and almost half of the youth labor force is unemployed

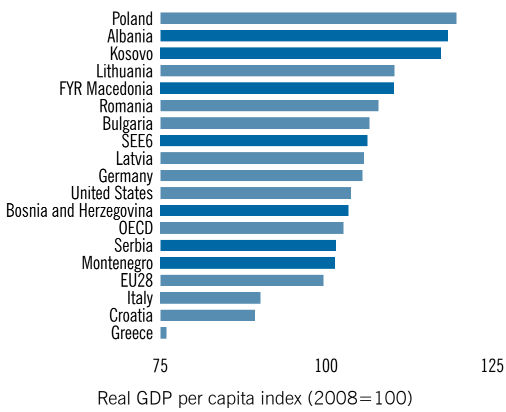


Source: National statistical office data.
Note: Albania data is for labor force aged 15–29, and therefore biases the Albania and the regional average down. Data may not be directly comparable across countries due to underlying data sources.

Albania, FYR Macedonia, and Kosovo compares well with fast-growing EU countries like Poland and Lithuania; but in Serbia, Montenegro, and Bosnia and Herzegovina, incomes are only 1–2 percent higher than in 2008—very close to the performance of crisis-impacted EU and OECD countries. In 2000, average SEE6 income per capita stood at 23 percent of the EU average; propelled by strong economic growth, it reached 31 percent in 2008. However, the 2008 global financial crisis and the subsequent slow growth in the SEE6 not only put poverty reduction on hold, they also slowed income convergence with the EU.

Figure 1.8: SEE6 income growth since 2008 has been higher than the EU average,…

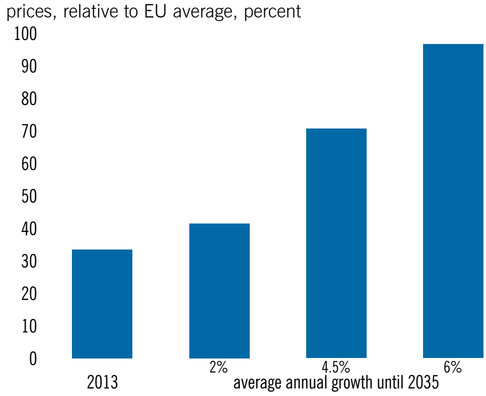
Real GDP per capita in 2014 relative to 2008



Source: World Bank calculations based on data from national statistical offices and World Economic Outlook (2015).

Figure 1.9: …but faster income convergence to the EU requires a sharp improvement in growth rates

SEE regional PPP GDP per capita, international dollars, 2011 prices, relative to EU average, percent



Source: WDI and World Bank calculations.
Note: EU real GDP per capita (PPP) assumed to grow by 1 percent per annum on average over 2014 to 2035 for purposes of illustration. SEE average is weighted by PPP GDPs.

Favorable International Economic Dynamics

Recent economic outcomes in SEE6 have been influenced by three major developments in the global economy: gradual pick-up in activity in the EU, falling global oil prices since mid-2014, and the weakening of the euro and strengthening of the U.S. dollar. These trends have fed into the economies of SEE6 through external balances, inflation, government budgets, and public debt dynamics.

First, the recent growth recovery in main trading partners had a positive effect on SEE6 exports. The growth rates of the region's major trade partners (weighted by export shares) have been moving up steadily. The EU28 economic growth increased from 1.5 percent in 2014 to a projected 1.9 percent in 2015, which is reflected on the region's imports. In the first half of 2015 real EU28 imports, on aggregate, rose year-on-year by 4.5 percent (5.2 percent in Q2 2015; 3.7 percent in Q1 2015), after growing 3.3 percent (year-on-year) in the second half of 2014. This demand has been refracted in the growth in SEE6 exports to the EU28 through 2015. For example, in the first seven months of 2015 Serbia's exports to the EU grow by 9.8 percent year-on-year, moving up the EU's share in total Serbian goods exports over the period to 66.8 percent from 66.1 percent a year earlier. Services exports from Montenegro have been especially strong over the same period, with tourism performance growing by over 12 percent. The rise in SEE6 exports is still modest with the goods exports increasing by a projected 1.1 percentage points of GDP to reach 25.5 percent of GDP as average growth rates of major trading partners are barely half of those seen before the crisis and are expected to increase only gradually. In this context, it is critical to pursue measures to increase competitiveness and diversification of the SEE6 exports.

Second, falling global oil prices are helping improve trade balances for SEE6 net oil importers. Except for Albania, the SEE6 countries are not major oil producers, and lower oil prices translated to lower import costs for this economies. Oil imports-to-GDP ratios range from 4 to 8 percent (2013 data) and are significant relative to overall current account deficits in many SEE6 countries. In Serbia, for example, the import oil bill declined to EUR 576 million in the year through July-2015 from EUR 729 million a year earlier.

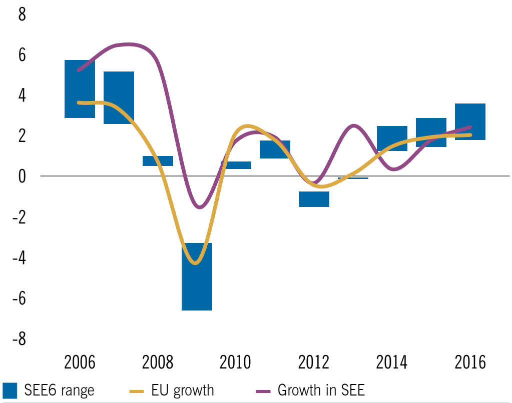
Third, exchange rates in the region continue to track closely the depreciation of the euro against the U.S. dollar (Figure 1.12).[3] Differences in U.S. and Euro Area monetary policy and the consequent higher U.S. bond yields have contributed to a marked strengthening of the dollar against the euro in 2014 and the first half of 2015. For SEE6 countries with floating exchange rates and fixed rates to the euro, there has been a significant nominal depreciation against the US dollar of about 12 percent for Albania, FYR Macedonia, and euro countries; and about 9 percent for Serbia since December 2014. This brings average nominal depreciation of currencies in the region against the US dollar to about 25 percent since 2013. Movement against the euro for the region's floating currencies, has been limited. As in many other emerging economies, the real exchange rate impact of the dollar's appreciation was only moderate, with the currencies of Bosnia and Herzegovina, FYR Macedonia and Serbia exhibiting a real depreciation of about 3-4 percent so far in 2015 (Figure 1.13). The price movements do not seem large enough to significantly boost trade, especially considering lags in other competitiveness factors, such as relatively large logistics costs.[4]

3 See the World Bank June 2015 *Global Economic Prospects* for further analysis of these trends.

4 See latest IMF surveillance country reports on the SEE6 countries, at www.imf.org.

Figure 1.10: Major export partner growth pick up moderately, but remain well below pre-crisis levels

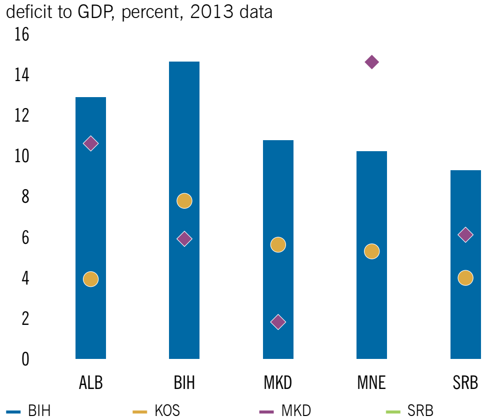
Real GDP growth, percent



Source: IMF Direction of Trade Statistics and World Economic Outlook; World Bank calculations.
Note: Major export partner growth calculated as average of export partner growth rates weighted by identified export shares (shares updated annually; with 2014 weights used for 2015 and 2016 projections). Min-max range for SEE6 excludes Kosovo because of lack of data.

Figure 1.11: Most of the region has benefited from declining oil import prices

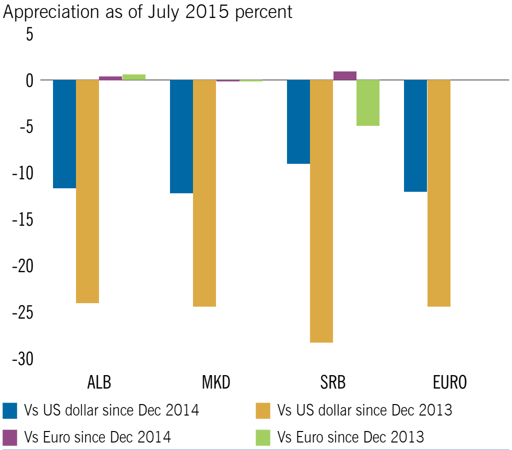
Oil imports to total exports and GDP, percent; current account deficit to GDP, percent, 2013 data



Source: Central banks and IMF data, World Bank calculations.
Note: Increase is an appreciation.

Figure 1.12: Marked depreciation of exchange rates against the dollar and the euro

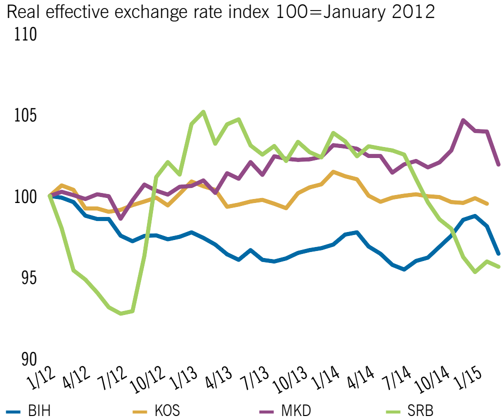
Appreciation as of July 2015 percent



Source: Central bank and IMF data. World Bank calculations.
Note: The Euro bar includes BIH, KOS, and MNE. Exchange rate data as of April for Macedonia vs US dollar and March vs euro. Monthly average exchange rates.

Figure 1.13: Real effective exchange rate movements have been more muted

Real effective exchange rate index 100=January 2012

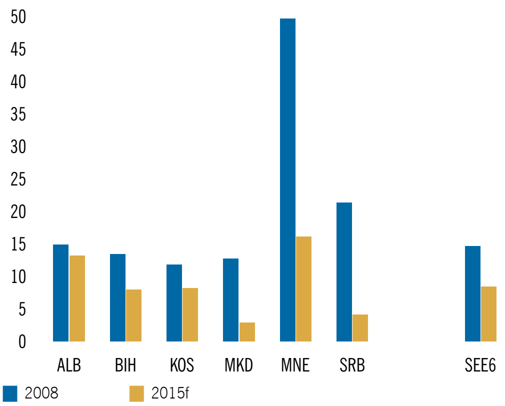


Source: Central banks and IMF data, World Bank calculations.
Note: Increase is an appreciation.

The current account rebalancing that took place after the global financial crisis has stalled. The domestic demand-driven pre-crisis growth model resulted in high external imbalances, with current account deficits averaging a weighted 18.6 percent of GDP in 2008. Even though current account deficits have narrowed significantly since the crisis (Figure 1.14), they have widened slightly in the past two years to 7.3 percent of GDP in 2014 and a projected 6.7 percent in 2015. The projected slight improvement in 2015 relative to the previous year comes from Serbia where export performance is expected to surpass the increase in imports, leading to an improved trade balance by 2 percentage points of GDP (Figure 1.15). Trade imbalances are expected to narrow in the rest of the SEE6 too, but due mostly to declining imports rather than a strong export performance. Aggregate current transfers are projected to decline across the SEE6 in 2015, partly reflecting the effects of the unfolding developments concerning Greece in the summer and partly the fragility of the growth prospects in the region and the rest of Europe.

Figure 1.14: Current account imbalances have largely narrowed since 2008…

Current account deficit, percent of GDP



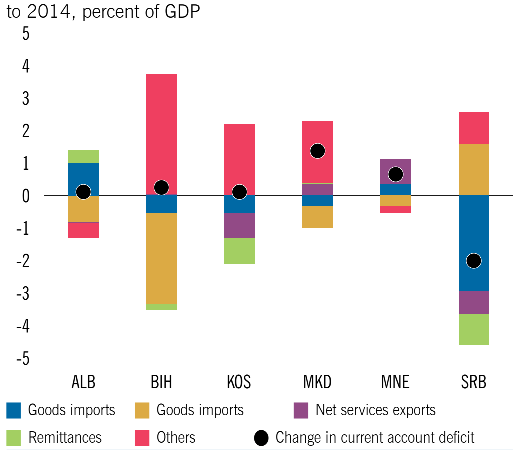
Source: World Bank calculations based on data from central banks and national statistical offices.

Remittance and foreign direct investment (FDI) inflows are increasing moderately with improvements in domestic and external economic conditions. The weighted average of remittance inflows to the SEE6 is expected to increase by 0.5 percent of GDP in 2015. The EU accession agenda has given impetus to reforms across SEE6. In this respect if successfully implemented, reforms may boost FDI inflows to the region. For example, FDI inlows to Serbia and Bosnia and Herzegovina, which are likely to see increases of 0.2–0.3 percent of GDP in 2015.

External debt has expanded in the recent years as the governments of SEE6 countries took advantage of the lower yields. Rising external debt ratios are thus common in almost all SEE6 countries, especially for the public sector (Figure 1.17).[5] This dynamic has been driven by a strategy of taking advantage of the yields on external financing being lower than on domestic, whether in U.S. dollars or more recently in euros. External debt ratios in the

Figure 1.15: …but the adjustment is stalling in 2015

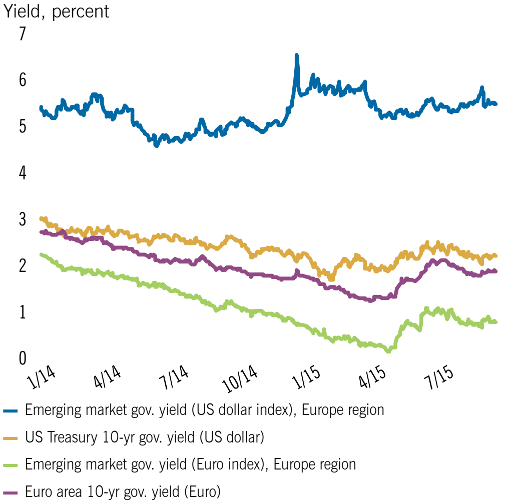
Contribution to change in current account deficit in 2015 relative to 2014, percent of GDP



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

5 Interestingly, as highlighted in the June World Bank Global Economic Prospects, the global picture for developing economies as a group is one in which private external debt has gone up noticeably but sovereign external debt only moderately, with a shift toward domestic borrowing.

Figure 1.16: US dollar yields have exceeded euro yields, although both have picked up recently

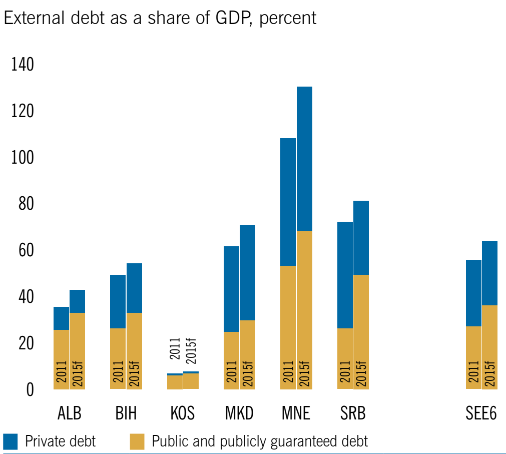


Source: Data from JP Morgan, Eurostat, and the Federal Reserve Board of the United States.
Note: The emerging market index is JP Morgan Emerging Market Bond Index global.

SEE6 have risen by an average of 6 percent of GDP since 2011 (the range is from 0.4 to 13 percent of GDP). In 2014, exchange rate depreciations against the dollar also pushed up external debt, especially for Serbia–a country with a relatively high share of debt that is denominated in dollars (Figure 1.18). Higher external debt raises refinancing risks, especially as tighter external financing conditions and further currency depreciation are likely. For example, Serbia's projected 2016 gross external financing need is equivalent to 16.6 percent of GDP, and in Montenegro it reaches 16 percent. Rising interest costs will also amplify the burden of interest payments, particularly for countries with a high share of debt issue at floating rates.

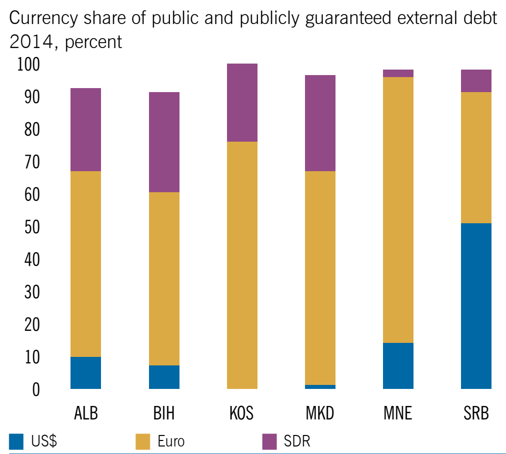
Inflation in the region is low. Three major developments are affecting inflation dynamics this year. First, after a slight pickup early in 2015, international oil prices are gradually ebbing to the levels seen in year-end 2014. Second, so far, as mentioned, SEE6 exchange rates against the U.S. dollar have moved in an offsetting direction, muting the local currency gains of lower international commodity prices. Finally, to a large extent administered energy prices and tax regimes in the SEE6 have limited pass-through of changes in international prices. For instance, relative to their peak in June

Figure 1.17: External public debt has picked up since 2011



Source: Ministries of Finance and central banks.

Figure 1.18: Exposure to depreciations against the dollar is limited, except in Serbia

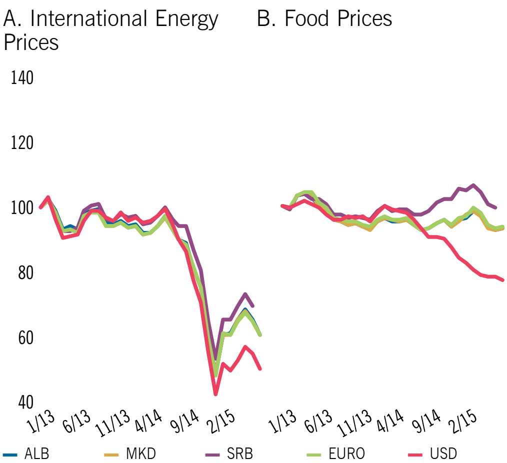


Source: World Development Indicators, national authorities.
Note: 2013 data for Bosnia and Herzegovina and FYR Macedonia.

2014, in January 2015 international crude-oil prices were down by almost 60 percent year-on-year in U.S. dollar terms, 50 percent in euro terms, and 47 percent in Serbian dinars. For the same period, the energy component of the CPI declined by an average of only 0.4 percent across the SEE6 (10.8 percent in Bosnia and Herzegovina), while overall inflation was 0.2 percent due to increasing food prices. In Bosnia and Herzegovina and Serbia there were unusually high seasonally-adjusted increases in the prices of unprocessed fruit, vegetables, and meat. Food inflation began to decline in Q2 2015. In Montenegro, higher domestic demand pushed up prices by 1.5 percent in the first seven months of 2015.

Figure 1.19: Currency weakness has offset some of the declines in global commodity price indices

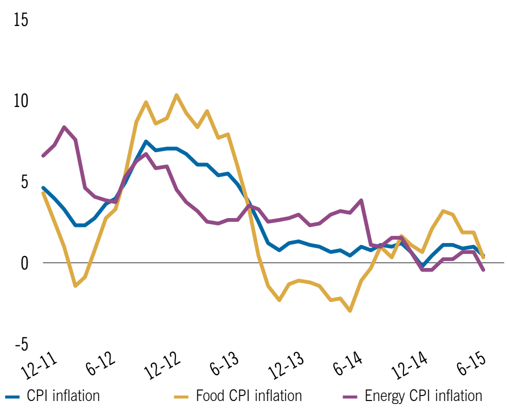
Local currency value of international commodity prices (Jan 2013=100)



Source: National central banks, IMF, World Bank calculations.
Note: U.S. dollar commodity price indices (World Bank) converted to local currency using average monthly exchange rates.

Figure 1.20: Energy price inflation has been less volatile while food price inflation started to fall

Inflation year-on-year, percent



Source: National central banks, IMF, World Bank calculations.
Note: Inflation rates weighted by PPP value of GDP.

Economic Growth Gaining Momentum, but with Medium-term Risks

In 2016–17, SEE6 growth is expected to rise to a broad-based 2.6 percent. External factors such as oil prices stabilizing at current levels and a gradual build up in external demand, including from the pick-up of growth in the Euro Area growth, will support economic activity in the region.

Although domestic demand is not likely to rebound to pre-2008 levels, in the near term private investment is expected to continue to firm up across SEE6. Real disposable incomes of households and firms are expected to inch up as inflation stays low, oil stabilizes at relatively low prices, some countries clear arrears, and investment projects funded by foreign investors and the EU get underway. However, the region is still burdened by some of the highest NPLs in Europe. Confidence could build if governments in the SEE6 launch and consistently sustain planned structural reforms. As economic growth takes hold, employment should gradually increase, but more slowly.

Table 1.1: The recovery in growth is projected to be sustained through 2017

SEE6 regional averages, percent of GDP unless otherwise stated	2014	2015f	2016f	2017f
Real GDP growth (percent)	0.3	1.8	2.4	2.8
Consumer price inflation (percent, period average)	0.8	1.5	..	..
Public revenues	34.6	34.8	34.1	33.8
Public expenditures	38.4	38.6	37.8	36.7
Fiscal balance	-3.8	-3.9	-3.7	-3.0
Public and publicly guaranteed debt	51.7	55.7	55.7	55.1
Goods exports	24.4	25.5	..	..
Trade balance	-17.3	-15.8	..	..
Current account balance	-7.3	-6.7	-6.5	-6.4
External debt	61.1	64.1	67.6	67.8
Non-performing loans (percent of gross loans)	15.8	15.6	..	..
Unemployment rate (percent, period average)	22.4	21.7	..	..

