

1 Economic context

Key economic features

The Western Balkan region consists of six small open economies: Albania, Bosnia and Herzegovina, Kosovo, Montenegro, North Macedonia and Serbia. In the post-transition period, the economies of this region have become predominantly service-oriented, though some manufacturing sectors have been expanding in recent years. Services account for the largest share of the regional gross domestic product (GDP) at 52.2%, dominated by wholesale and retail trade (World Bank, 2021^[1]). In Montenegro and Albania, tourism also contributes a significant share to the services sector (32.1% and 21.2% of GDP respectively) (World Travel and Tourism Council, 2020^[2]). Industry contributes 23.4% to GDP, with the highest contribution coming from the manufacturing and construction sectors. However, the share of the manufacturing sector varies across the six economies – from 4% of GDP in Montenegro and 6% of GDP in Albania to between 12% and 14% in the remaining four economies (World Bank, 2021^[1]). The agriculture sector has declined significantly over the past two decades, its contribution to GDP having fallen from 15.3% in 2000 to 8.6% in 2020 (World Bank, 2021^[1]). However, this sector's contribution to employment remains much more significant, at 18.6% in 2019 (World Bank, 2021^[1]). Its contribution to informal employment is also likely to be significant (ILO, 2021^[3]).

The growth of the Western Balkan economies has slowed down significantly in the aftermath of the global financial crisis, but it has become more balanced (World Bank, 2021^[1]). Their annual average growth rate has been 2.3% since 2010, compared to 5.8% in 2001-08. Prior to the crisis, GDP growth was driven predominantly by consumption and investment, fuelled by high capital inflows channelled through the newly privatised financial institutions. In the context of weak export growth and high reliance on imports, this led to the build-up of significant imbalances, including high trade and current account deficits and high levels of (external) debt, both public and private. In the post-crisis period, weaker credit growth has moderated the growth in consumption and investment, including foreign direct investment (FDI). Furthermore, productivity growth has been undermined by weaker labour reallocation from less productive sectors (mainly agriculture) to more productive service and manufacturing sectors, as well as by the decline in within-sector productivity growth. On the other hand, the growth in exports (from 28.8% to 44.6% of GDP between 2008 and 2019), fuelled in some economies (North Macedonia and Serbia) by the influx of export processing FDI, has resulted in more balanced growth and a more stable macroeconomic environment (World Bank, 2021^[1]).

The moderate economic growth of the past decade reflects numerous underlying structural challenges that undermine productivity and capital accumulation. Despite significant progress, the business environment remains challenging due to corruption, weak and uncertain contract enforcement, lengthy and costly procedures for obtaining licences and permits, and unfair competition from the informal sector, among others. Micro and small enterprises, especially start-ups, face considerable hurdles in obtaining financing from bank and non-bank financial institutions. Infrastructure gaps (including hard and soft transport infrastructure and, in economies such as Albania and Kosovo, energy infrastructure) further undermine competitiveness, investment – particularly export-oriented FDI – and integration into global value chains.

These challenges are also reflected in weak labour market and well-being outcomes. Unemployment remains an important problem for all economies in the region, with rates ranging from 9% in Serbia to 25.7% in Kosovo (Table 1.1). Youth unemployment is particularly high: almost 50% in Kosovo and between 27% and 35.5% in all other economies. A high share of the unemployed are long-term unemployed. Meanwhile, most employed people work in low-wage, low-productivity jobs, which is reflected in the still relatively large gap in per capita income vis-à-vis the European Union (EU) – less than 40% of the EU and OECD average GDP per capita (PPP adjusted) – and the relatively higher poverty rates (World Bank, 2021^[1]). High inequality also significantly affects well-being in the Western Balkan economies across gender, ethnicity and regions, with well-being also undermined by high pollution levels and environmental degradation.