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

Note: Weighted averages by PPP adjusted GDP except for fiscal and financial indicators, which reflect simple averages.

The projected upswing in the SEE6 outlook has downside risks, both external and domestic. International financial markets remain turbulent, although the focus of concern has shifted from the mid-year heightening of the crisis in Greece, which had little spillover to the region, to how and when the United States will raise interest rates and the outlook for China's economy. Thus the main external risks for the SEE6, as they are for other developing economies, are an upswing in financial volatility globally and protracted slow growth and the potential for deflationary pressures from the Euro Area.[6] Attention of policymakers in the region, as in the EU, has also been turning to the challenge of rising migration flows through the region to the EU. The main domestic risks are a slow and tenuous recovery of the credit supply, uncertainties related to political cycles, and delays in planned structural reforms, such as fiscal consolidation and privatization. Each key group of risks is discussed in turn:

- **Volatile financial flows:** Persistent strength in the U.S. dollar–euro exchange rate and a related reassessment of emerging market fundamentals could cause capital to flow out of the region, which would hit countries with significant dollar-denominated debt the hardest. Financial market volatility may also be associated with the U.S. move to normalize its monetary policy. Possible foreign bank deleveraging also carries a risk of financial outflows, and there is the risk that depreciations of national currencies could lead to balance sheet pressures for borrowers with unhedged foreign currency liabilities.

- **Protracted slower global growth, especially in the EU:** Since the positive

6 See World Bank. 2015, June. *Global Economic Prospects–The Global Economy in Transition*. http:// www.worldbank. org/content/dam/ Worldbank/GEP/GEP2015b/ACS.pdf.

growth forecast for SEE6 hinges on external factors, especially a rebound in the EU, a slower than expected recovery would reduce exports to and investment from the EU.[7] While the base case is for the EU recovery to build in 2015 and 2016, as domestic demand builds in the SEE6 the downside risks are significant. For example, a deeper contraction of economic activity in Russia and Ukraine could cloud the prospects for EU growth. This would raise indirect economic risks for the SEE6, though more from the effect on consumer and investor confidence than any direct costs. There are also broader risks emanating from the global economy, for example, that excessive depreciation of the U.S. dollar would dampen U.S. growth prospects or the low-probability event that China's gradual rebalancing of growth carries a steeper-than-anticipated decline in investment.[8]

- **Movement of global oil prices:** Though lower oil prices would dampen the inflation outlook in SEE6, it might also support the trade balances of oil importers and domestic economic activity through lower input costs. Despite their recovery earlier this year, oil prices are projected to decline by 40 percent for the year, after falling by an average of 7.5 percent in 2014. Even though they are expected to pick up in 2016 and 2017, global oil prices are still expected to be almost 40 percent lower in 2017 than they were in 2013.[9] Persistently lower prices and economic slack heightens the risk of second-round effects through lower nominal wage growth, which could entrench disinflationary pressures.

- **Domestic politics and a less supportive fiscal stance:** High debt and record-high NPLs will continue to dampen SEE6 economic prospects unless there is marked progress on structural reforms. The SEE6 are vulnerable to political instability, which may jeopardize current reform momentum and dilute government intentions to move on long-needed reforms to consolidate public finances, address rigidities in the capital and labor markets, refine legal systems, and restructure remaining SOEs, especially public utilities. Cost to government budgets may be incurred from managing the rising transit migration through SEE6 to the EU (see Box 1.2).

7 For further analysis of the outlook for the EU see World Bank. 2015. EU *Regular Economic Report: Modest Recovery, Global Risk*. http://www.worldbank.org/content/dam/Worldbank/document/eca/eu-rer-1-eng.pdf.

8 For detailed discussion of global risks see World Bank. op. cit., note 7. (2015), Global Economic Prospects – The Global Economy in Transition, June http://www.worldbank.org/content/dam/Worldbank/GEP/GEP2015b/ACS.pdf.

9 According to the World Bank projections of average crude oil spot prices.

Box 1.2: SEE6 and Migration

The SEE6 countries are among the top migrant-sending regions in the world. Today the equivalent of a quarter of the current population of SEE6 lives outside their home countries. In the course of two decades, the share of the region's emigrants in their source country population doubled from 13 percent in the 1990s to over 25 percent in 2013. Since the early 1990s, there has been a steady flow of migrants from the SEE6 to the EU with roughly 4.9 million people, having left their countries.

In contrast to the early 1990s when refugees fled the war-ridden territories of the former Yugoslavia, in the last two decades, migrants from the SEE6 have been predominately economic migrants. Low growth since the global financial crisis, chronically high unemployment, income levels at a third of the average of the EU, and vulnerability to external shocks and natural disasters, have constrained domestic income generation in the region. As such, people continue to emigrate in search of better economic opportunities. The majority of migrants are young, of working age, and generally with higher educational attainment than the respective age group in the home countries. Still, about one third of high-skilled emigrants from the SEE6 work in blue-collar or unskilled occupations in their host countries.

The last two decades of emigration have influenced the economic performance of the SEE6 countries. Remittances, almost 10 percent of GDP in SEE6 economies per year, have supported consumption and current account inflows. Migrants play a role in facilitating trade and investment. However, outmigration may negatively impact a country's human capital, while the fiscal impact is mixed.

The significant influx of people from the Middle East, Asia and Africa seeking refuge and economic opportunities in the EU has dominated recent headlines. According to the FRONTEX, the EU border agency, the EU has received more than 340,000 migrants between January and July 2015 compared to 123,500 during the same period in 2014. While this is a very small portion of the EU28 population it represents the largest inflow of individuals to the region since WWII.

It is uncertain how long recent trends will last and how they would affect migrants from the SEE6 in the host EU countries. Most migrants from the SEE6 leave their countries for economic reasons. Economic migrants move to where the jobs are. With an increased flow of new migrants in the EU, there is likely to be an increased demand for jobs in the host country. The extent will depend on the relative skills of and their substitutability among migrants from the SEE6 and any other groups of workers as well as the location of jobs offered, among other factors. Understanding the possible impact of changing migrant composition on individual migrants groups as well as on the host country labor market is important. While there is currently no comprehensive empirical work, it is clear that, the supply of labor migrants bring (regardless of their origin) could partly fill labor gaps in the host country and soften the effects of a shrinking and aging European population on the economy in the medium to long term.

Finally, the new wave of people seeking refuge in the EU, following a transit through the SEE6 region can also affect the region's economies. For now, the SEE6 region is not a final destination for the migrants from the Middle East, Asia and Africa; instead, it is just a transit area. However, this can change, as traditional host countries review immigration policies and border controls, and deal with the current large backlog of over half a million asylum applications in the EU. Migrants may see an increase in the time spent in transit through the Western Balkans, which in turn could increase costs to the transit countries governments.

2. Policies for Income Growth and Competitiveness

Maintaining sound economic policy management and advancing structural reforms are essential to ensure that the economic recovery is resilient and that growth prospects improve. On the fiscal side, given rising public debt and tighter financing conditions, sustained discipline would be key in keeping government balances in check. To ensure that recovery is resilient, it is essential to address structural rigidities in SEE6 budgets and clear fiscal space for mitigating the effects of any new shocks. Policies should continue to be channeled to, among other areas, redirecting public spending away from generous public wages and ill-targeted social assistance into productive investment; targeting and prioritizing expenditures; clearing public arrears; improving revenue collection; broadening the tax base; and reducing the labor tax wedge. As for monetary policy, with regional inflation low and output gaps in almost all SEE6 economies, there is scope for short-term easing of monetary conditions, especially in countries whose deficits have begun to decline. However, in countries where policy rates are already low by historical standards there is a need for caution to ensure consistency with external balances and limit the risk of adverse currency movements, which could put pressure on corporate, household, and public sector balance sheets, particularly where much debt is denominated in foreign currency. Similarly, in the financial sector, addressing high NPLs is critical to restarting the growth of credit, supporting entrepreneurship and job creation, and reinforcing the ability to deal with future pressures. For example, the possibility of further foreign bank deleveraging or adverse shocks to international financing conditions calls for sustained efforts to guard financial stability. During the summer proactive financial sector regulation inoculated the SEE6 against contagion from the Greek financial crisis. Demographic and structural issues are suppressing growth potential; unless addressed they will continue to slow SEE6 income per capita gains. Vigorously pursuing structural reforms while keeping the economy stable will provide the needed stimulus to potential growth.

Mixed Progress on Fiscal Consolidation

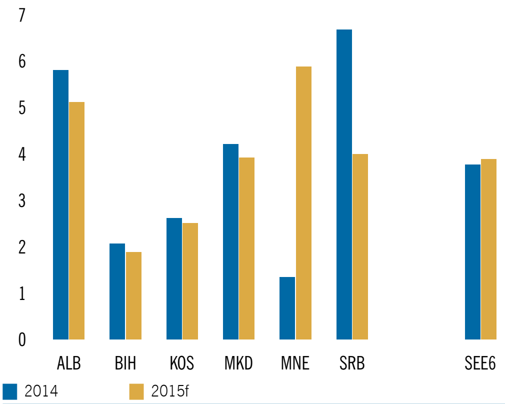
Fiscal deficits in SEE6 are still high in 2015, despite consolidation efforts (Figure 2.1). The largest deficit reduction from 6.7 percent of GDP in 2014 to 4 percent of GDP in 2015 is being undertaken by Serbia. The deficit reduction there is driven primarily by decreasing public sector wages and pensions, while strong revenue performance, particularly from non-tax revenues, have contributed to the stronger-than-previously-expected performance. In addition to successfully clearing a large stock of public arrears and in the conditions of underperforming revenues relative to expectations, Albania expenditure cuts are the main drivers of the reduction in the fiscal deficit in 2015. Fiscal imbalances in the rest of SEE6 countries, except Montenegro, are also expected to narrow, albeit less noticeably. Fiscal revenues are driving consolidation efforts in FYR Macedonia and Kosovo, despite underperforming initial budgets. In Bosnia and Herzegovina and Montenegro, fiscal revenues are expected to decline in 2015 relative to 2014. Efforts to improve revenue performance, widen the revenue base and professionalize tax administration are expected to lead to structural improvements in public finances in SEE6. Fiscal deficits are expected to widen in Montenegro, due to a massive increase in capital spending related to a large highway construction project.

Public and publicly guaranteed debt in SEE6 continues to inch up. Since 2008 public debt has risen not only in Albania, Montenegro, and Serbia, which have the highest debt-to-GDP ratios at about 70 percent, but also in the rest of the region. To finance persistent fiscal deficits, average public debt, including guarantees, went up by almost 20 percent of GDP between 2009 and 2015. With inflation low across the SEE6, reducing the debt-to-GDP ratios has become even more difficult. Thus far, interest costs have not put much pressure on public debt because the monetary policies of advanced economies are still accommodative. Nevertheless, Serbia among other economies has seen its debt ratios rise as the U.S. dollar strengthened. While in the short term benchmark sovereign yields may stay low, particularly in the Euro Area with European Central Bank quantitative easing, they have moved up recently, feeding through into emerging market yields. Global interest rates are bound to rise after monetary stimulus ends, which would imply for the SEE6 economies higher costs in managing and refinancing their debt. As mentioned above, during the transition, there are likely to be periods of heightened volatility.

Fiscal consolidation in SEE6 will not be effective if countries in the region do not address structural rigidities in their government budgets. With interest rates low and little room for monetary policy to respond to shocks, fiscal policy becomes the primary tool for smoothing fluctuations in economic activity. Building fiscal buffers should be a priority if SEE6 governments are to provide room for fiscal policy responses and support improved public sector performance and service delivery. Among numerous policy measures to reinforce the sustainability of public finances are (1) containing expenditures while changing their composition away from wages toward more productive and equitable areas; (2) 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; (3) ensuring long-term budget sustainability by reforming pension and related social benefits as well as targeting the large public sector; (4) clearing arrears and preventing their build-up; and (5) improving revenue collection and broadening the tax base while reducing the labor tax wedge.

Figure 2.1: Fiscal imbalances remain high in 2015

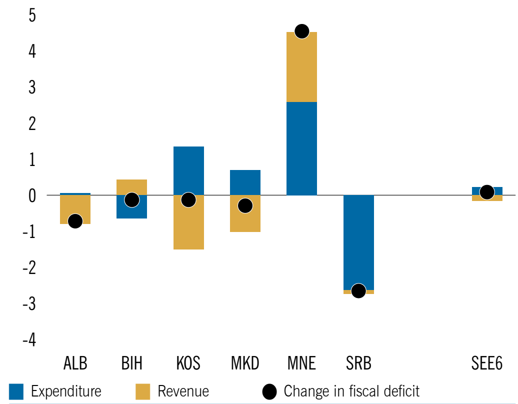
Fiscal deficit to GDP, percent



Source: Ministries of Finance.

Figure 2.2: Fiscal consolidation with mixed results in SEE6 in 2015

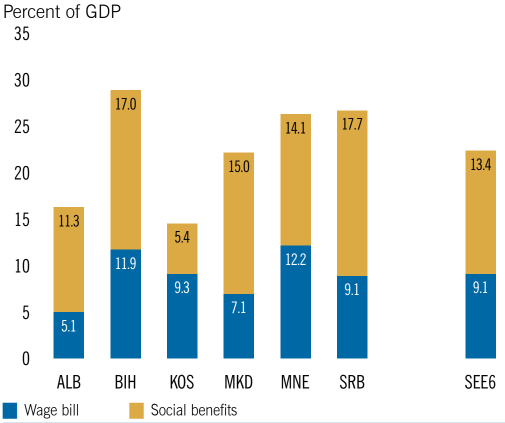
Contribution to annual change in fiscal deficit in 2015, percent of GDP



Source: Ministries of Finance.

Figure 2.3: The fiscal burden of wage and social spending, including pensions, is significant

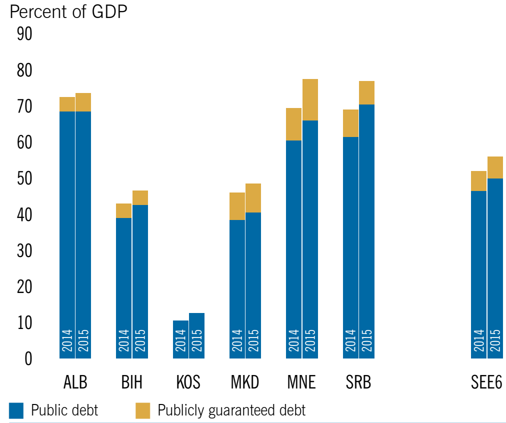
Percent of GDP



Source: Ministries of Finance.

Figure 2.4: High levels of public debt rise further in 2015

Percent of GDP



Source: Ministries of Finance.

Pressures on Monetary and Exchange Rate Policies

In the current domestic and global environment, monetary policy-makers are confronted by a range of challenges (Table 2.2). With overall inflation generally low, partially due to low import prices, policy makers in the region need to support growth and generate employment while pursuing fiscal consolidation. Meanwhile, the effects of shifting patterns of global capital flows and concerns about the quality of domestic bank assets need to be carefully managed, while solidly anchoring inflation expectations. Persistent unemployment in SEE6 has meant that the traditional short-term Philips curve trade-off between unemployment and inflation is not observed. Indeed for a number of countries, unemployment has fallen along with inflation.

SEE6 is absorbing the impact of the recent euro depreciation. The depreciation primarily affects Bosnia and Herzegovina, which has a currency board regime; and Kosovo and Montenegro, which have unilaterally adopted the euro. In Albania and FYR Macedonia, given their current account deficits and unemployment ratios, the flexibility to adjust policy depends in part on the quality of external financing; longer-term FDI is likely to be less sensitive to shifts in short-term interest rate differentials. In fact, in the last two years both countries have been able to finance an increasing share of their current account deficits through FDI. In Albania, net FDI inflows went up from 6.8 percent of GDP in 2012 to an average of 8.7 percent in 2013–14—above the 2008 level. In FYR Macedonia, though the increase was from 1.5 to 3.3 percent of GDP, FDI was still below that of 2008. In Serbia, where the current account deficit is lower, an accommodative monetary policy has mainly been exercised through reductions in headline rates and management of inflation expectations. Throughout the region policy rates are at historical lows.

The limited room for monetary policy flexibility adds impetus to the momentum for fiscal consolidation. Building up fiscal buffers for deployment against future shocks can help Albania, FYR Macedonia and Serbia to use the limited monetary policy room more effectively to support growth. However, any loosening in monetary conditions should be accompanied by continued efforts to improve financial stability so as to limit, for example, any rise in financial and corporate risk-taking and any deterioration in credit quality.

Table 2.2: Macro dynamics are challenging for monetary policy management in non-euro countries

Percent

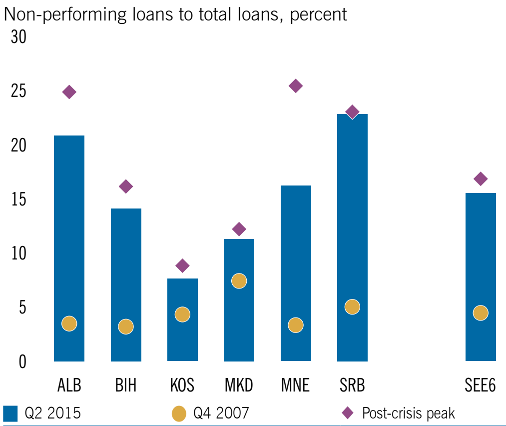
	Fixed Exchange Rate or Euro	Policy Rate	Inflation Target	Actual Inflation (2015f)	Real GDP Growth (2015f)	Unemployment Rate (2015f)	Fiscal Deficit to GDP (2015f)	Current Account Deficit-to-GDP (2015f)
ALB	n	2.0	2-4	2.1	2.7	17.1	5.1	13.1
BIH	y			0.5	1.9	27.5	1.9	7.9
KOS	y			-0.5	3.0	35.3	2.5	8.2
MKD	n	3.25	0.4	0.5	3.2	27.4	3.9	2.8
MNE	y			1.0	3.4	17.6	5.9	16.0
SRB	n	5	2.5–5.5	2.5	0.5	17.9	4.0	4.0

Source: Data from national authorities.

Note: FYR Macedonia has a de jure floating exchange rate. However, the National Bank of the Republic of Macedonia (NBRM) applies exchange rate targeting as a monetary policy strategy and participates in the foreign exchange market in order to maintain a stable exchange rate with a narrow fluctuation band vis-à-vis the euro. The de facto exchange rate regime is a stabilized arrangement, according to classification of IMF.

Asset Quality Concerns and Financial Sector Support for Growth

Figure 2.5: The sizeable rise in NPLs following the financial crisis have yet to be addressed



Sources: Central banks.

The SEE6 region is heavily burdened by NPLs, which are the highest in Europe. By July 2015, on average in SEE6 NPLs stood at 15.8 percent of total loans—triple what they were pre-crisis (Figure 2.5). Within the region Albania and Serbia have the highest NPLs at over 20 percent. Ineffective legal systems are among the main obstacles preventing banks from enforcing collection against defaulted borrowers and realizing on collateral. The weaknesses relate specifically to such factors as the corporate and personal insolvency regimes and creditor rights, along with ambiguity about selling NPLs. Moreover, tax law discourages write-off, restructuring, or sale of NPLs, and there is no law allowing corporate out-of-court debt restructuring. If unresolved, NPLs will continue to burden bank balance sheets, undermine profits and capital, and suppress bank consideration of new lending—and more generally bank ability to boost economic activity and growth. A decomposition of interest rate spreads demonstrates the toll NPL provisioning exerts on lending and profitability, although operational inefficiencies are still the predominant factor.[10]

NPL resolution is a problem throughout the region. Montenegro is the only SEE6 country that has been able to bring NPLs down to where they were before the global financial crisis.[11] While all SEE6 governments are making efforts to tackle the NPL issue in their countries, most recently two countries have shown progress: Serbia has adopted a specific strategy and action plan for resolving problem loans; and in Kosovo, a private bailiff system helping to enforce collateral recovery has helped push the share of NPLs down from 8.3 percent in December 2014 to 7.1 percent in July 2015.[12]

10 Interest rate spread is the difference between the lending and deposit rate. It can be decomposed (from an accounting identity) into profits, provisions, overheads, and reserves for each of the SEE6 countries. Interest rate spreads vary across SEE6, with spreads in Kosovo (at 9 pp) significantly exceeding the regional average. They are lowest in Bosnia and Herzegovina and Serbia at 4.3 and 4.4 percent respectively. The interest rate spread in most SEE6 countries is driven by operating costs and provisions associated with the deterioration in banks' asset quality in the wake of the global financial crisis. Only in Kosovo and Albania does the profit margin play a significant role, accounting for around a third of the total spread.

11 Montenegro recently adopted a law on voluntary financial restructuring called the "Podgorica approach." It allows for out-of-court restructuring of economically viable companies, e.g., through purchases of debtors' claims supported by tax and supervisory incentives. Further measures will now be necessary to ensure that banks share information and pursue a harmonized strategy for recovery from common borrowers. This is best done with backing from a strong, independent sponsor, such as a central bank or government agency. In August 2015, parliament also adopted a law for conversion of Swiss franc loans into euros; it affects one bank and 600 clients with indexed loans totaling some €30 million (0.8 percent of GDP). The whole amount of the exchange rate differences have to be equally shared among the borrowers, the bank and the state.

12 See http://www.nbs.rs/internet/english/55/npl/action_plan.pdf.

In addition to high NPLs, both supply and demand factors affect the slow recovery of growth of credit. Post-crisis tightening of credit standards and the deterioration in parent bank funding conditions have reduced the supply of credit throughout SEE6. Moreover, since the crisis fragile economic growth and limited corporate deleveraging have suppressed demand for credit. With economic growth firming up in 2015, credit growth has been relatively strong in FYR Macedonia and has picked up gradually in Kosovo, Albania, and Montenegro. In Bosnia and Herzegovina and Serbia, credit growth has been subdued (Figure 2.6).

While in general banks in the SEE6 are well-capitalized and liquid, other factors may directly affect the stability of the SEE6 financial sector:

- Stocks of foreign exchange loans to unhedged domestic borrowers—at least half of all borrowers—are high in SEE6. As of mid-2015, for example, the average share of foreign-current-denominated loans in Serbia was close to 65 percent.

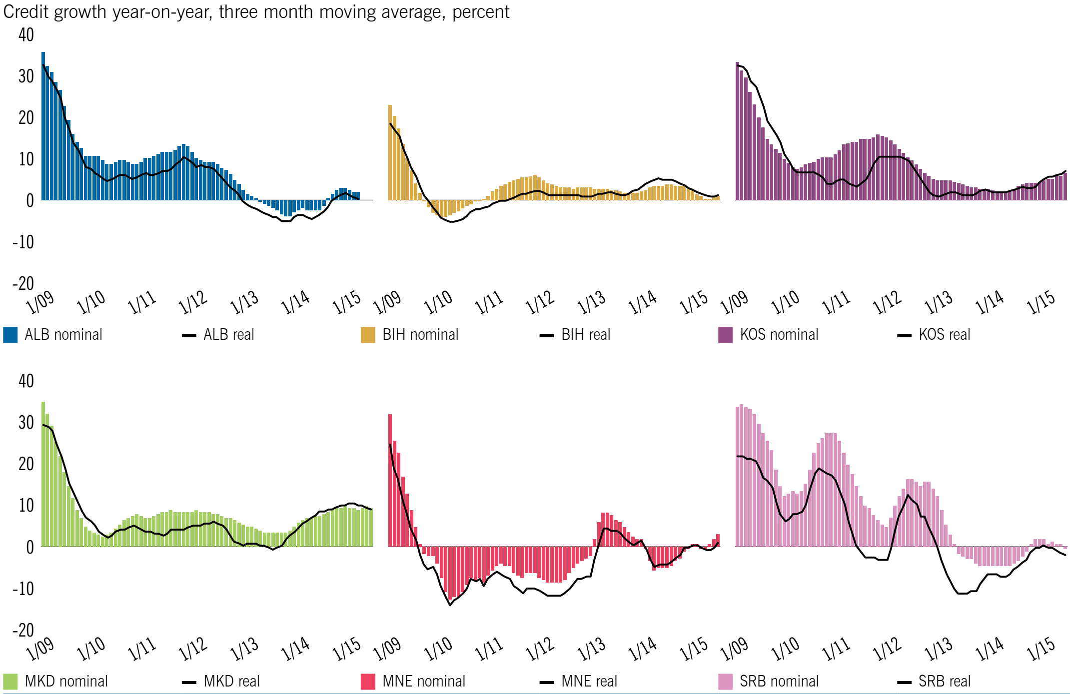
- There are also risks to financial stability related to external borrowings under tighter international financing conditions and the possibility of abrupt shifts in exchange rates.

Box 2.2. Safeguarding Financial Stability in SEE6

The midsummer 2015 Greek crisis tested the stability of SEE6 financial sectors. There are three Greek bank subsidiaries in Albania, two in Macedonia, and four in Serbia, which all share the characteristics of purely domestic banks. They constitute 12 to 22 percent of sector assets in these countries; in all three they are well-capitalized, liquid, not reliant on parent funding, and constitute a small share of parent assets. The Greek bank subsidiaries are independent legal entities rather than branches of the parent bank and are thus separately capitalized. Although currently stable and not in need of external funding, the recent events highlighted that persistent uncertainties related to evens in Greece may still trigger adverse fallout.

The authorities complemented previous ring-fencing actions with temporary measures to mitigate contagion and safeguard stability. All three countries intensified their monitoring and deployed proactive communication strategies. In Albania, the regulator continued to impose higher capital requirements and limited the dividends subsidiaries could pay to parent banks. The Bank of Albania issued an order prohibiting commercial banks to transfer money to banks in Greece. In FYR Macedonia, the Central Bank adopted temporary precautionary measures to restrict capital outflows to Greek entities. The authorities also required FYR Macedonian banks to withdraw all loans and deposits from banks based in Greece and their branches and subsidiaries in Greece or abroad, regardless of the agreed maturity. The Central Bank of Serbia formulated contingency plans, including liquidity support, and required banks to limit transactions with Greek parents. Notably, the Serbian banking crisis management regime has recently been aligned with EU standards; the changes introduced a separate structure and tools for resolving systemically important domestic banks. With the help of a World Bank project, the Deposit Insurance Fund has been strengthened and the top 12 banks are undergoing an Asset Quality Review.

Figure 2.6: Private credit growth in the region is generally muted



Sources: Central banks, IMF, World Bank calculations.
Note: Real credit growth 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.

- Developments in Greece may continue to add stress to SEE6 financial systems, as the June-July 2015 crisis demonstrated. Despite proactive measures by SEE6 authorities (see Box 2.2) there was some impairment of confidence, resulting in limited depositor outflows from Greek subsidiaries. However, the deposit withdrawals remained within the banking systems, being transferred to other local banks. Looking ahead, with the closing of the Greek banking system and the economic deterioration in Greece, authorities are concentrating on understanding the possibilities for future ownership structure of Greek-owned subsidiaries (see Box 2.3).

In general, financial policy in SEE6 should be directed to ensuring that deposit insurance schemes are adequately funded and there are recovery and resolution plans for systemic banks in place.

Box 2.3. Options for solvent and profitable Greek Subsidiaries

The upcoming completion of the Asset Quality Review for the Greek parent banks will bring back into the spotlight the issue of the ownership structure of Greek-owned subsidiaries. Greek banks are likely to downsize international operations, similarly and in continuation of agreements under the EC restructuring plans of 2014. The closing of the Greek banking system and economic deterioration in Greece suggests that its parent banks may seek or accelerate the divestment of their solvent subsidiaries in the region. Such actions could be hastened by ECB stress tests and as part of upcoming recapitalization packages. If Greek parent banks were determined to be insolvent while the subsidiaries continued being solvent, the subsidiaries would not have a shareholder with an ability to provide additional support when needed, and would be required to look for new shareholders with the required financial strength.

Possible scenarios for solvent and profitable subsidiaries depend on the specifics of each subsidiary and financial system they operate in. Subsidiaries' systemic importance, solvency and profitability would be key factors alongside their market features (e.g. extended branch network), leading to the following possibilities:

- **Sale to a local competitor** (a bank or other financial institution). Although possible in some markets, competition constraints, where ownership is already concentrated, may preclude such sales. Also, many local banks may not have the financial and operational capacity to absorb a merger with a Greek owned subsidiary.

- **Sale to an incoming strategic investor.** There has been limited activity in the past few years, mostly by Turkish or Russian banks (currently facing the deterring effect of sanctions). However, this option may be limited with multiple banks for sale and previous strategic investors reversing or having finished their expansion.

- **Sale to private equity or similar institutional investor.** Although not common in the region, this type of investors can be local or foreign, and typically seeks fire sale prices (which may not be received positively by local authorities). Islamic sources of fund are a possible option in Albania, although the interest may be less in other countries.

- **Sale via a public offering.** Markets in client countries are, however, too small to absorb anything but very small deals.

- **Absorption of subsidiaries' parts by other banks** (e.g. the loan book) and the rest sold and liquidated.

International financial institutions could play an important role in facilitating the sale of Greek subsidiaries. This could be in the form of performing appraisals, participating in financial solutions, and working on the consolidation and/or disposition of assets.

Structural and Demographic Issues

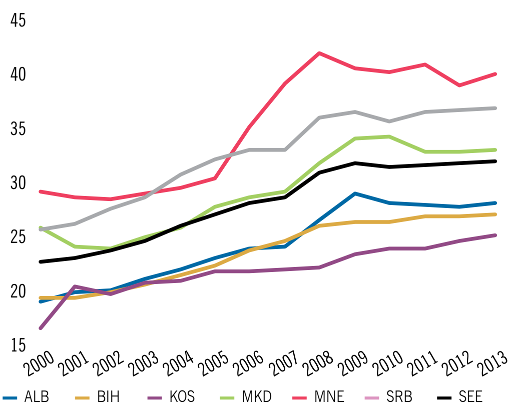
Structural issues must be tackled so that the SEE6 countries can accelerate growth and restart their EU convergence process. From 2000 to 2007, solid growth in the region moved average income per capita (on a PPP basis) up from 23 percent of the EU average to 31 percent (Figure 2.7). However, convergence decelerated after 2008, with relative incomes remaining at 31 to 32 percent between 2008 and 2013, when real PPP per capita in the EU fell by 2 percent (Figure 2.8). In addition, slow progress on structural reforms has held back potential growth in SEE6. Sustained growth has yet to revive in the SEE6, raising concerns that the region is caught in a middle-income trap.

Cyclical factors have clearly affected recent growth dynamics, but there is a general concern that the region's transition to high-income status will be seriously delayed by adverse demographic and structural factors.

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

Figure 2.7: Income convergence of the SEE6 with the EU has slowed…

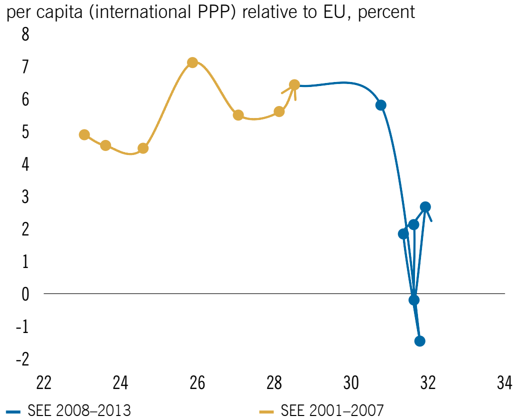
GDP per capita (international PPP) relative to EU, percent



Sources: WDI, World Bank staff calculations.
Note: ECA is developing Europe and Central Asia.

Figure 2.8: …as growth in the region has stalled since the global financial crisis

Growth in real GDP per capita (international PPP), percent; GDP per capita (international PPP) relative to EU, percent



Source: WDI, World Bank staff calculations.
Note: ECA is developing Europe and Central Asia.

Long-term income growth will be small in SEE6 unless countries in the region address their structural and demographic challenges.

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, and sluggish formal job creation. 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. Reform 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 investment climate and governance.** Even though some progress has been made in easing the problems of the investment climate (e.g., in FYR Macedonia and Montenegro), there is still room for improvement. Applying the law in non-discretionary 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 and efficiency of public services and social protection systems, while reducing the governments' footprint.** In most SEE6 countries, the public sector tends to be large and inefficient, delivering public services that are too expensive. Addressing structural rigidities related to the efficiency, size, equity and quality of public service delivery while maintaining fiscal sustainability is on the 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 to 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 trade integration.** Improving the physical and institutional connectivity of the SEE6 within and across countries and the rest of the world would help make the region 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 positive 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.

In the long term, income growth will be increasingly pressed by demographic factors including the aging and shrinking societies across the SEE6 (see Special Topic). The median person in the region is already 8.7 years older than the median person in the world. The difference will widen to a projected 11.7 years in the next 50 years. Today, there are on average 2.2 old-age dependents per 10 working-age people in the SEE6. By 2065, there will be a projected 5.6 old-age dependents per 10 working age people, bringing the total number of dependents to 8.1 per 10 working-age people. According to the UN population projections, not only is the composition of the population expected to change but also its size, shrinking by 25 percent by 2065. This demographic transformation may hurt economic growth as the working-age population of the region declines, all else remaining equal. Moreover, in the face of aging populations and rising fiscal costs of pensions and health care, weaker tax revenues is something many governments in SEE6 can ill afford and many countries continue to face fiscal pressures that could limit the scope for fiscal policy interventions. In the context of ageing societies, such developments represent a serious challenge to both persistent economic growth and the sustainability of public finances. However, it is possible to mitigate these effects with comprehensive policies focused on enhancing productivity and behavioral adjustments by individuals and firms toward flexible work in later age of life.[13]

Creating employment and income generating opportunities provides incentives for young individuals to stay or return home from abroad, attenuating not only the effects of aging, but also potentially increasing the quality and quantity of human capital in SEE6. In the last two decades, close to 5 million people originating from SEE6 countries are counted as migrants in another country; this is the equivalent of 25 percent of the source population in SEE6.[14] These migrants tend to be of working age, reducing the size of the labor force in their home countries (see Box 1.2). The

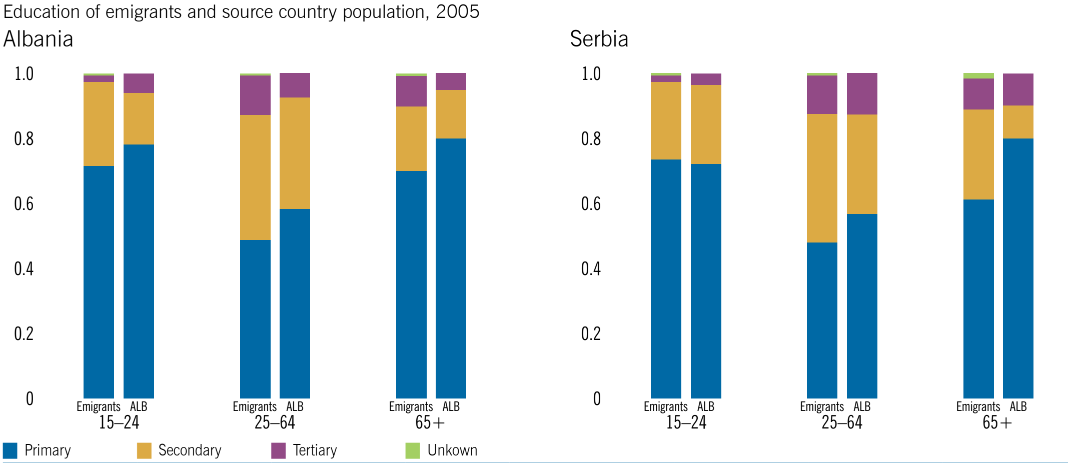
13 This RER Special Topic paper on aging in SEE6 discusses these issues.

14 UN International Migrant Stock 2013 Revision.

average migrant originating from SEE6 appear to be better educated than its resident counterpart. This is the case in particular for tertiary-educated Albanians and secondary-educated Serbians emigrants (Figure 2.9). These migrants have directly contributed to the economies of their "home" (Western Balkans) countries primarily through the remittances channel. But by moving abroad they have depleted the human capital stock of their countries. Slowing outmigration may not only partly increase the supply of working age people, but also in some cases may give a boost to skills in SEE6

Figure 2.9: Working age emigrants from Albania and Serbia tend to be better educated than their counterparts at home

Education of emigrants and source country population, 2005



Source: World Bank staff computations based on the following datasets. Education of emigrants: OECD DIOC 2005/06 database; education of source country population: Barro and Lee (2013).

In sum, there appear to be two requisites for sustained income growth at middle-income levels. The first is ensuring macrofiscal stability, so that any gains from growth are secure against being reversed by later crises. The second is addressing structural challenges, including related to demographic, that impede development, private sector competitiveness, and the efficiency and effectiveness of public services. A comprehensive reform agenda based on the pillars identified above that also ensures macrofiscal stability would build SEE6 resilience against medium-term shocks. It will also help countries move forward on the path to EU accession (see Box 2.4).

Box 2.4: EU Council Conclusions on SEE6 Economic Reform Programs

The economic and structural priorities the EU has recommended to the SEE6 are directed to macroeconomic stability and structural reforms. In May 2015 the ECOFIN Council adopted the first comprehensive approach to the economic policy dialogue in EU candidate countries. Two sets of priorities were flagged for the SEE6: (1) strengthening the medium-term macrofiscal framework; and (2) enhancing competitiveness and long-term growth. Assessments of SEE6 countries found that reinforcing public finances, improving the efficiency of the financial sector, removing rigidities in product markets, and upgrading the educational system to better align with the needs of the private sector should be priorities throughout the region (Table B2.4.1).

Table B2.4.1: Economic Reform Programs for SEE6, 2015

Country	Public finances			Financial sector	Labor market	Product & service markets		Education	Social inclusion	Admini-stration
	Public finances	**Taxation**	**Pension system**	**Banking and access to finance**	**Labor market**	**Services and network industries**	**Innovation and business environm.**	**Education and skills**	**Poverty and social inclusion**	**Adminis. moderni-zation & rule of law**
ALB	■			■		■	■	■		
BIH	■	■		■	■	■	■	■	■	■
MKD	■			■	■	■	■	■	■	■
KOS	■	■		■		■	■	■	■	■
MNE	■		■	■	■	■	■	■		■
SRB	■	■		■	■	■	■	■		■

Source: http://ec.europa.eu/europe2020/index_en.htm.
Note: The EC recommendations for 2015–16 were presented on May 13, 2015.

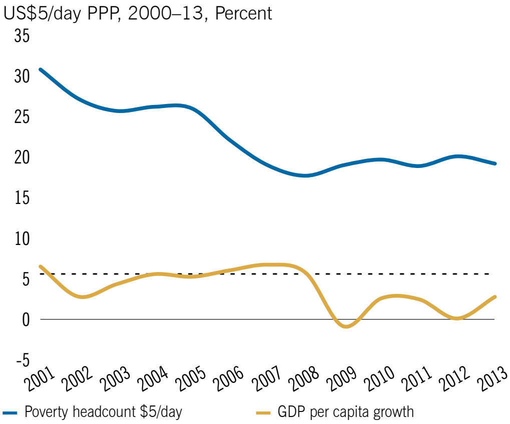
Spotlight: Poverty Trends and Expected Developments

Poverty Trends

In SEE6 poverty reduction after 2008 has been lackluster. Prior to the global crisis, economic growth was strongly associated with poverty reduction throughout countries in the region. In the aftermath of the crisis, the pace of economic growth decelerated and the downward poverty trend that most SEE6 countries had seen in the 2000s tapered off, and some of the gains eroded. Using the regional poverty line of US$5/day PPP, it is estimated that the poverty rate went back up in most SEE6 countries. (Figure S.1).

Figure S.1: Economic Growth and Poverty

US$5/day PPP, 2000–13, Percent



Source: The harmonized ECAPOV dataset and WDI.
Note: Regional average excludes Kosovo due to difficulties in calculating PPP welfare aggregates.

Worsening labor markets—in a region with already persistently high unemployment and low labor force participation—drove the declines in living standards across most countries. Access to income-generating opportunities for already disadvantaged groups further narrowed. Limited access to assets, weaker engagement in the labor market, and higher dependency rates reduced the coping mechanisms available to them. For example, throughout the region, unemployment and inactivity were concentrated among individuals with few skills—the poor, the bottom 40 percent of the welfare distribution, and minorities like the Roma—and among young people.

It is estimated that in most SEE6 countries economic growth and poverty reduction are slowly returning. The fact that countries with lower GDP growth in recent years are not yet consistently reducing poverty underscores the importance of rekindling economic growth and job creation.

- After major improvements in living standards in **Albania** up to the 2008 global financial crisis, as economic growth slowed between 2008 and 2012, poverty reduction stagnated. Weak labor markets—particularly rising unemployment—and a reduction in remittances inflows have limited the recovery in recent years. This year growth is slowly accelerating, and as economic growth translates into job creation, poverty is expected to have a slow downward trend.

- In **Bosnia and Herzegovina**, after a sluggish economic performance in 2014 driven by the impact of the floods, the economy seems to be gradually recovering, with GDP growth projected at 1.9 percent growth for 2015. The precrisis poverty reduction trend, driven by economic growth, stalled.

- In **Kosovo**, an exception to regional poverty reduction trends, consumption per capita grew by nearly 4 percent annually

This spotlight is based on the World Bank "Macro and Poverty Outlooks" of October 2015.

for the bottom 40 percent from 2008 through 2011, compared to 2.4 percent for the top 60 percent; both poverty and inequality thus receded. Although GDP growth decelerated to 1 percent in 2014, it is expected to pick up to 3 percent for this year, which should help improve living standards.

- In **FYR Macedonia**, national poverty estimates show poverty as having decreased since 2010. According to data from the Survey of Income and Living Conditions (SILC) for 2010–13, the share of the population at risk of poverty declined from 27.0 percent in 2010 to 26.2 percent in 2012 and then to 24.2 percent in 2013. Considering that the threshold for those at risk of poverty went up between 2010 and 2013 by 6 percent in real terms, this result signals an improvement in living conditions at the bottom of the distribution.

- In **Montenegro**, the poverty rate, measured at US$5/day PPP, increased from an average of 15.2 percent in 2005–2008 to 19.2 percent in 2012. It is estimated that poverty reduction resumed with positive GDP growth and employment expansion in 2014.

- In **Serbia**, after substantial progress in reducing poverty in the mid-2000s, since 2008 minimal growth and poor labor market outcomes have heightened both poverty and vulnerability: poverty had risen from 10.6 percent in 2008 (US$5/day PPP) to 15.1 percent by 2010. Serbia's economy, which has been struggling in recent years, moved back into recession in 2014, primarily because of the floods, which pushed poverty up. With the recovery of economic growth in early 2015, it is expected that poverty will again start to slowly decline.

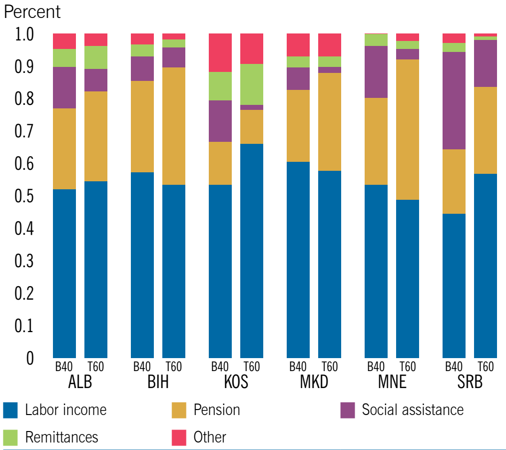
Labor Markets and Poverty

Despite disproportionate reliance by international standards on non-labor income, labor is still the largest source of income in SEE6 countries. Although labor income accounts for a majority of income in all countries but Serbia, its relative share is still lower than in other middle-income regions like Latin America. Pension income comprises the second largest source of income in most SEE6 countries, particularly for better-off households. The share of social assistance in total household income varies by country, but together with pensions helps explain the relatively low reliance in labor market income in SEE6 (Figure S1.2).