Table 1.1. WB6: Main regional macroeconomic indicators (2020)

Indicator	Unit of measurement	Albania	Bosnia and Herzegovina	Kosovo	Montenegro	North Macedonia	Serbia	WB6 average
GDP growth ¹	% year-on-year	-3.3	-4.5	-3.9	-15.2	-4.5	-1.0	-3.3
GDP per capita ²	Current international \$	13 818	15 612	11 368	20 567	16 927	19 231	17 093
Agriculture, forestry, and fishing, value added ²	% of GDP	19.3	6.2	7.6	6.4	9.1	6.5	8.6
Industry (including construction), value added ²	% of GDP	19.7	23.9	25.8	16.1	22.6	24.8	23.4
Services, value added ²	% of GDP	48.4	55.7	44.2	58.7	57.0	51.5	52.2
Net FDI ¹	% of GDP	7.3	1.8	4.2	11.2	1.9	6.2	5.1
Exports of goods and services ¹	% of GDP	23.3	32.1	21.6	25.8	58.1	47.7	40.2
Imports of goods and services ¹	% of GDP	38.1	45.9	53.7	60.6	70.9	56.6	53.9
Current account balance ¹	% of GDP	-8.9	-3.1	-7.1	-26.0	-3.5	-4.3	-5.7
Unemployment ¹	%	12.2	18.0	25.7*	18.4	16.4	9.0	14.1
Youth unemployment ^{*2}	% of total labour force ages 15-24	27.0	34.0	49.5**	25.3	35.5	27.1	31.6
Inflation ¹	Consumer price index, annual % change)	1.6	-1.1	0.2	-0.8	1.2	1.6	0.5***
Public and publicly guaranteed debt ³	(% GDP, estimate for 2020)	77.4	39.6	22.8	109.2	60.0	58.2	57.5
External debt ^{*4}	% of GDP	60.1	64.3	30.8	170.2	72.2	66.1	65.8
Exchange rate (if applicable local currency/euro) ¹	Value	123.77	1.96	61.67	117.58	..
Remittance inflows ²	% of GDP	9.9	9.2	18.9	12.6	3.4	7.3	8.5
Mean population exposure to PM2.5 ^{*5}	Micrograms per cubic metre	18.5	30.3	..	22.3	32.7	25.5	..

Note: Unless specified otherwise, all WB6 averages are weighted averages.

* 2019 data due to unavailability of 2020 data; ** For Kosovo this is an economy-wide estimate as opposed to ILO modelled estimate for all remaining economies. *** Simple average.

Source: 1) (European Commission, 2021^[4]) *EU Candidate Countries' and Potential Candidates' Economic Quarterly (CEEQ) Q1 2021* https://ec.europa.eu/info/sites/default/files/economy-finance/tp048_en.pdf; 2) (World Bank, 2021^[1]), *World Development Indicators* <https://databank.worldbank.org/source/world-development-indicators>; 3) (World Bank, 2021^[5]), *Western Balkans Regular Economic Report, Spring 2021* <https://openknowledge.worldbank.org/bitstream/handle/10986/35509/Subdued-Recovery.pdf?sequence=1&isAllowed=y>; 4) (EBRD, 2020^[6]), *Transition Report 2020-21*, <https://2020.tr-ebd.com/countries>; 5) (OECD, 2021^[7]), *Statistics*, https://stats.oecd.org/Index.aspx?DataSetCode=EXP_PM2_5.

Sustainable development

All of the Western Balkan economies have committed to implementing the 2030 Agenda for Sustainable Development; however, progress in improving well-being outcomes has been relatively modest over the past decade. Achieving the 2030 targets will require considerable effort across most of the 17 Sustainable Development Goals (SDGs).

Since the start of the economic transition, the WB economies have made significant progress in improving economic and social outcomes. Strong economic growth, particularly in the period leading up to the global financial crisis, led to significant job creation, rising productivity and incomes, and declining poverty. These trends have continued over the past decade, though progress has been slow, and significant gaps with the 2030 targets remain (Table 1.2):

- Health and well-being outcomes are strongly affected by high rates of non-communicable diseases (cardiovascular disease, diabetes, cancer, etc.) and obesity; lack of access to high-quality healthcare; high out-of-pocket expenditures for healthcare etc. Air and water pollution also negatively affect health and well-being.
- High and rising inequality is an important challenge in the Western Balkan economies, as well as globally. Inequality is manifested not only in terms of income (as measured by the Gini coefficient), but also in all kinds of well-being outcomes – from access to quality education and healthcare, to municipal infrastructure, etc. Inequality is visible across various dimensions including gender, ethnicity, regions, and urban vs. rural areas.
- Economic outcomes are undermined by weaknesses in competitiveness, infrastructure and innovation, manifested in low job creation and high unemployment. Weaknesses in the quality and relevance of education also damage productivity and long-term growth prospects.
- Environmental outcomes are poor across all relevant SDGs. Air pollution is high, and is a major problem especially in the region's largest cities. Significant progress can be made in improving energy efficiency. Environmental degradation on land and below water represents a major challenge in most economies, as does the building of a circular economy.

Table 1.2. Progress towards achieving the SDGs

SDG	Albania	Bosnia and Herzegovina	North Macedonia	Montenegro	Serbia
1 – No Poverty	Challenges remain	SDG achieved	Challenges remain	Challenges remain	SDG achieved
2 – Zero Hunger	Significant challenges remain	Significant challenges remain	Significant challenges remain	Major challenges remain	Significant challenges remain
3 – Good Health and Well-Being	Significant challenges remain				
4 – Quality Education	SDG achieved	Information unavailable	Challenges remain	Challenges remain	SDG achieved
5 – Gender Equality	Significant challenges remain				
6 - Clean Water and Sanitation	Significant challenges remain				
7 - Affordable and Clean Energy	Challenges remain	Significant challenges remain	Significant challenges remain	Challenges remain	Challenges remain
8- Decent Work and Economic Growth	Major challenges remain	Significant challenges remain	Significant challenges remain	Significant challenges remain	Significant challenges remain
9 - Industry, Innovation and Infrastructure	Significant challenges remain				
10 - Reduced Inequalities	Significant challenges remain	Significant challenges remain	Major challenges remain	Major challenges remain	Significant challenges remain
11 - Sustainable Cities and Communities	Significant challenges remain	Major challenges remain	Significant challenges remain	Significant challenges remain	Significant challenges remain
12 - Responsible Consumption and Production	Significant challenges remain	Significant challenges remain	Significant challenges remain	Major challenges remain	Significant challenges remain
13 - Climate Action	SDG achieved	Significant challenges remain	Significant challenges remain	Significant challenges remain	Challenges remain
14 - Life Below Water	Major challenges remain	Challenges remain	Information unavailable	Major challenges remain	Information unavailable
15 - Life on Land	Significant challenges remain	Significant challenges remain	Significant challenges remain	Major challenges remain	Major challenges remain
16 - Peace, Justice and Strong Institutions	Significant challenges remain				
17 - Partnerships for the Goals	Significant challenges remain	Challenges remain	Challenges remain	Challenges remain	Challenges remain

Note: An assessment is not yet available for Kosovo. The order of progress (from greatest to least) is as follows: SDG achieved; challenges remain; significant challenges remain; major challenges remain.

Source: (Sachs et al, 2021^[8]), *Sustainable Development Report 2021: the Decade of Action for the Sustainable Development Goals*, <https://s3.amazonaws.com/sustainabledevelopment.report/2021/2021-sustainable-development-report.pdf>.

Structural economic challenges

Significant outstanding structural challenges undermine the Western Balkan economies' competitiveness, investment environment and integration into global value chains (GVCs):

Weak knowledge and skills hinder economic diversification and upgrading

- **Improving the quality of education** is a major challenge for the six economies of the Western Balkan region (WB6). Student performance in international assessments, such as the Programme for International Student Assessment (PISA), is significantly behind OECD countries, as well as Central and Eastern European peers. For example, around 50% of students in the WB6 fail to achieve the baseline level of proficiency (level 2) in each of the three subjects tested by PISA

(mathematics, science and reading). By comparison, about 80% of OECD students achieve baseline proficiency across each of the three tested subjects (OECD, 2018^[9]).

- There are many reasons for the poor quality of education at all levels, including low and inefficient spending on education. The relatively low spending on education is reflected in inadequate teaching facilities, limited access to technology and other teaching tools (OECD, 2020^[10]). The quality of spending is also a challenge in many economies. For example, low student-teacher ratios result in high spending on teacher salaries, which does not translate into superior student performance (OECD, 2020^[10]).
- **Skills gaps** are another important challenge for education in the Western Balkan economies. Skills gaps undermine investment and growth in existing sectors of an economy, and also limit the scope for economic upgrading through investment (including FDI) in more knowledge-based sectors. The employer Skills Measurement Program (STEP) survey conducted by the World Bank in a number of regional economies has pointed to skills gaps as a major cause of hiring difficulties (World Bank, 2021^[11]). Meanwhile, a significant share of respondents to the Balkan Barometer survey do not feel that the skills they obtained during their education meet the needs of their jobs. The skills most lacking include technical skills, as well as more cognitive and behavioural skills such as communication, the ability to learn on the job, creativity, innovation and risk taking (Regional Cooperation Council, 2019^[12]).