Sluggish labor markets have slowed progress in reducing poverty. Despite some recent improvements, labor markets are weak throughout SEE6. In Albania, an increase in the unemployment rate from 13.7 percent in Q2 2012 to 17.3 percent in Q2 2015 limited the impact on poverty of increased economic growth in 2013 and 2014. Labor markets have recently been picking up, however: employment rates rose by about 2 percentage points between Q2 2014 and Q2 2015, benefitting workers in all sectors.

In **Kosovo**, labor markets are a major challenge. Unemployment in 2014 is estimated to have been 35 percent. Long-term unemployment

Figure S1.2: Household Income by Source in SEE6



Source: World Bank. 2014. Southeast Europe "Regular Economic Report Special Topic: First Insights into Shared Prosperity."

Note: B40 refers to the bottom 40 percent and T60 to the top 60 percent of income distribution. Additional data are from the Montenegro 2013 HBS and from Serbia 2013 SILC.

reached 69 percent of the unemployed, and youth unemployment exceeded 61 percent. Discouraged workers accounted for about 10.7 percent of the working-age population in 2014. The labor force participation rate was 4 percentage points higher than in 2012 but is still extremely low at 41.6 percent. The employment rate increased from 25.6 percent in 2012 to 28.4 percent in 2013, but fell again to 26.9 percent in 2014.

In **Bosnia and Herzegovina**, the unemployment rate in Q1 2015 was unchanged at 27.5 percent, compared to Q1 2014. Unemployment among youth (15–24) was extremely high at 62 percent, according to 2015 LFS. Among the unemployed, 82 percent have been seeking employment for over 1 year. The total number of the employed in the economy increased by 1.7 percent for Q1 of 2015 with respect to Q1 of 2014, but much of the increase originated in public administration, while gross earnings remained constant during 2014–2015.

Labor market outcomes have improved slightly in **FYR Macedonia**, but the unemployment rate still averaged 28 percent in 2014, just 1 percentage point lower than in 2013, and between 2013 and 2014 employment went up from 40.6 to 41.2 percent of the working-age population. The biggest contributors to employment growth were the public sector and information and communication, followed by water supply and administrative services. Manufacturing, construction and trade also contributed to job creation, although in relative terms their sectoral growth was modest. However, youth unemployment rose from 51.9 to 53.1 percent in 2014, the third highest in the region after Bosnia and Herzegovina and Kosovo.

In the first half of 2015, the unemployment rate in **Montenegro** was at 17.6 percent, its lowest level since 2008. The labor force participation rate for people aged 15 and over went up to 53.1 percent and employment to 43.8 percent, but are still low by international standards. Gross wages were flat in 2014, however; growth in labor income was primarily driven by hiring.

In **Serbia**, labor market outcomes stumbled after the 2009 crisis, and unemployment among those of working-age increased from 13.6 percent in 2008 to a peak of 23.9 percent in 2012. As the Serbia economy moved out of recession in the second quarter of 2015, the unemployment rate in the second quarter was 17.9 percent, down from 20.3 percent a year earlier. Among young people, unemployment is particularly high at 43.1 percent. With public wages frozen, overall real wages fell in early 2015.

Beyond labor income, pensions and public and private transfers made useful contributions to poverty trends in several countries. In Albania, Bosnia and Herzegovina, and Montenegro, pensions have been a key poverty-reducing factor, partially mitigating the impact of the economic downturn. As seen in Figure S1.2, remittances have become especially significant in Kosovo, where an estimated 20 to 25 percent of households (particularly among the better-off) receive foreign remittances. Remittances have a large role in household income in all SEE6 countries and have an important role in supporting growth and inclusiveness in SEE6. Austria, Germany, Italy, and Greece are the main destinations for SEE6 migrants.

Poverty Outlook

As economic growth firms up in the medium term, poverty is expected to go down in several countries; nevertheless, weaknesses in the labor market will continue to act against sustained poverty reduction throughout the SEE6. Progress in reducing poverty and boosting shared prosperity will be particularly difficult because of persistently high unemployment, low labor force participation rates, and high degrees of informality. Only 32 percent of working age people in Bosnia and Herzegovina are employed, and 56 percent are out of the labor force. Bosnia and Herzegovina and Kosovo have youth unemployment rates above 60 percent, with FYR Macedonia and Serbia not far behind. Globally, employment has been shown to be the single most effective and durable mechanism for reducing poverty, but the SEE6 countries are still heavily reliant on non-labor income. Especially in a context of limited fiscal space, where it is difficult to support large transfers, dysfunctional labor market is a critical bottleneck to continued progress in every SEE6.

In **Albania**, as the economy continues to gradually accelerate, further reductions in poverty are expected in 2016 and 2017. However, a prolonged crisis in neighboring Greece may further adversely impact Albania's growth and poverty prospects, through reduced remittances, exports, and investment. If these risks materialize, labor markets and remittances inflows could weaken and living standards of the population could be affected.

In **Bosnia and Herzegovina**, unemployment is expected to remain high, particularly among youth. Constraints on hiring created in part by the high tax burden are expected to continue, while the substantial slack remaining in the labor market will contain real wages. The incidence of poverty (US$5/day PPP) is likely to fall only marginally in 2015–17.

In **Kosovo**, the national poverty rate is not expected to improve significantly during 2015–2017. Little progress is expected in reducing high unemployment and poverty. Unemployment remains high because the pace of job creation is expected to absorb only two-thirds of new job seekers. In the absence of dynamic job creation, steady migration outflow has helped release the pressure on the Kosovo labor market. Moreover, low inflation and positive and significant growth in agriculture might accelerate growth in consumption by the bottom 40 percent, as most live in rural areas.

In FYR **Macedonia**, poverty is expected to continue its decreasing trend in the next few years. The positive economic growth in 2014 and the expected positive rates for the 2015–2017 period should keep pushing poverty down, as employment continues to be created in construction (propelled by public investment), manufacturing and export related industries. Increases in social benefits are expected to have contributed to further decreases in 2015, and to keep playing an important role in the upcoming years, although there are concerns about its fiscal sustainability. The agricultural sector has had slow growth and has been volatile in recent years, hence making unlikely a considerable reduction of rural poverty in the near term.

In **Montenegro**, positive economic growth is expected to reduce poverty further via higher employment (largely in construction and tourism) and wages and a deceleration of private sector deleveraging. However, the labor market is exposed to volatile regional economic developments, and household welfare remains highly vulnerable to macro risks.

The poverty outlook for **Serbia** mirrors the vulnerability of the macro-fiscal outlook. Poverty is expected to slowly decline with returning economic growth, some improvements in labor demand and employment expansion. However, poverty reduction remains highly fragile due to still weak labor markets and the potential impact of the structural reform measures that have been announced.

In addition to the adverse impacts of the global economic crisis and the economic and weather shocks that followed, unaddressed structural issues will continue to hinder prospects for poverty reduction and shared prosperity. Especially, sustained poverty reduction will be undermined if the economic recovery does not translate into jobs, and if the barriers and disincentives that confront people trying to access jobs are not addressed.

In an environment of slow and volatile growth, and limited fiscal space, boosting job opportunities for the population, particularly the poor and vulnerable, is a critical challenge for all SEE6 countries. In addition, providing well-targeted social safety nets is critical to ensure that shocks, like the ones the region has suffered in recent years, do not erode progress toward better living standards. The need to boost job opportunities, alongside social protection, is even greater for countries undergoing fiscal consolidation reforms like Serbia.

SEE6 Country Notes

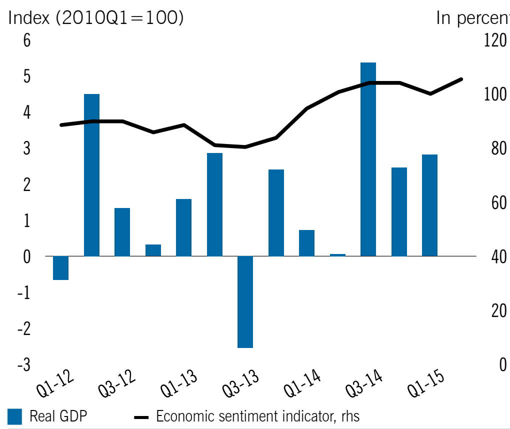
Albania

Albania's economy continued to expand in the first half of 2015, albeit remaining below potential. Growth was driven primarily by investment and net exports, while private consumption continued to suffer, reflecting sluggish consumer confidence. Private investments have benefited from improvements in business climate and the repayment of a large stock of government arrears to the private sector, and are expected to continue strong in the near term. In contrast, public investment, which has expanded so far, could be affected by fiscal consolidation efforts, in the absence of other adjustments. Real GDP growth is expected to reach 2.7 percent in 2015, up from 2.1 in 2014. Main downside risks to economic growth include high NPLs that limit credit growth, low oil prices and subdued external demand.

Albania's economy continues to grow in 2015 on account of stronger domestic investments. Real growth reached 2.8 percent year-on-year in the first quarter of 2015. Growth has been mainly driven by investment and net exports, which compensated for a contraction in private consumption. Available high frequency data suggest a similar pattern in the second quarter of the year, although with slightly lower growth rate due to the impact of the Greece crisis on remittances, exports and credit. Our latest projections see a downward revision of growth in 2015 to 2.7 percent from 3 percent we projected earlier in the year. Improvements in business confidence and the steady increase in capacity utilization rates suggest that private investment, mainly FDI driven, will be a key contributor to GDP growth.

The merchandise trade deficit narrowed as a result of both increasing exports and decreasing imports. Exports continued to increase for the second quarter in a row despite lower oil prices, contributing to the reduction in the nominal trade deficit. While the value of imports decreased on annual terms, imports of machinery and equipment remained strong, suggesting a pickup in investment. FDI increased significantly during the first quarter of 2015 by around 53 percent year-on-year after falling in the last quarter of 2014, driven by FDI to the drilling sector. Additionally, net

Real GDP, annual growth rates and Economic Sentiment Indicator



Source: Bank of Albania, INSTAT.

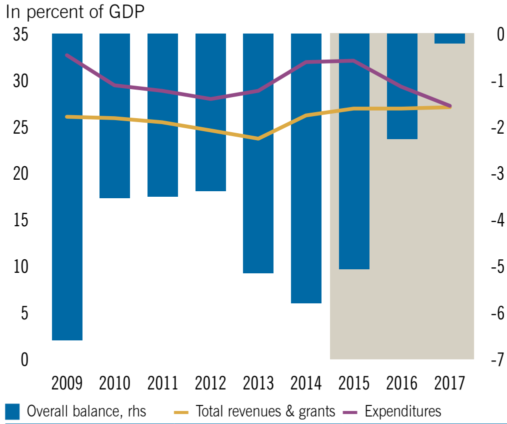
inflows in the financial account increased by 26.5 percent annually, contributing positively to the financing of the current account deficit. These positive results happened despite the declining export income, remittances, and FDI inflows from Greece.

Average inflation remained below the target band of 2–4 percent, reflecting deflationary pressures from abroad and depressed domestic consumption. Inflation followed a positive trend during the first months of 2015, driven by supply-side shocks (floods in January and February 2015) and price volatility of specific goods (i.e. unprocessed food prices). However, starting from May 2015, the low import prices pushed inflation down below the targeted range, reaching 1.3 percent in July 2015. The Central Bank maintained a lax monetary policy stance, by keeping the policy interest rate unchanged at a historic minimum of 2 percent. The lower policy rate translated into lower credit interest rates, which contributed to the increase in lek lending (7.5 percent on annual terms). The developments in Greece over the summer prompted the Central Bank to step up efforts to further safeguard the financial system, lower financing costs and address NPLs. Coupled with the regulatory measures already started at the beginning of the year, these efforts reduced the NPLs from 22.4 percent of gross loans at the end of 2014 to 20.9 percent by the second quarter of 2015. However, NPLs remain still high reflecting sizable default risk, and with weak credit demand and conservative lending practices suppress the credit recovery.

Labor market indicators suggest a modest, but positive employment growth during the second quarter of 2015. Employment increased by 10.6 percent compared to the same quarter of 2014. Employment has increased in previously declining sectors such as construction, non-market services, manufacturing and activities of market services. The unemployment rate reached 17.3 percent in the second quarter of 2015, which is lower compared to the same quarter of 2014 (18.6 percent). Participation rate has marginally decreased in the first quarter 2015 reaching 63 percent from 63.6 percent in last quarter of 2014, however has increased compared to the first quarter of last year (57.9 percent).

Fiscal Revenues, Expenditures, and Overall Balance

In percent of GDP



Source: Ministry of Finance, WB staff calculations.

Fiscal consolidation is falling on the expenditure side. During the first half of 2015 expenditures shrank by 0.9 percent year-on-year to 195.6 billion Lek. In contrast, capital expenditure rose by 5.4 percent relative to the same period of 2014, which reinforce the positive contribution of investment to GDP in the first quarter of 2015.

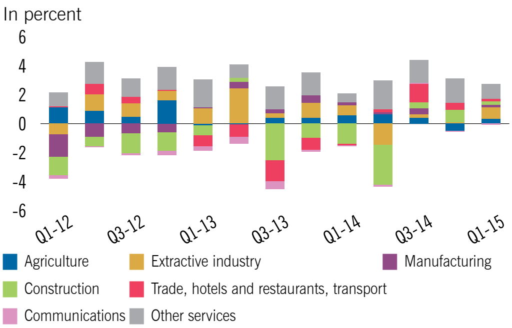
On the revenue side, consolidation efforts were less effective than on the expenditure

side due to poor revenue collection, as well as lower than expected inflation and oil prices. This dynamic already noticed in the budget indicators for the first quarter, continued to be present during the second quarter as well. By June 2015, tax revenue grew by 4.4 percent from a earlier year (instead of 9.4 percent expected), or 8.6 billion Lek shorter than originally forecasted. While revenues from the "small business tax" and profit tax increased by 22.5 percent and 21.7 percent, respectively, other taxes underperformed in the first half of 2015. The "custom duties" and "national tax and others" revenues shrank by 4.1 percent and 3.0 percent on annual terms, respectively, during the same period. Although revenues underperformed mainly due to tax administration bottlenecks, their dynamics is somehow consistent with an investment-driven domestic demand and sluggish consumption. The fiscal deficit is likely to reach 5.1 percent in 2015 given the continuation of the government to clear off the arrears in the upcoming months. The fiscal deficit will be funded largely by external funds, including of IFIs, while the share of domestic financing is decreasing. Public debt is projected to marginally increase to 73.2 percent of GDP in 2015 from 72.5 percent of GDP in 2014. It still remain at elevated levels and subject to the fiscal consolidation and refinancing risk. Persistent fiscal adjustments are expected to put debt to a downward trajectory to 57.1 percent of GDP by 2019.

Outlook

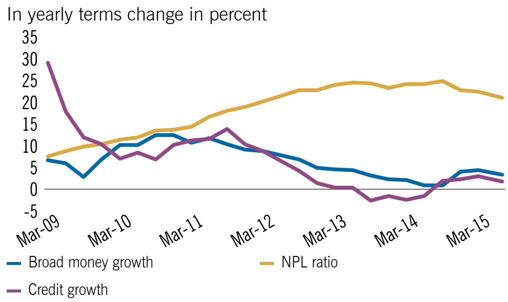
Growth is expected to increase gradually over the medium term to reduce the output gap. Real GDP growth is projected to rise from 2.1 percent in 2014 to 2.7 percent in 2015, 3.4 percent in 2016 and 3.5 in 2017 supported largely by an increase in investment. Additionally, private consumption is expected to gain strength, increasing its contribution to growth. This projection assumes the realization of the structural reforms in energy, financial management of public investment and pensions. Expected improvements in the business climate and investor confidence and strong FDI inflows are likely to positively affect economic activity. Lower financing cost and comprehensive efforts to lower NPLs are expected to strengthen credit, private consumption and investment. Fiscal deficit is projected to decline from 5.1 percent of GDP in 2015 to 2.3 percent of GDP in 2016 due to further fiscal consolidation efforts on both expenditure and revenue sides, and despite the continued clearance of arrears. On the external front, higher imports of investment goods are likely, while export growth continues to moderate in dollar terms as a result of subdued oil prices.

Sectoral contributions to GVA growth (production side)



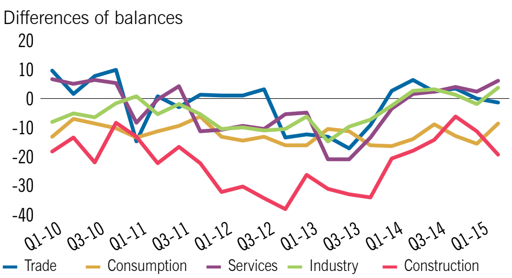
Source: INSTAT, WB staff calculations.

Monetary aggregates



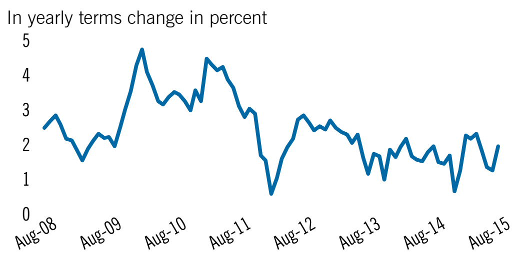
Source: Bank of Albania, WB staff calculations.

Confidence Survey indicators



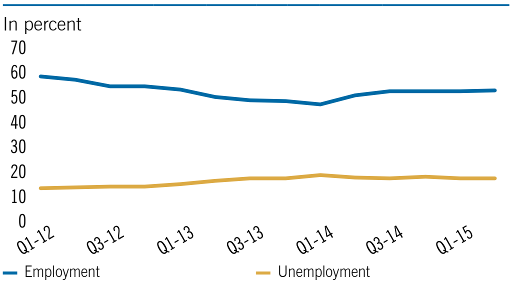
Source: Bank of Albania.

Headline inflation



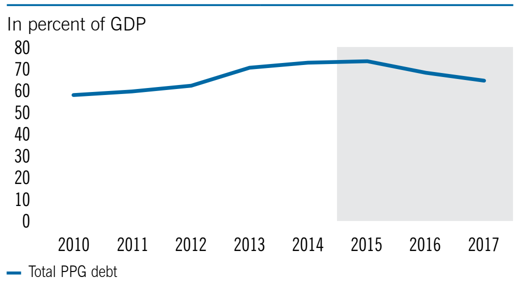
Source: INSTAT.

Unemployment and Employment



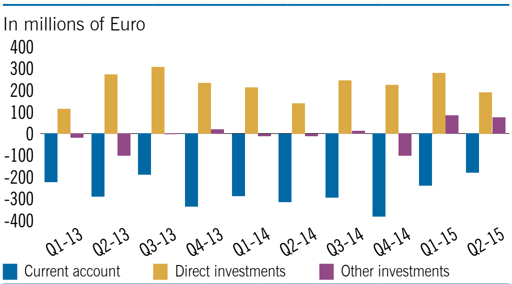
Source: INSTAT, WB staff calculations.

Public Debt



Source: Ministry of Finance, WB staff calculations.

CAD, FDI and other investments



Source: Bank of Albania

ALBANIA	2012	2013	2014	2015f
Real GDP growth (percent)	1.6	1.1	2.1	2.7
Composition (percentage points):				
Consumption	0.3	1.2	3.7	-0.6
Investment	-2.3	-0.8	0.2	2.0
Net exports	3.7	0.7	-1.7	1.2
Exports	-0.3	3.5	-6.1	-0.6
Imports (-)	4.0	-2.8	4.4	1.8
Consumer price inflation (percent, period average)	2.0	1.9	1.6	2.1
Public revenues (percent of GDP)	24.7	23.7	26.2	27.0
Public expenditures (percent of GDP)	28.2	28.9	32.0	32.1
Of which:				
Wage bill (percent of GDP)	5.2	5.2	5.1	5.1
Social benefits (percent of GDP)	10.5	11.1	11.7	11.3
Capital expenditures (percent of GDP)	4.6	4.8	4.3	4.4
Fiscal balance (percent of GDP)	-3.5	-5.2	-5.8	-5.1
Primary fiscal balance (percent of GDP)	-0.3	-1.7	-2.4	-0.6
Public debt (percent of GDP)	58.0	66.3	68.4	68.5
Public and publicly guaranteed debt (percent of GDP)	62.0	70.1	72.5	73.2
Of which: External (percent of GDP)	26.8	26.6	29.2	32.9
Goods exports (percent of GDP)	15.9	18.1	9.2	8.2
Goods imports (percent of GDP)	36.8	35.7	30.6	29.8
Net services exports (percent of GDP)	2.2	-0.2	2.7	2.7
Trade balance (percent of GDP)	-18.7	-17.9	-18.7	-18.9
Remittance inflows (percent of GDP)	9.2	7.0	7.2	6.8
Current account balance (percent of GDP)	-10.2	-10.7	-13.0	-13.1
Foreign direct investment inflows (percent of GDP)	6.8	9.5	8.0	8.2
External debt (percent of GDP)	35.6	34.3	36.7	42.3
Real private credit growth (percent, period average)	4.6	-3.5	-1.4	0.6
Non-performing loans (percent of gross loans, end of period)	24.0	24.1	22.4	20.9
Unemployment rate (percent, period average)	13.4	16.0	17.5	17.1
Youth unemployment rate (percent, period average)	26.1	27.2	32.5	33.6
Labor force participation rate (percent, period average)	57.3	52.4	53.7	55.1
GDP per capita, PPP (current international $)	10,123.2	10,363.5	10,736.5	11,334.5

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. Youth unemployment rate is for labor force aged 15–29.