A challenging business climate undermines investment and private sector development

Over the past decade, most Western Balkan economies have made progress in simplifying and streamlining administrative procedures to make it easier to start and operate businesses. This has helped boost their rankings in the Doing Business report. However, many challenges still persist, including high corruption, weak and costly contract enforcement, lengthy and costly licensing and permitting procedures, and high levels of informality (World Bank, 2020^[13]).

- **Corruption** remains an important obstacle to doing business in the Western Balkan region. In recent enterprise surveys, firms from the WB6 economies noted a higher prevalence of corruption than did aspirational peers. Likewise, a large share of WB6 firms identified corruption as a major obstacle to doing business in the region. The challenge is particularly large in Kosovo, Albania and Bosnia and Herzegovina, according to the Business Environment and Enterprise Performance Survey (BEEPS). In Kosovo, for example, over 50% of surveyed firms identified corruption as a major constraint, compared to the Europe and Central Asia (ECA) average of 17.9%. The equivalent figure for Albania was over 43.4%, and 29.5% for Bosnia and Herzegovina. In Albania, 36.1% of firms stated that they had experienced at least one bribe payment request, which is considerably higher than the ECA average of 8.3% (World Bank, 2019^[14]). The most recent Transparency International Corruption Perception Index ranks most economies in the Western Balkan region at over 100th place out of the 180 participating economies (Transparency International, 2020^[15]).
- **Contract enforcement** is slow, costly and unreliable in the WB6 economies. It takes on average 542 days, which is somewhat faster than the OECD average (590 days), but considerably longer than the global leaders on the Doing Business index (164 days in Singapore) (World Bank, 2020^[13]). In many economies, the process is slowed down by an overburdened court system which has a significant backlog of cases. At 34.5% of the claim value, contract enforcement is also costly compared to the OECD average of 21.5% (World Bank, 2020^[13]). Finally, and perhaps most importantly, confidence is lacking in the judicial system's fair and impartial decision making, which elevates the uncertainty in contract enforcement. In the latest Regional Cooperation Council barometer survey, 58% of respondents in the WB6 stated that they do not trust the court system, while 64% stated that they do not believe that the judiciary is independent of political influence.

Likewise, 70% of WB respondents do not believe that the law is applied equally to everyone (Regional Cooperation Council, 2019_[12]).

- **Obtaining licenses and permits** is also a relatively long and costly process in most WB6 economies. According to the latest Doing Business report, obtaining a construction permit in Albania, Bosnia Herzegovina and Kosovo takes on average 247 days (compared to a 152-day average for the OECD) and requires 18 procedures (compared to the OECD average of 13). The cost of obtaining these permits ranges from 5.2% of the warehouse value in Kosovo, to 20.3% in BIH (compared to 1.5% for the OECD) (World Bank, 2020_[13]).
- **Unfair competition**, particularly from the informal sector, represents an important constraint for businesses in most WB6 economies. In the BEEPS enterprise survey, 44.5% of Western Balkan firms stated that they compete against informal firms, while 35.5% of firms stated that informal competition is a major obstacle for their business (World Bank, 2019_[14]). The share of informal employment in the region is estimated at 17-40% (The Vienna Institute for International Economic Studies, 2019_[16]).

Infrastructure deficiencies undermine investment, trade and GVC integration

The infrastructure gap varies across economies. All economies face important challenges with respect to the size and quality of transport infrastructure, particularly in the railway sector, while some economies also experience important challenges in the reliability of electricity supply.

- **Deficiencies in transport infrastructure connectivity:** Road and railway density is low compared to CEEC¹ peers and the EU, and the quality of infrastructure in both transport modes is relatively weak due to underinvestment and inadequate maintenance (Eurostat, 2020_[17]). The underdeveloped selection and implementation processes for transport infrastructure projects in the WB6 are also an obstacle to the efficient development of the transport network, although some WB6 economies (Albania and Serbia) have recently made progress in implementing more transparent and efficient project prioritisation processes.
- **The unreliable electricity supply** is an important obstacle to doing business in the region. According to the latest World Bank Enterprise Survey, around 30% of surveyed firms stated that they considered electricity supply to be a major constraint in 2019 (an increase of 10% since 2013) (World Bank, 2019_[14]). High distribution losses are another important challenge, as all the WB6 economies experience higher levels of distribution losses (around 18.5% on average) than the EU (6.7%) and CEEC (5.2%) averages. This is particularly true for Albania and Kosovo, where electricity distribution loss levels are around 34% and 28% respectively (CEER, 2020_[18]). The WB6 economies are all reliant on coal-fuelled electricity generation (around 50% in 2018), and have limited non-hydro renewable capacity, which limits their domestic generation potential and greenhouse gas emissions reduction capabilities (Eurostat, 2021_[19]).