Bosnia and Herzegovina

Economic activity improved in the first half of 2015. The economy continues its recovery from the impact of the 2014 floods with indirect revenue collection, industrial production and the net trade balance all showing positive trends. Growth for 2015 as a whole is expected to reach 1.9 percent, up from 1.2 percent in 2014. A joint agreement between the national and sub-national authorities on the priority reform agenda for Bosnia and Herzegovina (BH) was signed in July 2015 and implementation of such reforms is key to an improved medium-term outlook. The agenda includes long-awaited labor reforms, on which there is some positive momentum with the recently adopted Labor Law in the Federation of BH (FBH). However, the quality and pace of implementation of the agreed reforms will depend crucially on political dynamics.

Recent developments

The first half of 2015 saw an acceleration of economic activity, continuing the recovery from the impact of the 2014 floods. Improvements were seen in indirect revenue collection, industrial production and the net trade balance. The official estimates show real GDP growth of 2.1 percent in Q1 2015. The growth was mainly driven by construction and services. After exhibiting negative growth for almost a year industrial production recorded positive growth in July reaching 2.4 percent growth year-on-year (y/y). Energy output, which was particularly affected by the devastating floods of May 2014, seems to have recovered faster than that of agriculture, which was also hit hard. Energy output grew in Q1 after four consecutive negative quarters. This year's summer drought is adding to an already difficult situation in agriculture and hence the recovery in activity in rural areas will take some time.

Consumption appears to have slightly improved in the first half of 2015, as seen in growing imports of consumer goods, supported by increased bank credit to households. Investment, however, remains unchanged. Imports of capital goods grew by only 1.2 percent y/y in H1 2015, while long-term bank credit to private enterprises has experienced negative growth through the entire period since February, contracting by 0.9 percent y/y in June.

Improved indirect tax revenue performance in 2015 to date may reflect both the pick-up in activity, as well as improved cooperation among domestic tax agencies. In June the gross collection of indirect tax revenues (ITA) increased by 8.3 percent y/y, on the back of higher VAT and excise tax collections, which contributed 3.8 and 4.8 percentage points respectively to overall ITA revenue growth. Excise tax collection rose by 9.5 percent and VAT by 2 percent, with the former mainly driven by the excise tax on tobacco products (accounting for 62 percent of excise taxes in June) and on petroleum (29 percent). This progress was mainly due to expanded cooperation between four tax agencies on the exchange of taxpayer information. The authorities have also harmonized excises on different tobacco products in recent years.

Although growth is improving, unemployment remains high and little changed given slow progress in advancing economic reforms in 2014. While some improvements in the employment numbers were recorded in Q1 2015, much of the increase originated in areas of public administration. Gross earnings also remained constant during 2014–2015. However, signs of progress on much-needed labor reforms have been seen. The new labor code, which includes amendments to, for example, collective agreement and termination provisions, was adopted in the Federation of FBH (FBH) at the end of July while in the Republika Srpska (RS) the government has started consultations on the new labor code, including with trade unions. If implementation of the new labor legislation is done promptly some improvements to unemployment rates should be expected in a year from now.

Imported deflationary pressures further pushed down consumer prices. Deflation moderated in the first half of 2015 but remained negative with consumer prices falling by 0.5 percent y/y in the first half of 2015, down from a contraction of 1.5 percent a year earlier. The biggest drivers of the fall came from the price of imported goods, for example, for transport, reflecting weak oil prices, food, clothing and footwear. In contrast, prices of alcohol and tobacco, as well as of education, health, housing and water rose in June.

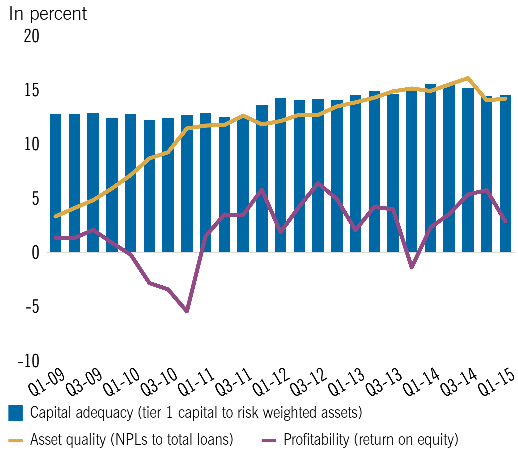
The currency board continues to support monetary policy. International reserves remained at a comfortable level in H1 2015, at around 6 months of imports. The euro-pegged convertible mark (BAM) appreciated slightly against the US dollar over the quarter, down 1.5 percent in July relative to March, but remains 12 percent weaker than in December 2014 following the marked depreciation earlier in 2015. Including the currency's movements against other trading partners, the nominal effective exchange rate (NEER) was unchanged in July relative to March, 2 percent weaker than in December 2014. However, BH's relatively low inflation contributed to a further weakening of the real effective exchange rate, which as of July had fallen by 4 percent relative to December 2014, supporting the relative price competitiveness of the domestic economy.

The Fiscal Council came to an agreement on the fiscal framework for 2016–2018 at the end of June 2015. This came after the delayed adoption of the 2015 budget by the BH institutions, following the protracted time for government formation in FBH and BH Institutions, the fiscal deficit is estimated to reach 1.9 of GDP in 2015 on the back of improved revenue collection and some slowdown in expenditures. In July 2015 the central bank published consolidated fiscal accounts data for 2014 indicating a deficit of 2.1 percent of GDP. This was little changed from the 2013 deficit (down by 0.1 percentage points of GDP due to faster growth in revenues than expenditures).

The current account deficit narrowed in the first quarter of 2015. The current account deficit declined to BAM 387 million in Q1 2015, versus BAM 478 million in Q1 2014. On a rolling four-quarter basis the current account deficit in Q1 was 7.2 percent of GDP (down from 7.5 percent for 2014 as a whole). The narrowing of the current account deficit primarily reflected a decline in the trade deficit as goods exports rose by 8 percent y/y against a 1 percent contraction in imports. Data for the second quarter indicating a continuation of this trend with export growth, although at 5.5 percent down slightly on Q1, continuing to outstrip that of imports (2.1 percent). Exports are expected to further improve in the second half of the year, supported by the recovery in the euro area, as well as support to competitiveness from the real exchange rate and, over the longer-term, from reforms in the area of business competitiveness and labor market. Worker remittances continued to be strong, supporting private consumption. In terms of the financing of the current account deficit, net FDI flows were weaker than a year earlier and covered about 22 percent of the quarter's current account deficit. The remaining financing was from capital account inflows and other investments (mainly new loans).

Concerns over asset quality in the banking sector remain. The share of nonperforming loans in commercial banks' portfolios was 14.2 percent at end-March 2015, up from 14.0 percent at end-December 2014. Banks' profitability also deteriorated in the first quarter, partly due to high provisioning. Asset quality is becoming an important obstacle for reestablishing bank profitability mainly owing to poor corporate resolution and insolvency frameworks. The capital adequacy ratio of 16.2 percent at end-March 2015 remains above the prescribed level of 12 percent and central bank stress tests show an adequate level of capitalization. However, if the situation deteriorates further, some banks could need additional capital.

Selected Financial Soundness Indicators



Source: Central Bank of BiH.

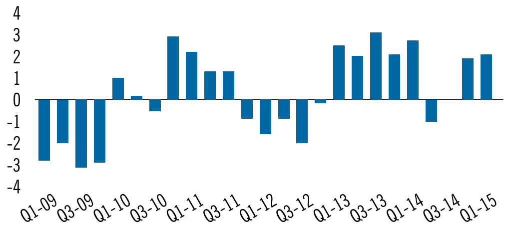
Outlook

Growth is projected to strengthen to 2 percent in 2015 and to rise moderately in the medium term. In the near term, this is likely to be mainly due to the recovery in external demand and the stepping up in reconstruction efforts after the 2014 floods. Enhanced progress on the implementation of long-standing reforms will be required for the medium-term growth outlook to improve relative to this baseline. Other potential risks to the outlook include possible delays in Europe's overall economic recovery that would have an impact on exports, remittances and capital flows.

The challenge for fiscal policy will be to secure medium-term sustainability while supporting the still-needed recovery in growth. Fiscal consolidation will need to be gradually introduced in order to absorb the shock caused by the floods. The sustainability of public debt needs to be closely monitored as its scope, size and complexity has increased. In addition, particular focus will be needed on documentation of the arrears, full accounting of which does not exist. A related, persistent challenge is the high cost of employment, given the high tax wedge on labor. Reforming the labor market and improving the delivery of social protection delivery will also need to stay in the government's focus while making sure that macro stability remains preserved.

Real GDP growth

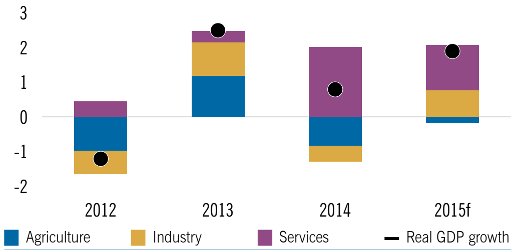
Percent change, year-on-year



Source: BH Agency for Statistics.

Agriculture, manufacturing and energy

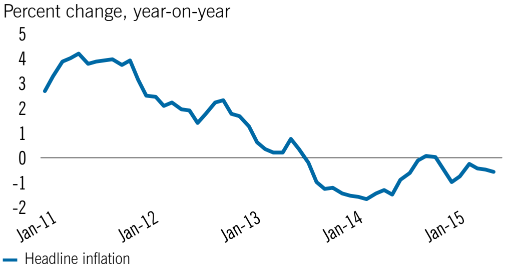
Percent change, year-on-year, GDP production side



Source: BH Agency for Statistics.

Consumer prices

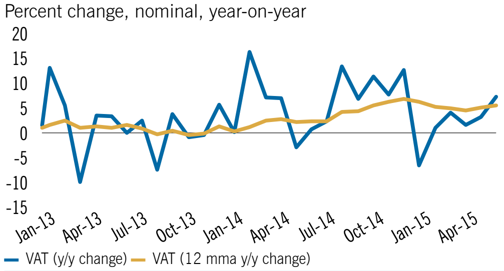
Percent change, year-on-year



Source: BH Agency for Statistics.

VAT

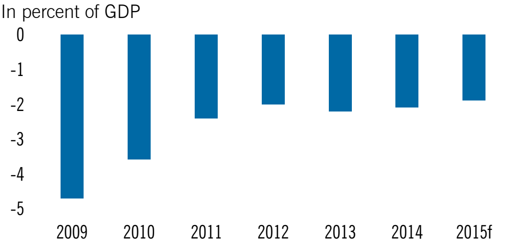
Percent change, nominal, year-on-year



Source: BH Indirect Taxation Authority.

General government fiscal balance

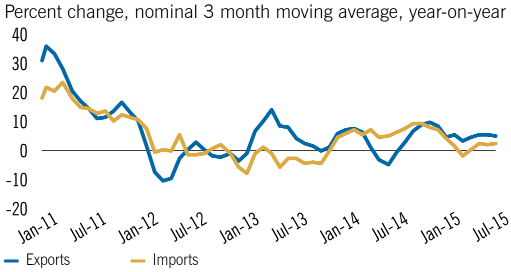
In percent of GDP



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

Exports and imports

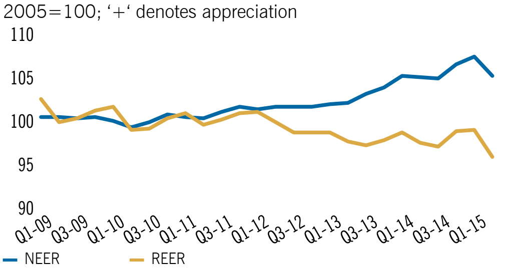
Percent change, nominal 3 month moving average, year-on-year



Source: BH Agency for Statistics, WB Staff calculations.

Real and nominal effective exchange rate index

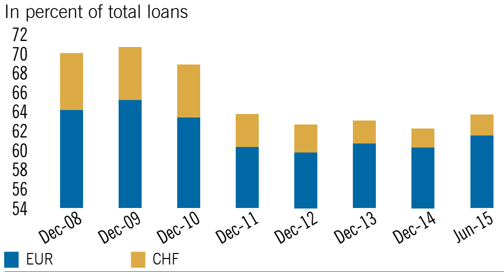
2005=100; '+' denotes appreciation



Source: Central Bank of BH, WB Staff calculations.

Share of foreign-currency indexed loans in total loans

In percent of total loans



Source: Central Bank of BH, WB Staff calculations.

BOSNIA AND HERZEGOVINA	2012	2013	2014	2015f
Real GDP growth (percent)	-1.2	2.5	0.8	1.9
Composition (percentage points)				
Consumption			1.1	1.5
Investment			0.5	0.7
Net exports			-0.7	-0.2
Exports			-0.5	0.7
Imports (-)			-0.2	-0.9
Consumer price inflation (percent, period average)	2.0	-0.1	-0.9	0.5
Public revenues (percent of GDP)	44.5	43.4	44.4	43.9
Public expenditures (percent of GDP)	46.6	45.6	46.4	45.8
Of which:				
Wage bill (percent of GDP)	12.9	12.5	12.1	11.9
Social benefits (percent of GDP)	17.1	16.8	17.3	17.0
Capital expenditures (percent of GDP)	3.2	4.0	4.3	4.5
Fiscal balance (percent of GDP)	-2.0	-2.2	-2.1	-1.9
Primary fiscal balance (percent of GDP)	-1.5	-1.7	-1.5	-1.3
Public debt (percent of GDP)	38.8	37.2	38.7	42.1
Public and publicly guaranteed debt (percent of GDP)	43.6	41.6	42.7	46.1
Of which: External (percent of GDP)	27.8	28.1	30.5	33.0
Goods exports (percent of GDP)	22.6	24.3	24.6	25.1
Goods imports (percent of GDP)	53.5	52.0	54.6	51.8
Net services exports (percent of GDP)	7.0	6.8	6.8	6.7
Trade balance (percent of GDP)	-24.0	-20.8	-23.3	-20.0
Remittance inflows (percent of GDP)	8.1	8.1	8.4	8.6
Current account balance (percent of GDP)	-8.8	-5.7	-7.7	-7.9
Foreign direct investment inflows (percent of GDP)	-2.0	-1.7	-3.1	-3.1
External debt (percent of GDP)	52.2	50.8	54.6	54.2
Real private credit growth (percent, period average)	1.0	1.9	4.0	2.1
Non-performing loans (percent of gross loans, end of period)	13.5	15.1	14.2	14.1
Unemployment rate (percent, period average)	28.1	27.4	27.5	27.7
Youth unemployment rate (percent, period average)	63.3	58.8	62.9	62.3
Labor force participation rate (percent, period average)	44.0	43.6	43.7	44.1
GDP per capita, PPP (current international $)	9,214.0	9,562.8	9,808.0	10,359.6

Sources: Country authorities, World Bank estimates and projections.

Notes: Real GDP growth data are based on production approach, which differ from estimates and projections based on expenditure approach. Historical data are not available for the latter. 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.

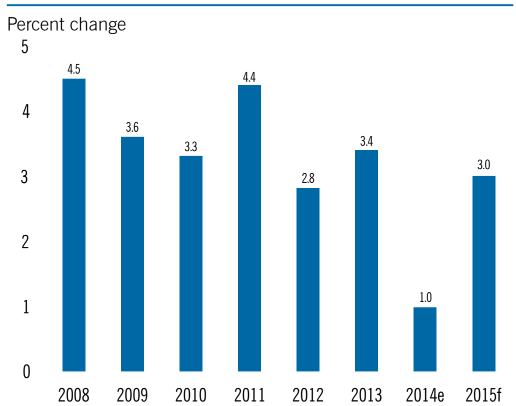
Kosovo

Although estimated real economic growth in the first quarter of 2015 was a very low 0.2 percent, it is expected to reach 3 percent for the year as a whole, fueled by consumption, exports of goods and services, and investments, both public and private. Foreign direct investment was promising in the first half of 2015, with more investment originating in the EU, and is expected to accelerate now that Kosovo and Serbia signed some initial political agreements in August 2015. Despite solid revenue growth in the first half of the year, fiscal consolidation is underway, rectifying the original 2015 budget revenue plans that had been based on the previous budget's baseline and on optimistic projections, resulting in considerable revenue shortfalls. Without fiscal adjustment in 2015, it would have been difficult to honor the fiscal rule capping budget deficits, with few exceptions, at 2 percent of GDP. The IMF approved a 22-month, €184-million Stand-by Arrangement on July 29th, 2015.

Recent developments

This year the economy is showing signs of broad-based recovery, mainly driven by domestic demand and lower negative net exports. The latest data from the Kosovo Agency of Statistics estimated that economic growth in Q1 2015 was only 0.2 percent, the result of 2.3 percent growth in private consumption, a drop of 1.5 percent in government consumption, investments that were lower by 0.6 percent, and a zero contribution from net exports. On the production side, agriculture and food processing are growing at rates significantly higher than the economy as a whole. However, even though Q2 growth numbers have not yet been released, we project that a stronger pick-up of private consumption and investments will be driving higher economic growth for the remainder of the year. The 25 percent increase in public wages since March 2014 was partially offset by a cut in public spending on goods and services and moderation in the growth of government consumption to 0.3 percent, mainly due to the price deflator. That negative price effect will disappear starting in Q2 2015, and public consumption is estimated to have made a solid

Real GDP Annual Growth Rates, Kosovo, 2008–15



Source: Statistics Agency of Kosovo, and World Bank staff projections.
Note: 2014 growth is a very preliminary estimate based on preliminary quarterly data while 2015 is WB projection.

contribution to growth in the first half of the year. Workers' remittances continued strong, rising by 18.7 percent y-o-y in the first half of 2015. Combined with higher wages and pensions they will support the growth of private consumption. Growth in private investment, boosted by more FDI and greater access to mortgage loans (albeit from a very narrow base), is compensating for low public investment. Although exports of goods are growing more than imports (14.5 percent vs. 5.1 percent), net export of goods was flat in the first half (y-o-y) because of a larger import base. However, in services faster growth in imports than exports (30 percent vs. 8.5 percent) meant that the contribution of net exports to growth was negative by the end of May. The net export of services normally shifts in favor of exports during the summer when numerous members of the diaspora return to visit, as they have been doing this year.

Kosovo's demographics—the average age of the population is 26 years—create both labor market and social pressures. Combined with feeble growth, this has led to social protests and reportedly high emigrations to the EU at the beginning of the year. The labor force data show that the unemployment rate went up in 2014 by 5 percentage points, to 35 percent; Kosovo's unemployment, which is worse among the youth and females, continues to be the highest in SEE6.

External imbalances widened in the first half of 2015. Higher investment- and consumption-related imports of goods and services (telecom, transport, and travel services) and more outflows than inflows of primary income helped to push up the current account deficit by 16 percent by June 2015. At that point construction of the highway to FYR Macedonia had increased imports of investment goods (machinery imports went up by 7.8 percent and means of transport more than tripled, y-o-y) as well as transport services (which rose 86 percent, y-o-y). More Kosovars traveled abroad, raising imports of travel services by 14.4 percent and telecommunication services by 129.7 percent by June (y-o-y). Total exports of goods and services rose by 11.3 percent by June (y-o-y), largely because exports of travel services grew by 19.6 percent and of base metals by 39.2 percent.

Financial account balances went up by 94 percent, with inflows of FDI showing signs of solid recovery so far in 2015. The failed telecom privatization, a weak business environment, and domestic political turbulence in 2014 were among the factors that had caused a substantial decline of net FDI in 2014; it reached only 2.8 percent of GDP, compared to 4.7 percent in 2013. FDI in the construction sector may have also declined due to policies imposed in 2014 by the new mayor of the capital city of Prishtina, to halt construction. Net FDI inflow through June 2015 is estimated to have grown by 3.1 times (y-o-y) and reached about 6 percent of GDP; most FDI originates in the EU. This is a very important development: FDI from the EU had declined to just 7 percent of the euro amount in 2007; it suggests that the trend is reversing. In 2015 real estate, rentals, and business activities continued to attract the bulk of FDI. Portfolio investments also grew by 3 percent.

By June 30, 2015, under-execution of the capital budget (traditionally the fiscal buffer) had produced a temporary fiscal deficit of 1.3 percent of GDP. Revenues had gone up by

7 percent due to more economic activity, more imports, and the intensified efforts of the tax collection authorities. However, revenues still underperformed by 5.5 percent due to earlier over-optimistic revenue plans: By June 30, Customs had collected only 42 percent of what had been budgeted and the Tax Administration just 38 percent. Public expenditures had grown by 5.8 percent. Although revenues were less than expected, the temporary fiscal deficit was only 1.3 percent of GDP in June because capital spending had been only 24 percent of the budget for the year. Capital spending is expected to rise quickly as bills for construction of the highway and other roads come due after construction accelerated during the summer.

An average y-o-y deflation of 0.5 percent was recorded between December 2014 and July 2015. The consumer price index turned to a negative 0.4 percent in December and remained flat through 2015, because prices for transportation fuel declined in the second half of 2014. Prices for higher education, and accommodation services also plunged. Transportation annual price effects will carry into November, but the education price effect should disappear by September.

The financial sector continued to be profitable and credit grew at an annual rate of 7.1 percent from January through July 2015. Commercial bank profits increased by 67 percent y-o-y in the first seven months of 2015, driven by large cuts in expenditures. Interest rate spreads narrowed by an average 2.8 percentage points to 7.3 percent as lending interest rates fell. Improving supply and demand conditions reflected on private credit, which increased by 7.1 percent (y-o-y), driven by faster growth in credit to households (10.9 percent, y-o-y) than to businesses (6.2 percent). About two-thirds of credit still goes to businesses and one-third to households; corporate consumption loans went up by 16.5 percent, faster than the growth of investment loans at 12.1 percent. Household mortgage loans went up by 41.8 percent, fueling investments in housing; household consumption loans grew just 6.7 percent.

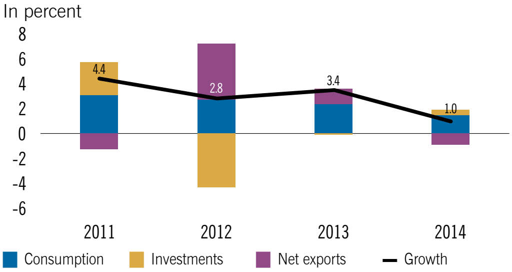
Nonperforming loans (NPLs) are declining. They fell to 7.2 percent of total loans in June 2015 from their peak of 8.8 percent in February 2014, and the trend is in the right direction: NPLs are lower in Kosovo than in the other SEE6 countries. The improvement came because corporate NPLs went down, mainly due to successful activity of the new established private enforcement agents. Meanwhile, household NPLs went up slightly.

Outlook

Economic growth is expected to increase from 3 percent in 2015 to 3.5 percent in 2016 and 3.7 percent in 2017, supported by political stability (following political impasse in 2014), larger FDI, consumption growth and rising exports. In 2015 we assume no interruptions on energy production (unlike explosion in Kosovo A power plant in June 2014) and no large price deflation of consumption caused by public wage increase (April 2014). Consumption, fueled by remittances; investments, especially FDI; and exports of goods and services are all expected to support growth in 2015 and beyond. The negative effect that public wage increases have had on prices since March 2014 will start to disappear in Q2 2015 and public consumption is expected to stimulate growth. Also, the government has announced an economic program to improve the business environment and foster growth based on tax policy changes effective in September and other structural changes to encourage new investments. The Republic of Kosovo and the Republic of Serbia have recently signed agreements that are a significant step toward resolution of their political conflict. That is expected to further improve Kosovo's image of stability and attract even higher FDI from the EU; up to now all interested foreign investors, especially those from the EU, had perceived the political risk as relatively high.

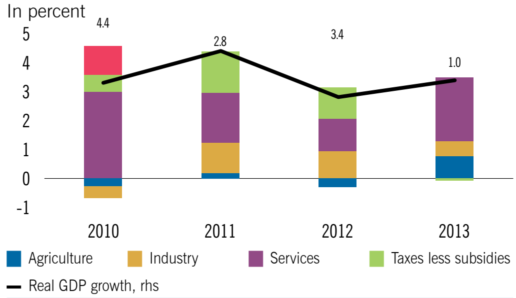
The new standby agreement (SBA) with the IMF is designed to support fiscal consolidation and macroeconomic stability while giving Kosovo fiscal space for growth, supported by other international financial institutions (IFIs), to boost capital spending. The IMF board approved a 22-month SBA for €184 million on July 29, 2015. Fiscal policies will be directed to keeping average deficits over the course of the program within the fiscal rule ceiling of 2 percent of GDP. This will keep public debt sustainable at well below 30 percent of GDP. It will also permit more productive capital investments beyond the 2 percent ceiling, allowing for IFI-supported public investments that amount to as much as 1.9 percent of GDP annually. The fiscal consolidation measures are expected to yield savings by containing the impact of last year's pre-electoral decisions: they will keep public wages at their current nominal value, contain spending on goods and services, and delay execution of new schemes. Also, revenue-boosting measures inaugurated in 2015 will raise the main VAT rate from 16 to 18 percent (while introducing a lower rate on specific goods) and increase excise taxes on commodities with environmental and/or health-related externalities, both effective September 1, 2015, and also raise fees for sale of telecom operating licenses.

Growth in Aggregate Demand, 2011–14



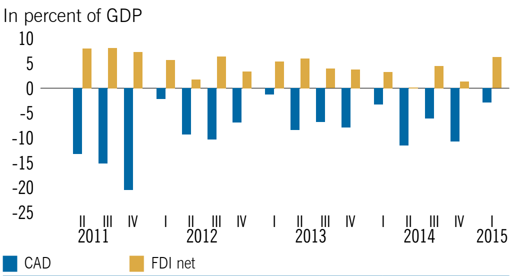
Source: Statistics Agency of Kosovo and World Bank.

Growth in the Economy by Sector, 2010–14



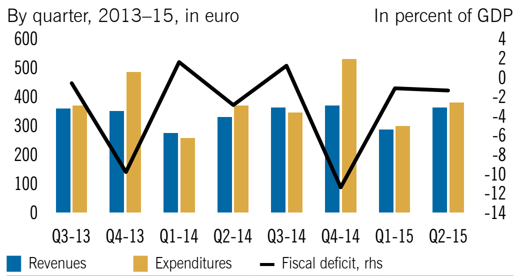
Source: Statistics Agency of Kosovo and World Bank.

Current Account Balance and FDI, 2011–15



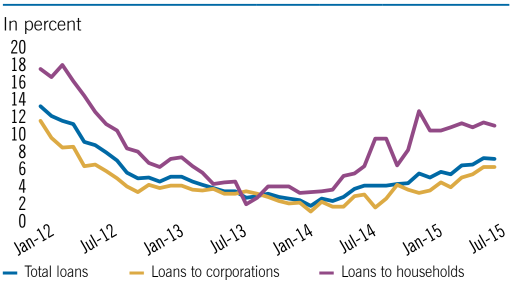
Source: Central Bank of the Republic of Kosovo and World Bank.

General Government Deficit



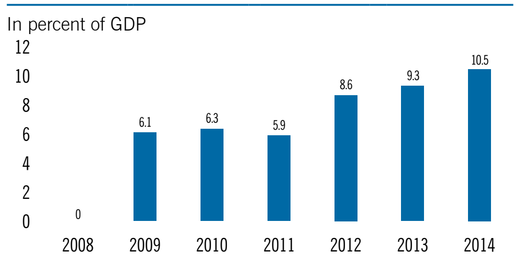
Source: Ministry of Finance and World Bank.

Annual Growth in Loans, 2012–15



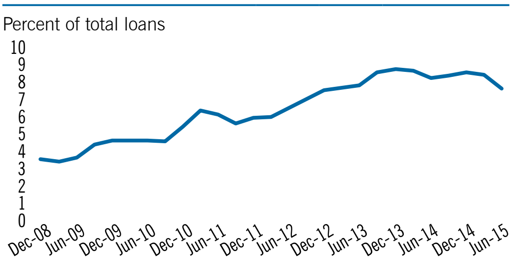
Source: Central Bank of the Republic of Kosovo.

General Government Debt, 2008–14



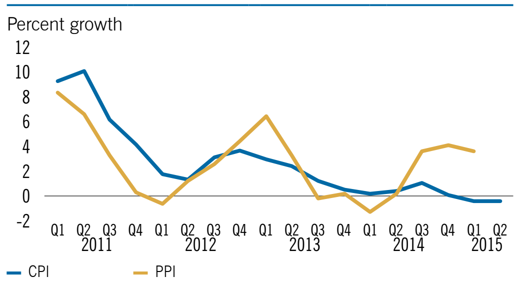
Source: Ministry of Finance.

Nonperforming Loans, 2008–15



Source: Central Bank of the Republic of Kosovo.

CPI and PPI. 2011–14



Source: Statistics Agency of Kosovo.

KOSOVO	2012	2013	2014	2015f
Real GDP growth (percent)	2.8	3.4	1.0	3.0
Composition (percentage points):				
Consumption	2.7	2.3	1.5	3.2
Investment	-4.4	-0.1	0.4	1.4
Net exports	4.5	1.2	-0.9	-1.6
Exports	0.1	0.4	3.0	2.2
Imports (-)	4.4	0.8	-3.9	-3.8
Consumer price inflation (percent, period average)	2.5	1.8	0.4	-0.5
Public revenues (percent of GDP)	25.9	25.2	24.4	25.8
Public expenditures (percent of GDP)	28.5	28.1	27.0	28.3
Of which:				
Wage bill (percent of GDP)	8.1	7.9	8.9	9.3
Social benefits (percent of GDP)	3.7	4.1	4.9	5.4
Capital expenditures (percent of GDP)	10.8	10.1	7.5	7.6
Fiscal balance (percent of GDP)	-2.6	-2.9	-2.6	-2.5
Primary fiscal balance (percent of GDP)	-2.4	-2.5	-2.4	-2.2
Public debt (percent of GDP)	8.2	9.0	10.6	12.5
Public and publicly guaranteed debt (percent of GDP)	8.2	9.0	10.6	12.5
Of which: External (percent of GDP)	6.7	6.1	6.0	6.4
Goods exports (percent of GDP)	5.6	5.5	5.9	6.5
Goods imports (percent of GDP)	46.3	43.1	43.5	43.5
Net services exports (percent of GDP)	6.4	5.9	6.1	6.9
Trade balance (percent of GDP)	-34.3	-31.8	-31.4	-30.2
Remittance inflows (percent of GDP)	12.0	11.7	12.7	13.5
Current account balance (percent of GDP)	-7.5	-6.9	-8.1	-8.2
Foreign direct investment inflows (percent of GDP)	4.2	4.7	2.8	5.8
External debt (percent of GDP)	7.3	6.6	6.5	7.1
Real private credit growth (percent, period average)	5.8	1.9	3.0	5.1
Non-performing loans (percent of gross loans, end of period)	7.5	8.7	8.5	6.7
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	3,990.1	3,548.9

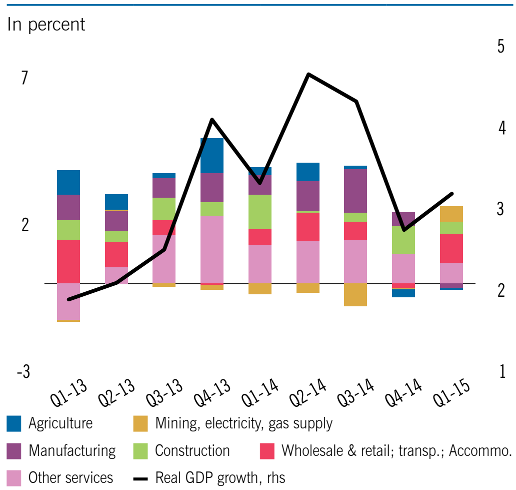
Sources: Country authorities, World Bank estimates and projections.
Notes: Credit growth for 2015 reflects year-to-date annual rolling averages. Non-performing loans show year-to-date actuals.

FYR Macedonia

FYR Macedonia's economic growth is expected reach 3.2 percent in 2015, supported by continued public investment and strong FDI-related exports. The continued expansion in economic activity reflects on the labor market outcomes with the unemployment rate down to 27.3 percent in the first quarter of 2015. However, relative to 2014, growth moderated in FYR Macedonia in the first half 2015, driven by slowdowns in manufacturing and services. Private consumption and investment also weakened following the recent political developments. The trade deficit narrowed down significantly in the first half of 2015 as exports outperformed imports, but net FDI inflows declined slightly in the same period. The public deficit for 2015 has been revised upwards after the government presented a supplementary budget with higher expenditures, particularly on transfers. While the political turmoil has moderated, it remains latent until elections take place in April 2016 and still represent a downside risk.

High frequency data suggests a moderate, but widespread slowdown of economic activity in the second quarter of 2015, possibly linked to the political turmoil faced by the country. Industrial production remained stagnant in the second quarter of 2015, growing by 0.2 percent (y-o-y), which lowers average growth for the first half of 2015 to 0.8 percent (y-o-y). The slowdown seemed widespread, reaching apparel, mining, manufactures of tobacco products, non-metallic mineral products and electrical equipment. In contrast, construction activities, measured by the value added of complete construction work, rebounded in the second quarter of 2015.

Contribution to GDP growth by sectors



Source: State Statistics Office and World Bank staff calculations.

On the demand side, consumption and investment leading indicators provide mixed signals. VAT revenues and imports and domestic production of consumption goods have declined. However, retail trade increased by 3.3 percent (y-o-y) in real terms and household credit growth remained robust averaging 12 percent (y-o-y) in Q2 2015. We project private consumption to be fueled by the announced increase in public wages, pensions and social benefits (which accounts to more than one fifth of the population) in H2 2015. Gross investment also appears to have moderated as government capital investments and FDIs slowed down. Nevertheless, investment loans to companies increased by 7.6 percent (y-o-y) in H1 2015 (compared to 4.4 percent increase for 2014). It is possible that a lack of resolution on the political crisis continue to affect investment decision during the second half of the year.

Deflation persisted in the first half of 2015. Lower prices shifted to an increase of 0.5 percent year-on-year in June, driven by increases in food and energy prices. Nevertheless, prices fell once again by 0.4 percent (y-o-y) in July 2015 as energy prices declined. For the period January–July 2015, prices were 0.3 percent lower than a year earlier on average.

Unemployment continues on a downward trend in the first half of 2015, helped by job creation in most sectors of the economy. Unemployment, averaged 28 percent in 2014 (one percentage point lower than in 2013). In the first quarter, unemployment averaged 27.3 percent, down from 28.4 percent a year earlier. Youth unemployment declined significantly to 48 percent in Q1 2015, after increasing in 2014 to 53 percent, but it is still among the highest in the region after Kosovo and Bosnia and Herzegovina. Long-term unemployment remains a problem, as 46 percent of the unemployed had been without a job from more than a year (as measured by the Employment Agency). High frequency data for Q2 2015 points to an increased number of new job contracts, consistent with the net employment creation trend observed in sectors such as construction, manufacturing, business and financial services, and public administration. This result suggests a continuous decline in unemployment.

Export growth moderated slightly in the second quarter of 2015, in part due to the developments in Greece, but continues to be higher than imports growth. Exports increased by 9.9 percent (y-o-y) in EUR terms in Q2 2015 (compared to 13.6 percent in Q1), but declined by 11.9 percent (y-o-y) in US$ terms as the Denar (which is pegged to the EUR) depreciated vis-à-vis the US$. A decline in exports to Greece (amounting 0.6 % of total exports) helps explain this deceleration. Export growth was driven by FDI-related exports and iron and steel products, while the more "traditional" industries like apparel and tobacco have declined. Overall exports increased by 11.7 percent (y-o-y) in H1 2015 in EUR terms. Imports picked-up in Q2 2015, growing by 9.1 percent (compared to 5.3 percent in Q1) in EUR terms and also declined in US$ terms. Import growth was largely driven by raw-materials used in the FDI sector.

The trade deficit narrowed in the first half of 2015 and net inflows of FDI declined. The trade deficit narrowed by 35 percent in H1 2015 (y-o-y), as exports performed better than imports. Private transfers were slightly lower than in H1 2014, but provided full coverage of the trade deficit, alleviating external financing pressures. Net FDI inflows decreased by 40 percent (y-o-y), largely due to capital outflows registered in May 2015 (the height of the political uncertainties in the country and the Greek crises). Net inflows of FDI for 2015 are estimated to reach 3.0 percent of GDP.

The Government adopted a supplementary budget in July 2015, which increased

expenditures and targets a higher deficit. Budget performance in the first half of 2015 was relatively good. On one hand, revenues increased by 14 percent (y-o-y), largely thanks to re-introduction of the corporate profit tax and to strong performance of contributions, excises and personal income tax. On the other hand, expenditures increased only 5 percent (y-o-y) in the same period. Instead of using the extra revenues to frontload the announced fiscal adjustment, the Government opted for a supplementary budget that foresees higher expenditures to accommodate increases in public wages, pensions and social transfers in H2 2015, estimated at around 0.2 percent of GDP. Subsidies and interest payments are also expected to increase by 0.2 percent of GDP, each. Finally, capital expenditures had also been augmented by 0.2 percent of GDP, but given historical performance, they are hardly likely to be realized. As a result, the Government increased the expected fiscal deficit for 2015 from 3.5 to 3.7 percent of GDP. The revised deficit is higher than the level announced in the 2015–2017 Medium-Term Fiscal Framework.

Public debt as a share of GDP declined in the first half of 2015, but is expected to increase again as the government has stepped-up its domestic borrowing. Public debt stood at 43.7 percent of GDP (as estimated by the Ministry of Finance) in the first half of the year, declining from 46.0 percent in end 2014. This decline was led by the pre-payment of the outstanding debt with the IMF (US$173 million). However, the supplementary budget is expected to shift the Government financing structure in the second half of the year from mostly external to mostly domestic borrowing (at higher interest rate and shorter maturity). The government issued EUR 121 million of new domestic debt in the first seven months of 2015 and plans to issue an additional EUR 263 million till the end of 2015 in order to accommodate additional expenditures, the re-payment of EUR 150 million Eurobond coming due in December 2015, and the pre-finance part of the deficit level for 2016.

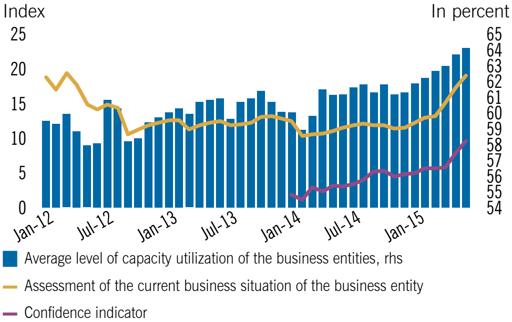
Credit growth remained robust in the first half of 2015, but declined slightly in May and June, possibly affected by domestic and external developments. Stronger economic activity and laxer credit requirements (especially for SMEs) contributed to credit growth in the first four months of 2015 (10.2 percent y-o-y), particularly for corporate lending. Nevertheless, credit growth slowed down to 9.2 percent y-o-y in May and June as the political turmoil and the crisis in Greece intensified. According to the latest Central Bank survey, banks expect further relaxing of credit requirements for both corporate and household lending, supporting strong credit growth in the coming period. Nonperforming loans (NPLs) remain elevated, averaging 11.3 percent in H1 2015, with corporate NPLs standing at 15.7 percent in June 2015. Deposit growth remains solid, but declined slightly in May and June. The loan-to-deposit ratio remains below the benchmark of 100 percent (at 91.5 in June 2015) and liquidity in the financial sector is high, indicating a potential for further credit growth.

Political tensions decreased, but remain latent, as the political parties negotiate the intern period till elections in April 2016. Mediated by the EU and the US, the political parties were able to reach an agreement on the intern period till the elections in April 2016. Under this agreement the current Prime

Minister (PM) should resign office in January 2016 and an intern PM should take his place and form a government with a specific mandate to organize the early elections. In addition, the political parties are negotiating a whole set of reforms including (i) appointment of a special public prosecutor with a mandate to investigate possible crimes related with the disclosed telephone conversations of government officials; (ii) appointment of new ministers and deputies proposed by the opposition to key ministries; (iii) changes in the country electoral system, including the state electoral committee and the electoral registry. According to this agreement the opposition agreed to return to the parliament in September 2015.

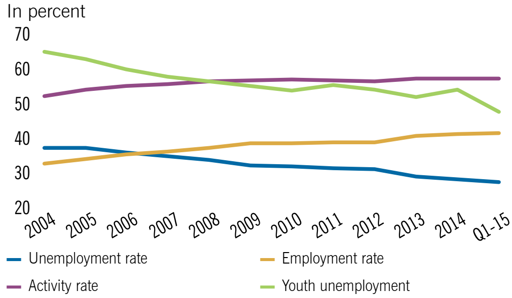
Growth is expected to moderate to 3.2 percent in 2015, affected by the repercussions of the recent political turmoil. Public investment and FDI-related exports will remain the main drivers of growth in 2015. A number of public investment projects, which include the construction of two new highways are in full swing and should continue in the coming period. FDI related exports performed well in the past months and are expected to remain robust in 2015 and 2016. The announced pipeline of FDI inflows remains sizable, even though somewhat lower than before the crises. Nevertheless, the current political uncertainties pose a downside risk to the economy, especially to investment and consumption. Escalation of the current refugee crises may also pose a downside risk, especially to the government accounts.

Business tendencies in the manufacturing industry



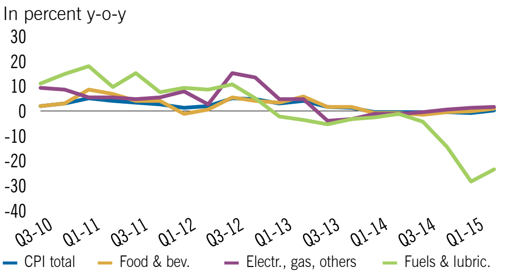
Source: State Statistics Office and WB staff estimates.

Labor market developments



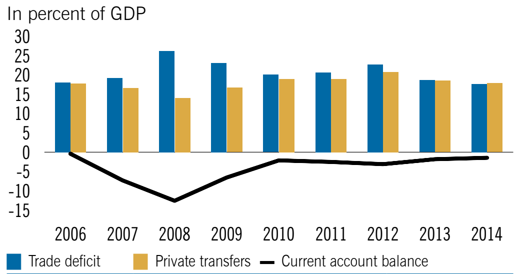
Source: State Statistics Office (Labor Force Survey) and World.

CPI and its main components



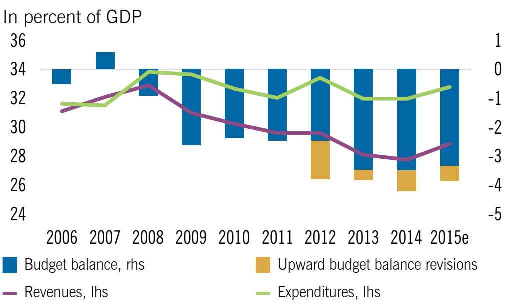
Source: State Statistics Office.

Current account balance, trade deficit and private transfers



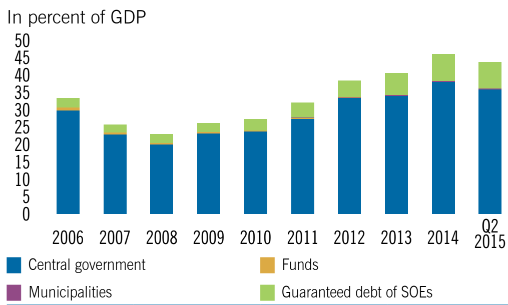
Source: National Bank and WB staff calculations.

Central Government budget execution



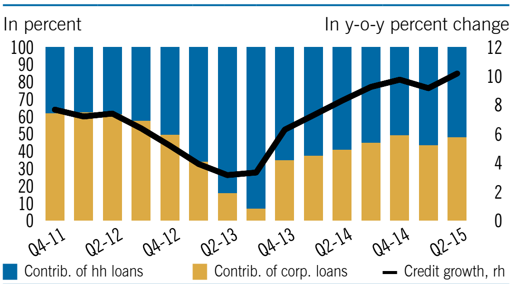
Source: Ministry of Finance and WB staff estimates.

Public debt by government levels



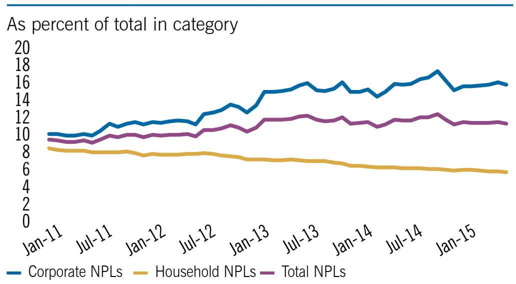
Source: National Bank and WB staff calculations.

Credit growth and contribution to credit growth



Source: National Bank and WB staff calculations.

Non-performing loans



Source: National Bank and WB staff calculations.

MACEDONIA, FYR	2012	2013	2014	2015f
Real GDP growth (percent)	-0.5	2.7	3.8	3.2
Composition (percentage points):				
Consumption	0.1	-0.5	0.3	0.1
Investment	1.9	0.4	3.2	3.5
Net exports	-2.4	2.9	0.2	-0.4
Exports	-2.0	-0.4	5.9	2.9
Imports (-)	-0.5	3.3	-5.7	3.3
Consumer price inflation (percent, period average)	3.3	2.8	-0.3	0.5
Public revenues (percent of GDP)	32.1	30.2	29.8	31.0
Public expenditures (percent of GDP)	36.0	34.2	34.0	35.0
Of which:				
Wage bill (percent of GDP)	7.7	7.2	7.0	7.1
Social benefits (percent of GDP)	14.9	14.9	14.9	15.1
Capital expenditures (percent of GDP)	5.2	4.4	4.3	4.4
Fiscal balance (percent of GDP)	-3.9	-4.0	-4.2	-3.9
Primary fiscal balance (percent of GDP)	-3.0	-3.1	-3.2	-2.7
Public debt (percent of GDP)	33.7	34.2	38.2	40.2
Public and publicly guaranteed debt (percent of GDP)	38.3	40.5	46.0	48.4
Of which: External (percent of GDP)	25.6	25.6	31.9	29.2
Goods exports (percent of GDP)	30.4	29.2	32.5	32.8
Goods imports (percent of GDP)	56.9	52.2	54.3	53.6
Net services exports (percent of GDP)	4.0	4.4	4.2	3.8
Trade balance (percent of GDP)	-22.5	-18.5	-17.6	-17.0
Remittance inflows (percent of GDP)	20.6	18.4	17.8	17.8
Current account balance (percent of GDP)	-2.9	-1.8	-1.4	-2.8
Foreign direct investment inflows (percent of GDP)	1.5	3.3	3.3	3.0
External debt (percent of GDP)	66.1	64.0	69.8	70.4
Real private credit growth (percent, period average)	3.7	1.3	8.5	9.6
Non-performing loans (percent of gross loans, end of period)	10.3	11.3	11.1	11.2
Unemployment rate (percent, period average)	31.0	29.0	28.0	27.4
Youth unemployment rate (percent, period average)	54.0	51.9	53.1	49.1
Labor force participation rate (percent, period average)	56.5	57.2	57.3	57.3
GDP per capita, PPP (current international $)	11,669.4	12,263.5	12,937.9	13,330.0
National poverty rate (60% median equalized income, percent of population)	26.2	24.2	..	..

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).

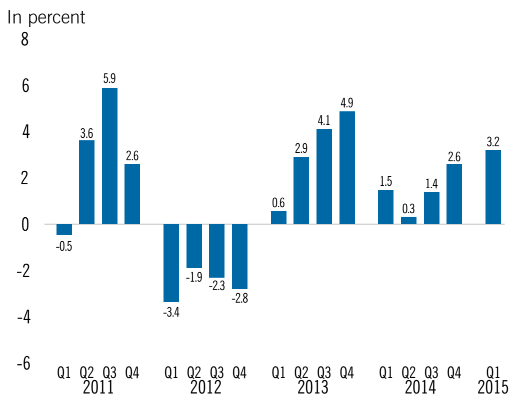
Montenegro

Growth strengthened in the first half of 2015 boosted by rising domestic demand, as both consumption and investments surged. As positive developments continued in the beginning of the third quarter, for 2015 as a whole growth is expected to reach 3.4 percent as the Bar-Boljare highway section construction gets started in September and personal consumption strengthens amid a solid tourism season. Activity and employment rates improved to historical highs for Montenegro, but unemployment at 18 percent remains a challenge, especially among the most vulnerable groups. External imbalances deepened in 2015, as highway-related imports surged while exports of food, especially meat and electricity fell. While the fiscal deficit declined to 1.4 percent of GDP in 2014, highway construction costs (about 23 percent of GDP over four years) will likely increase the deficit to close to 6 percent of GDP in 2015 despite continued consolidation measures. A concomitant rise in public debt is expected to raise financing costs and risks over the medium term.

Economic activity accelerated in early 2015. Real GDP rose by 3.2 percent from a year earlier in the first quarter of 2015 supported by domestic demand after increasing 2.6 percent in the last quarter of 2014. Personal and government consumption and investment grew by 4.5 percent, 3.6 percent and 6.8 percent y-o-y, respectively. At the same time, the contribution of net exports remained negative despite exports growing by 6.3 percent annually, driven mostly by tourism.

Favorable developments continued in the second and the beginning of third quarter of 2015. Industrial production surged by 12.8 percent y-o-y in the second quarter and 33.6 percent in July driven by strong manufacturing production of pharmaceuticals, other non-metallic minerals, aluminum and machinery and equipment. At the same time, food production declined significantly. Construction also accelerated in the second quarter leading to a rise of 9.7 percent in the first half of the year. Although slightly decreased in March–May period, real retail trade recovered in June and further increased in July by 3.8 percent y-o-y amid a solid tourism season. Growth of tourist arrivals and overnight

Real GDP, annual growth rates



Source: MONSTAT.

stays by July reached annual growth of 21.3 percent and 28.6 percent, respectively.

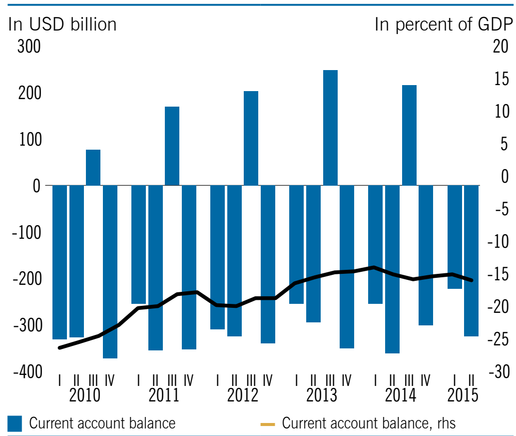
After deflation throughout 2014, inflation was positive in 2015 supported by domestic demand pick-up. Consumer prices increased 1.9 percent year-on-year in June and July, after 2.3 percent in May, the highest rate since July 2013. In January–July, prices were up 1.5 percent y-o-y, boosted by food and clothes prices, while oil prices fell.

The labor market improved on the back of service sector employment. The survey data reports that unemployment dropped in the first half of 2015 by 3.2 percent y-o-y, while the number of employed increased by 2.5 percent resulting in a slight increase in labor force. In particular, new employment was generated in service activities and agriculture. The unemployment rate decreased to a still high (a four-quarter average) 17.6 percent by June 2015, while both activity rate and employment rate increased to 53.1 percent and 43.8 percent, respectively (both historical highs for Montenegro). Improvement continued at the beginning of the third quarter, as administrative employment data suggest a further increase (1 percent y-o-y by July) with the administrative unemployment rate declining to 14.7 percent in June and further to 14.6 percent in July.

External imbalances deepened in 2014 and first half of 2015 on the back of highway construction-related imports. A five-year positive trend in declining external imbalances ended in 2014 with the current account deficit (CAD) reaching 15.4 percent of GDP and further increasing to 15.9 percent of GDP in the first half of 2015. Services surplus increased by 1 percent of GDP annually as tourism continues to remain strong, as well as surplus on the income account which grew by 2.8 percent due to rise in compensation of employees and interest payments decline. On the other hand, the merchandise deficit further deteriorated as exports disappointed (mostly of electricity and food, especially meat to Belarus, affected by Russian trade sanctions) and initial highway-related imports' started to mount. Cumulatively, in the first seven months of 2015, the merchandise deficit reached 42.1 percent of GDP.

Montenegro continued attracting robust foreign investments in real estate. Russian citizens hold the largest share of real estate among foreigners. Net FDI reached 10.7 percent of GDP in the twelve months to June 2015. However, debt-creating inflows remained high leading to a further rise in external debt to GDP ratio estimated at 121 percent.

Current account balance



Source: CBCG, MONSTAT, WB staff calculations.

After months of declining, lending growth turned positive in May. After an increase of 1.1 percent in May total loans continued to grow by 0.2 percent annually in June and July boosted by recovery of corporate sector loans (0.3 percent) and continued increase of loans to households (2.4 percent). In contrast, the government reduced its borrowing from the banking sector. At the same time, domestic deposits accelerated annual growth to 13.2 percent in July reducing the loan-to-deposit ratio to 97.2 percent, the lowest level since August 2007. The share of non-performing loans (NPLs) in total loans reached 16.4 percent in July, compared to 15.9 percent at the end of 2014. In parallel, the newly enacted Law on Consensual Financial Restructuring of Debts to Financial Institutions (so-called Podgorica approach) will hopefully lead to voluntary resolution of bad assets to unlock further access to capital to corporates. In addition, in August 2015, the parliament adopted the law for conversion of Swiss franc loans into euro which concerns one bank and 600 clients with indexed loans totaling some EUR30 million (0.8 percent of GDP). The whole amount of the exchange rate differences have to be equally shared among the borrowers, the bank and the state.

Fiscal consolidation efforts moderated vulnerabilities in 2014. The fiscal deficit was reduced to 1.4 percent of GDP in 2014, led by an equal revenue and expenditure consolidation effort. Public debt growth slowed down, although debt reached 60.5 percent of GDP at the end of 2014.

However, highway construction costs will widen the fiscal deficits in 2015–2018. The 2015 deficit was planned at 5.9 percent of GDP, in spite of the additional revenue measures (retaining the crisis PIT tax and increase in the rate of health insurance contribution by 0.5 percentage points) as well as pension indexation freeze in 2015 and abolishment of the privileged retirement schemes. However, according to the Macroeconomic and Fiscal Policy Guidelines for 2015–2018 adopted in April, public spending in the next three years will be relatively high due to the highway construction, reaching 49 percent in 2015 before easing to 43 percent of GDP in 2018, with capital outlays amounting to about 9 percent of GDP every year. Excluding highway costs, spending is expected to remain flat in nominal terms.

The general government cash deficit already widened this year. The deficit grew to 3.2 percent of GDP in the first seven months of 2015 due to expenditure growth of 7.7 percent y-o-y. The latter reflected a rise in capital expenditures, transfers to local governments to help clear subnational arrears and larger interest payments. The repayment of arrears (of pension debt, court case resolutions, and utilities) amounted to 1.4 percent of GDP. In the same period, revenues went up by only 2.9 percent annually on the back of improved contribution collection and excises.

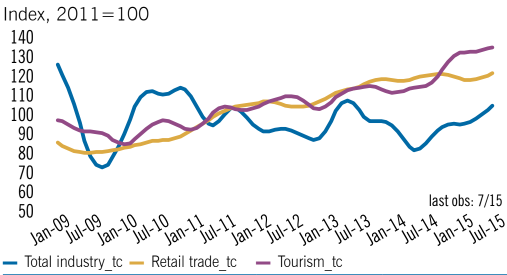
As the deficit widened, so did public debt. Public debt increased by 22.2 percent in nominal terms in the first half of 2015 compared to end-2014 on the back of external borrowing, EUR500 million in Eurobonds to cover the July bond redemption, and EUR170 million of the first Chinese EXIM Bank disbursement. In relative terms, it reached 70.8 percent of GDP (or 82.2 percent of GDP including guarantees). Public debt is expected to reach 77 percent of GDP by 2018. Financing needs will double in 2015 and 2016 to close to 16 percent of GDP, with large Eurobond repayments coming due.

S&P affirmed the external (domestic) sovereign credit rating on Montenegro at B+(B) with stable outlook. It reflects a balance of risks from worsening external, fiscal, and general government debt metrics against the country's growth potential over the coming 12 months. The rating could be lowered if: (i) the country's fiscal metrics deteriorate further than currently envisaged (cost overruns related to the highway construction, further costs incurred in relation with legal proceedings and restructuring of KAP, or expenditure overruns from lower levels of government); (ii) the country finds it harder to roll over its external debt; (iii) large-scale FDI projects stall or do not materialize as this would depress Montenegro's growth prospects. On the other side, the ratings would be raised if Montenegro's economic growth will pick up faster than anticipated in conjunction with a decline in the government and external debt.

In July 2015, the Government adopted the Montenegro Development Directions for 2015–2018. This development strategy proposes ways for a long-term increase of living standards through alignment with the Europe 2020 strategy. Recognizing the available potential, tourism, energy, agriculture, rural development, and processing industry are emphasized as priority sectors of Montenegro's development. Total estimated value of planned public and private sector investments during the three-year period amounts to EUR2.9 billion or close to 81 percent of current GDP.

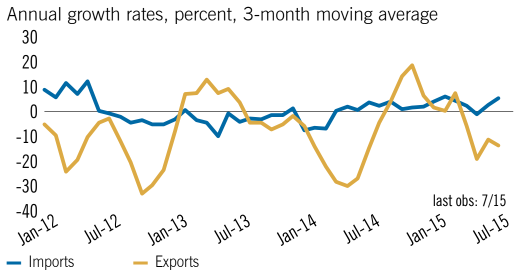
Growth is expected to pick up to 3.4 percent in 2015 driven by investment in public infrastructure and stronger tourism. The outlook has notable downside risks, external and domestic. The crisis in a country in Southeast Europe and geopolitical tensions have minimal direct impact on Montenegro, but carry financial and growth risks via second-round effects. Financial volatility caused by weaker growth and financial turmoil in China and anticipation of further monetary normalization in the US could put pressure on balance sheets due to the highway loan denominated in US$ (EUR809 million). Any rise in the cost of financing, in particular for vulnerable emerging markets, would also lead to higher cost of debt service. There are also additional risks on the fiscal side that include the rollover of the 5-year Eurobond issue equivalent to 10 percent of GDP maturing in 2016. The main domestic risks refer to slow recovery of credit supply, and delays in planned structural reforms, which are expected to raise potential growth once the highway construction ends.

High frequency data, trend-cycle adjusted series



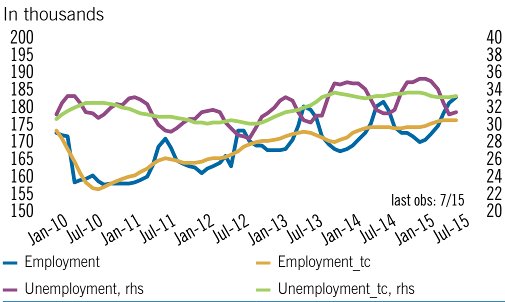
Source: MONSTAT, WB staff calculations.

External trade



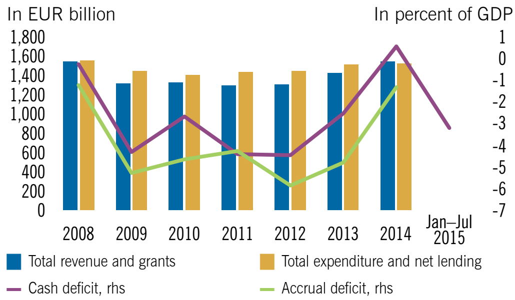
Source: MONSTAT, WB staff calculations.

Labor market, administrative data



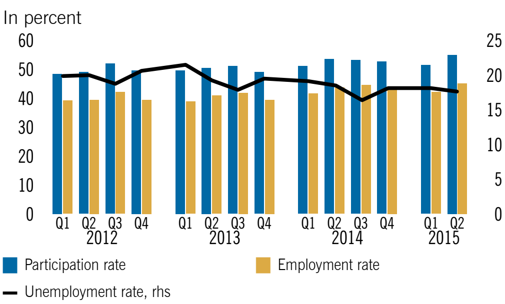
Source: MONSTAT, WB staff calculations.

General government deficit



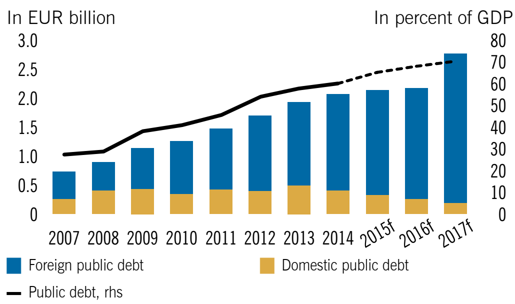
Source: MoF, MONSTAT, WB staff calculations.

Labor market, survey-based data



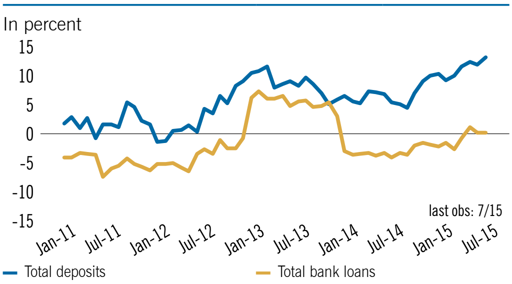
Source: MONSTAT.

General government debt



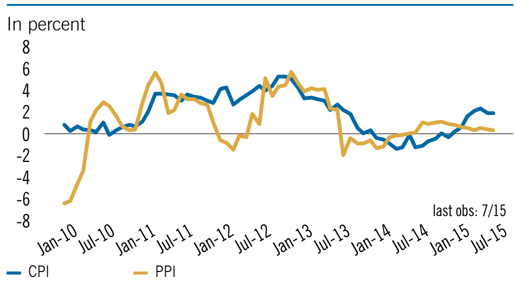
Source: MoF, MONSTAT, WB staff calculations.

Loans and deposits, annual growth



Source: CBCG, WB staff calculations.

CPI and PPI, annual growth rates



Source: MONSTAT.

MONTENEGRO	2012	2013	2014	2015f
Real GDP growth (percent)	-2.5	3.3	1.5	3.4
Composition (percentage points):				
Consumption	-2.0	1.2	1.4	0.3
Investment	0.6	0.6	1.3	5.9
Net exports	-1.1	1.6	-1.1	-2.8
Exports	-0.5	-0.6	-0.2	0.3
Imports (-)	-0.6	2.1	-0.9	-3.1
Consumer price inflation (percent, period average)	4.1	2.2	-0.7	1.0
Public revenues (percent of GDP)	41.4	42.8	44.9	42.9
Public expenditures (percent of GDP)	47.2	47.6	46.2	48.8
Of which:				
Wage bill (percent of GDP)	13.4	12.7	12.8	12.2
Social benefits (percent of GDP)	15.3	14.5	14.4	14.1
Capital expenditures (percent of GDP)	4.4	4.1	5.5	9.5
Fiscal balance (percent of GDP)	-5.9	-4.8	-1.4	-5.9
Primary fiscal balance (percent of GDP)	-4.0	-2.7	0.9	-3.6
Public debt (percent of GDP)	54.0	58.1	60.5	65.7
Public and publicly guaranteed debt (percent of GDP)	66.1	67.5	69.5	77.1
Of which: External (percent of GDP)	53.2	52.5	57.3	67.4
Goods exports (percent of GDP)	12.4	11.9	10.4	10.1
Goods imports (percent of GDP)	56.6	51.8	50.6	50.3
Net services exports (percent of GDP)	19.4	19.6	20.2	19.4
Trade balance (percent of GDP)	-24.7	-20.3	-20.0	-20.9
Remittance inflows (percent of GDP)	2.3	2.4	2.3	2.3
Current account balance (percent of GDP)	-18.7	-14.6	-15.4	-16.0
Foreign direct investment inflows (percent of GDP)	14.7	9.7	10.3	10.7
External debt (percent of GDP)	115.1	115.4	120.7	129.4
Real private credit growth (percent, period average)	-9.3	2.6	-2.5	-0.4
Non-performing loans (percent of gross loans, end of period)	16.5	17.5	15.9	16.2
Unemployment rate (percent, period average)	19.7	19.5	18.0	17.6
Youth unemployment rate (percent, period average)	43.7	41.6	35.8	36.3
Labor force participation rate (percent, period average)	49.8	50.1	52.7	53.1
GDP per capita, PPP (current international $)	13,588.9	14,135.6	14,323.3	14,624.0
Poverty rate at US$5/day, PPP (percent of population)	19.2	19.1	18.7	17.3

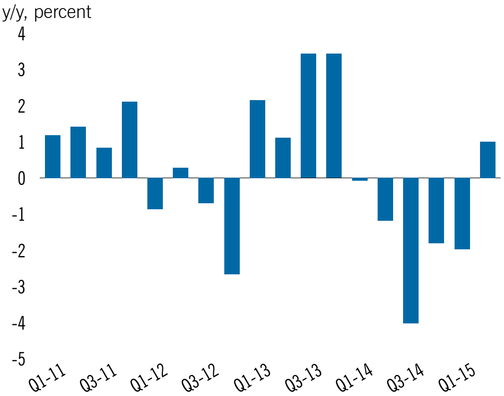
Sources: Country authorities, World Bank estimates and projections.
Notes: Labor market and financial sector data for 2015 reflect year-to-date annual rolling averages unless otherwise stated.

Serbia

Serbia's economy moved out of recession in the second quarter of 2015, growing by 1 percent year-on-year (y/y) following five consecutive quarters of decline in economic activity. Growth for 2015 as a whole is projected at 0.5 percent, compared to a contraction of 1.8 percent in 2014, because of the strong recovery of industrial production from the impact of the 2014 floods and improved external demand as EU growth has picked up. Fiscal performance in 2015 to date has out-performed expectations. Significantly higher revenues, although partly driven by one-off non-tax revenues, supported by a strict control of expenditures, led to a significantly lower fiscal deficit over the first seven months of 2015. However, public debt-to-GDP remains high, moving up to 73 percent at end-July. With the improved external environment supporting exports of goods and services, as well as remittances, the current account deficit in euro terms fell by 30 percent in the first half of the year compared to the same period 2014. Progress has also been seen on structural reforms as well, for example, with the financial consolidation plan of the electricity company approved and electricity prices increases, new laws on construction; inspections, and public sector employment enacted and implemented although in some areas, such as the resolution of socially owned enterprises from the Privatization Agency portfolio, progress was somewhat slower than earlier expected. Sustained implementation of the fiscal consolidation program, as supported by the IMF, including the set of structural reforms remains crucial in order to maintain macroeconomic stability and to create an environment conducive for faster growth.

According to the latest estimates Serbia's real GDP grew by 1 percent y/y in Q2 2015. The main driver was industry, whose real value added was up 8.6 percent y/y in Q2 2015 (in part reflecting base effects as the impact of the floods in May 2014 unwinds). In contrast, and dragging down overall growth, agriculture value added was hit by the recent drought, contracting by 9.4 percent y/y in real terms. On the expenditure side, consumption has been under pressure from cuts in public sector wages and pensions. In Q2 consumption indeed declined by 1.7 percent y/y, but this was significantly less than previously projected as private sector wages started to increase, thus partially compensating for the decrease in public sector wages over the same period. Pensions, around 30 percent of the average household's income, declined by 4 percent y/y (nominal) over the first five months. Investment and exports increased significantly in Q2 (up 8.6 and 8.7 percent y/y respectively, again reflecting base effects from the 2014 floods as well as improved external demand) supporting the recovery, while government investment fell by 7.5 percent.

Real GDP Growth



Source: Statistics Office.

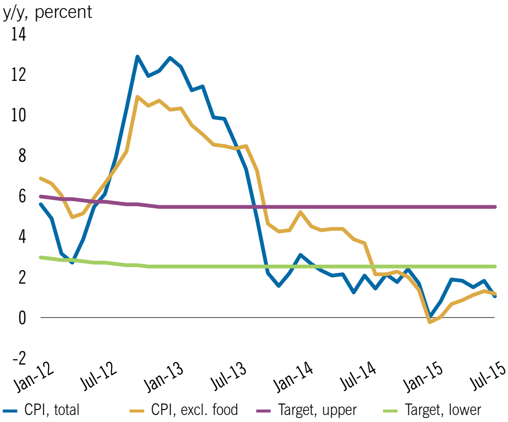
The general government deficit over the first seven months of 2015 was 1 percent of full-year GDP (versus 2.9 percent of GDP in the same period of 2014). The deficit reduction came primarily as a result of increased revenues (up 5.6 percent y/y in nominal terms). VAT and excises pushed total tax revenues up by 1 percent. However, the strong overall revenue performance was supported by a major increase in non-tax revenues primarily due to one-off measures (i.e., payment of net income from state owned enterprises and proceeds from the sale of 4G licenses) as well as by the introduction of surcharges on public sector wages. Total nominal government expenditures declined by 1.8 percent as a result of major savings on wages and pensions (down by 11.1 and 3.3 percent, respectively). Despite lower net fiscal financing needs, central government debt (including guarantees) moved up to 73 percent at end-July 2015 from 71.0 percent at end-2014, in part due to US dollar strength earlier in 2015 (33 percent of the total stock of debt is dollar-denominated).

The annual 2015 fiscal deficit is now expected to be significantly lower than the previously projected level of 5.9 percent of GDP. Once the impact of budget performance from the first seven months is taken into consideration, the annual deficit may be around 4 percent of GDP. One of the main risks to budget savings is slippages on reforms to financial support to SOEs, including the policy of no new liquidity guarantees for SOEs. As the resolution of the remaining SOEs in the Privatization Agency portfolio has been partially delayed (17 enterprises employing 21,500 people received the one-year extension for completion of privatization), fiscal risks stemming from the need to extend financial support to these enterprises have increased.

The IMF reached a staff level agreement with authorities during the second review of Serbia's precautionary Stand-By Arrangement (SBA). The review recognized the government's success in controlling its budget and structural reform progress (albeit uneven). The next review will be in late October, ahead of adoption of the 2016 budget.

Upward inflationary pressures have been limited by relatively weak domestic demand and the absence of adjustments of administratively controlled prices. Consumer price inflation remained in the range of 2 percent over H1 2015, below the target band of the National Bank of Serbia (NBS) of 4 +/-1.5 percent, and slowed to 1 percent (y/y) in July, primarily as a result of lower food price inflation. Food price inflation in H1 was 3 percent while in July it was just 0.6 percent. Core inflation peaked in March at 2.9 percent, falling thereafter, down to 2.2 percent in May (the latest available data). In coming months, inflation is expected to rise more significantly following August's electricity price increase, bringing inflation back up into the target band by year-end.

Inflation



Source: National Bank of Serbia.

The recovery in activity was reflected in the labor market with the unemployment rate declining to 17.9 from 19.2 percent in Q1. Relative to the previous quarter, the number of employed rose by 2.9 percent, mainly due to the creation of formal full-time jobs (informal employment actually went down by 1.7 percent). As a result, the employment rate reached 42.3 percent, the highest level since Q2 2009. As mentioned, while private sector wage growth was positive (3.4 percent y/y in nominal terms over the first five months 2015), public sector wages declined (down 6.4 percent y/y over the same period). As a result, overall real wages fell again over the first six months of 2015, down 1.6 percent y/y following a reduction of wages by 0.7 percent in real terms over 2014 as a whole.

External adjustment continues. The current account deficit (CAD) of EUR 728 million in the first half of 2015 was 30 percent lower than in the same period of 2014. Over this period, export of both goods and services rose notably (5.8 and 15 percent respectively). Net transfers also improved, as remittance inflows rose by 12.9 percent y/y, in euro terms. In the financial account there was a further decrease of net FDI in H1 by 4.3 percent y/y (in euro terms) in the absence of any major new projects. Nevertheless, FDI net-inflow almost entirely covered the CAD in H1.

The Dinar remained broadly stable in nominal terms through August 2015. Unlike in 2014, when the NBS intervened heavily in order to prevent a significant depreciation of the currency, this year NBS has been a net-purchaser of euros in order to prevent appreciation of the dinar as the current account balance has improved. After falling significantly in Q4 2014, official reserves increased by EUR 723 million over the first seven months, in part likely reflecting valuation effects as the dollar appreciated against the Euro, and stood at EUR 10.6 billion at the end of July.

After a short-lived recovery, largely driven by lending to SOEs, credit activity slowed. Loans were up 4.7 percent y/y over the first seven months 2015 (not adjusted for currency movements). While loan growth to enterprises turned positive, this was entirely driven by lending to SOEs as loans to private enterprises declined by 4.2 percent y/y over the first seven months. The NBS is more actively working on the resolution of the longstanding problem of non-performing loans, which accounted for 22.8 percent of total loans in June 2015, under the new Action Plan for NPLs resolution (approved in August). Developments in Greece to date have not had a major impact on the

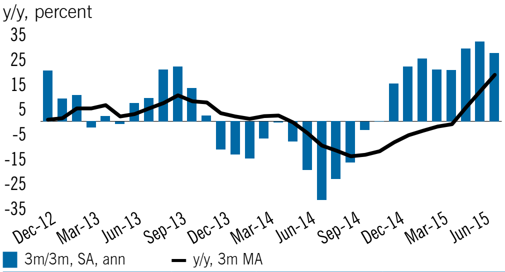
Serbian banking sector with the authorities taking proactive policy measures and total deposits remained broadly flat over recent months. The NBS continues to take steps to provide supportive monetary policy, given tightening fiscal conditions, improved capital inflows but still weak growth, and lowered the key policy rate to 5.5 percent on August 13th.

Outlook

Serbia's economy is expected to return to growth of 0.5 percent in 2015, supported by improved external demand and the recovery from the 2014 floods. The baseline scenario assumes ongoing progress on core structural and fiscal reforms. Most importantly, Serbia is expected to come close to completing the resolution of a significant portfolio of enterprises managed by the Privatization Agency and to continue with public administration rightsizing. Although these reforms may have immediate adverse impacts for the employment and living standards of those directly affected, household consumption is expected to recover gradually over 2015 as a whole, as well as government investment. In addition, external factors should help to support Serbia's near-term macro outlook. Nevertheless, over the medium term, the macro-fiscal outlook for Serbia remains fragile and highly dependent upon the implementation of the government's fiscal consolidation and structural reform program. However, if successfully implemented reforms should help Serbian economy to grow at about 1.5 and 2.5 percent in 2016 and 2017, respectively.

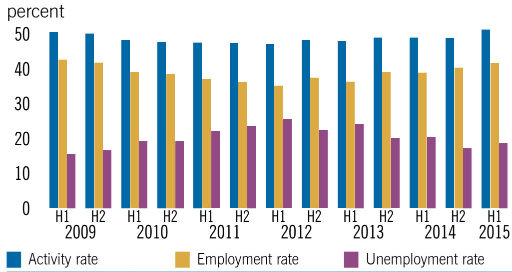
The outlook for external demand, as well as internal reform progress, poses both upside and downside risks to the outlook. The extent of the support to growth from the recovery in the Euro zone and global economy is a one risk to the outlook. Turbulence in international financing conditions could also spill over to the domestic economy via access to external financing (although this risk is mitigated by the government's reduced financing needs in 2015).

Industrial output growth



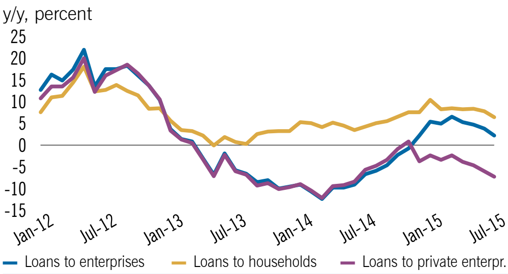
Source: Statistics Office.

Unemployment rate



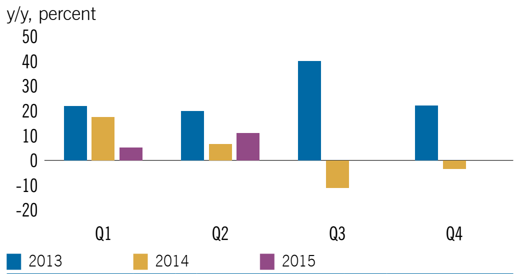
Source: LFS, Statistics Office.

Nominal loan growth



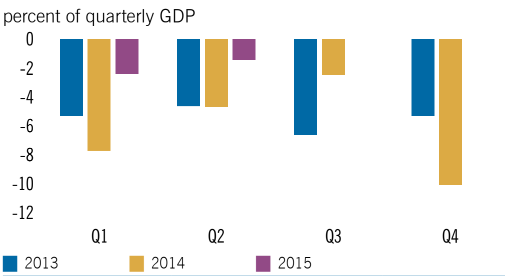
Source: National Bank of Serbia.

Export value growth



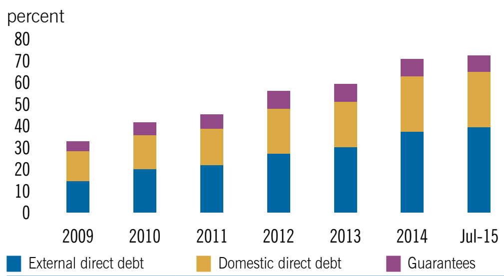
Source: Statistics Office.

Quarterly fiscal deficits



Source: Ministry of Finance.

Government debt-to-GDP



Source: Ministry of Finance - Public Debt Administration.

SERBIA	2012	2013	2014	2015f
Real GDP growth (percent)	-1.0	2.6	-1.8	0.5
Composition (percentage points):				
Consumption	-1.2	-0.6	-1.0	-1.1
Investment	0.6	-1.5	-0.7	1.1
Net exports	-0.4	4.8	-0.2	0.6
Exports	0.3	7.4	1.6	3.9
Imports (-)	-0.7	-2.6	-1.8	-3.3
Consumer price inflation (percent, period average)	7.3	7.7	2.1	1.6
Public revenues (percent of GDP)	39.4	37.9	40.0	40.1
Public expenditures (percent of GDP)	46.6	43.5	46.7	44.1
Of which:				
Wage bill (percent of GDP)	10.5	10.1	10.0	9.1
Social benefits (percent of GDP)	18.7	17.2	17.8	17.7
Capital expenditures (percent of GDP)	3.3	2.1	2.5	3.1
Fiscal balance (percent of GDP)	-7.2	-5.6	-6.7	-4.0
Primary fiscal balance (percent of GDP)	-5.3	-3.2	-3.7	-0.6
Public debt excluding guarantees (percent of GDP)	50.1	53.1	63.3	70.0
Public and publicly guaranteed debt (percent of GDP)	58.3	61.4	71.0	76.7
Of which: External (percent of GDP)	33.2	35.7	43.1	49.0
Goods exports (percent of GDP)	26.5	30.7	32.2	35.1
Goods imports (percent of GDP)	44.3	42.8	44.6	46.2
Net services exports (percent of GDP)	0.4	0.9	1.4	2.1
Trade in goods and services balance (percent of GDP)	-17.5	-11.2	-11.0	-9.0
Remittance inflows (percent of GDP)	6.1	6.3	5.6	6.6
Current account balance (percent of GDP)	-11.6	-6.1	-6.0	-4.0
Foreign direct investment inflows (percent of GDP)	2.4	3.8	3.7	4.0
External debt (percent of GDP)	81.2	75.1	78.4	80.9
Real private credit growth (percent, period average)	6.3	-9.2	-4.0	-1.4
Non-performing loans (percent of gross loans, end of period)	18.6	21.4	23.0	22.8
Unemployment rate (percent, period average)	24.0	22.1	18.9	17.9
Youth unemployment rate (percent, period average)	51.0	49.4	47.0	43.6
Labor force participation rate (percent, period average)	56.5	57.2	57.3	57.3
GDP per capita, PPP (current international $)	12,790.8	13,380.2	13,329.2	13,380.4

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.

SEE6:
Key Economic Indicators

SEE6: Key Economic Indicators

	2012	2013	2014	2015f	2016f	2017f
			Real GDP growth (percent)			
Albania	1.6	1.1	2.1	2.7	3.4	3.5
Bosnia and Herzegovina	-1.2	2.5	0.8	1.9	2.3	3.1
Kosovo	2.8	3.4	1.0	3.0	3.5	3.7
Macedonia, FYR	-0.5	2.7	3.8	3.2	3.4	3.7
Montenegro	-2.5	3.3	1.5	3.4	2.9	3.0
Serbia	-1.0	2.6	-1.8	0.5	1.5	2.0
SEE6	*-0.4*	*2.5*	*0.3*	*1.8*	*2.4*	*2.8*
			Consumer price inflation (percent, period average)			
Albania	2.0	1.9	1.6	2.1		
Bosnia and Herzegovina	2.0	-0.1	-0.9	0.5		
Kosovo	2.5	1.8	0.4	-0.5		
Macedonia, FYR	3.3	2.8	-0.3	0.5		
Montenegro	4.1	2.2	-0.7	1.0		
Serbia	7.3	7.7	2.1	1.6		
SEE6	*4.6*	*4.2*	*0.9*	*1.2*		
			Public expenditures (percent of GDP)			
Albania	28.2	28.9	32.0	32.1	31.4	30.1
Bosnia and Herzegovina	46.6	45.6	46.4	45.8	45.2	44.9
Kosovo	28.5	28.1	27.0	28.3	28.4	27.5
Macedonia, FYR	33.4	31.9	32.0	32.7	32.3	31.8
Montenegro	47.2	47.6	46.2	48.8	47.3	45.8
Serbia	46.6	43.5	46.7	44.1	42.1	40.3
SEE6	*38.4*	*37.6*	*38.4*	*38.6*	*37.8*	*36.7*
			Public revenues (percent of GDP)			
Albania	24.7	23.7	26.2	27.0	27.0	27.1
Bosnia and Herzegovina	44.5	43.4	44.4	43.9	43.4	43.2
Kosovo	25.9	25.2	24.4	25.8	25.4	25.0
Macedonia, FYR	29.6	28.1	27.8	28.8	28.8	28.8
Montenegro	41.4	42.8	44.9	42.9	41.9	41.4
Serbia	39.4	37.9	40.0	40.1	38.1	37.2
SEE6	*34.2*	*33.5*	*34.6*	*34.8*	*34.1*	*33.8*

			Fiscal balance (percent of GDP)			
Albania	-3.5	-5.2	-5.8	-5.1	-4.4	-3.0
Bosnia and Herzegovina	-2.0	-2.2	-2.1	-1.9	-1.8	-1.7
Kosovo	-2.6	-2.9	-2.6	-2.5	-3.0	-2.5
Macedonia, FYR	-3.8	-3.9	-4.2	-3.9	-3.5	-3.0
Montenegro	-5.9	-4.8	-1.4	-5.9	-5.5	-4.4
Serbia	-7.2	-5.6	-6.7	-4.0	-4.0	-3.1
SEE6	*-4.2*	*-4.1*	*-3.8*	*-3.9*	*-3.7*	*-3.0*
			Public debt (percent of GDP)			
Albania	58.0	66.3	68.4	68.5	65.1	60.2
Bosnia and Herzegovina	38.8	37.2	38.7	42.1	39.2	36.8
Kosovo	8.2	9.0	10.6	12.5	13.9	15.6
Macedonia, FYR	33.7	34.2	38.2	40.2	40.1	40.8
Montenegro	54.0	58.1	60.5	65.7	68.5	70.4
Serbia	47.8	50.5	61.1	70.0	73.0	73.4
SEE6	*40.1*	*42.6*	*46.3*	*49.8*	*50.0*	*49.5*
			Public and publicly guaranteed debt (percent of GDP)			
Albania	62.0	70.1	72.5	73.2	70.0	65.4
Bosnia and Herzegovina	43.6	41.6	42.7	46.1	43.0	40.4
Kosovo	8.2	9.0	10.6	12.5	14.2	16.0
Macedonia, FYR	38.3	40.5	46.0	48.4	49.2	50.6
Montenegro	66.1	67.5	69.5	77.1	79.3	80.8
Serbia	56.1	58.8	68.8	76.7	78.4	77.7
SEE6	*45.7*	*47.9*	*51.7*	*55.7*	*55.7*	*55.1*
			Goods exports (percent of GDP)			
Albania	15.9	18.1	9.2	8.2		
Bosnia and Herzegovina	22.6	24.3	24.6	25.1		
Kosovo	5.6	5.5	5.9	6.5		
Macedonia, FYR	30.4	29.2	32.5	32.8		
Montenegro	12.4	11.9	10.4	10.1		
Serbia	26.5	30.7	32.2	35.1		
SEE6	*22.5*	*24.7*	*24.4*	*25.5*		
			Trade balance (percent of GDP)			
Albania	-18.7	-17.9	-18.7	-18.9		
Bosnia and Herzegovina	-24.0	-20.8	-23.3	-20.0		
Kosovo	-34.3	-31.8	-31.4	-30.2		
Macedonia, FYR	-22.5	-18.5	-17.6	-17.0		
Montenegro	-24.7	-20.3	-20.0	-20.9		
Serbia	-17.5	-11.2	-11.0	-9.0		
SEE6	*-21.1*	*-16.9*	*-17.3*	*-15.8*		

	Current account balance (percent of GDP)					
Albania	-10.2	-10.7	-13.0	-13.1	-13.4	-12.6
Bosnia and Herzegovina	-8.8	-5.7	-7.7	-7.9	-6.0	-6.5
Kosovo	-7.5	-6.9	-8.1	-8.2	-8.0	-7.9
Macedonia, FYR	-2.9	-1.8	-1.4	-2.8	-3.1	-3.0
Montenegro	-18.7	-14.6	-15.4	-16.0	-16.4	-16.8
Serbia	-11.6	-6.1	-6.0	-4.0	-4.0	-3.8
SEE6	*-9.8*	*-6.6*	*-7.3*	*-6.7*	*-6.5*	*-6.4*
	External debt (percent of GDP)					
Albania	35.6	34.3	36.7	42.3	45.6	43.8
Bosnia and Herzegovina	52.2	50.8	54.6	54.2	54.5	54.0
Kosovo	7.3	6.6	6.5	7.1	7.6	7.2
Macedonia, FYR	66.1	64.0	69.8	70.4	71.0	70.8
Montenegro	115.1	115.4	120.7	129.4	140.9	147.2
Serbia	81.2	75.1	78.4	80.9	86.3	83.6
SEE6	*59.6*	*57.7*	*61.1*	*64.1*	*67.6*	*67.8*
	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	33.3		
Macedonia, FYR	31.0	29.0	28.0	27.4		
Montenegro	19.7	19.5	18.0	17.6		
Serbia	24.0	22.1	18.9	17.9		
SEE6	*23.9*	*23.3*	*22.4*	*21.6*		

Source: World Bank calculations and projections based on data from national authorities and World Economic Outlook (2015).

WORLD BANK GROUP
Macroeconomics & Fiscal Management