Poor access to finance hinders SME investment, innovation and technology adoption

- **Access to finance** remains an important challenge across all Western Balkan economies, particularly for micro and small enterprises. These enterprises cannot meet the relatively stringent requirements for bank lending, including high collateral, turnover, credit history and other requirements. Furthermore, they have limited alternatives to bank financing. Progress has been made in many WB6 economies to boost financing for small and medium-sized enterprises (SMEs) through credit guarantee schemes, financing through national development banks, innovation funds and other public entities. Nevertheless, the financing gap still remains relatively wide; closing it will be an important challenge over the coming decade – especially if the region's governments wish to develop more competitive and innovative knowledge-based economies.

Cross-cutting and sector-specific constraints undermine the growth of key sectors

- **Agriculture** in the region is mainly characterised by smallholder and subsistence farming, high land fragmentation, low access to and take-up of new technologies, limited compliance with quality standards, limited access to finance, and, in some cases, high input costs. The result is low productivity and low value added per worker (the latter is roughly one-quarter of the EU average or less in most economies) (World Bank, 2021^[11]).
- **Manufacturing** development, export growth and GVC integration are all constrained by weaknesses in infrastructure, customs and logistics and the business environment; by skills gaps and firms' limited capacities for technology adoption; and limitations in access to finance, among others. However, analyses of the WB6 economies' product spaces reveal considerable long-term potential for growth in the automotive industry (vehicle and engine parts), electronics, machinery and metal processing (OECD, 2019^[20]).
- **Tourism** in the region is highly seasonal and mainly concentrated in those economies with coastlines – leading to over-crowded and congested coastal areas. Given their relatively small size, most economies have scope to benefit from more high-end tourism offers, but development of this theme is still limited. The development and upgrading of the tourism sector across the Western Balkan region are hampered by poor infrastructure, lack of quality standards, high pollution levels and environmental degradation, weak protection of cultural heritage, and weak branding and marketing.
- **Information and communication technology (ICT)** is a fast-growing sector in most Western Balkan economies and has considerable potential to boost the value added and exports of services across the region. However, the sector is constrained by infrastructure gaps, the low supply of skilled workers, weak collaboration between the sector and the relevant educational institutions, and lack of access to finance (particularly for start-ups) and high-risk venture capital.

Weak management of public finances holds back long-term development

- **Fiscal policy challenges** are considerable in many economies in the region. Revenue performance is weak due to a relatively narrow tax base, tax evasion and the large informal sector. Low tax rates and lack of tax progressivity in many economies further limit the scope for boosting revenues. On the other hand, a high and growing share of public expenditures go to public sector wages, as well as subsidies and transfers. This has not only limited the level of discretionary spending, as exemplified in the response to the COVID-19 pandemic – it has also had an impact on capital spending in many economies. In some economies, such as Albania and Montenegro, this has also had a strong impact on the levels of public debt and the sustainability of public finances. The economies' long-term development prospects will depend significantly on governments' efforts to widen the tax base, improve compliance and boost the efficiency and effectiveness of public spending and its targeting to areas with strong productivity enhancing potential (e.g. green infrastructure, health, education, etc.)

Environmental degradation threatens long-term development and well-being

- **Air pollution** has become an acute challenge in all the major cities of the WB6. For example, the exposure of the Western Balkan economies' populations to fine particulate matter (PM_{2.5}) is two to three times higher than the World Health Organization's (WHO) recommended highest levels of 10 µg/m³ (OECD, 2021^[7]). Air pollution levels are particularly high in the winter months, when pollution from ageing vehicles (the average age is considerably higher than in developed countries) and other sources is compounded by pollution from residential heating, often sourced from burning wood or coal.

- **All of the Western Balkan economies are highly prone to natural disasters** (e.g. floods, earthquakes and landslides) and have suffered significant economic and physical damage as a result. With the frequency and severity of some of these hazards likely to increase with climate change, the importance of addressing underlying man-made environmental degradation and strengthening adaptation to climate change will be critical over the coming decades (European Commission, 2020^[21]).
- **Natural resource conservation** is critical for the well-being of people and wildlife, and has important economic benefits as well. For example, reducing land and water pollution and increasing biodiversity conservation would have a strong positive impact on the region's attractiveness for tourists and the potential for upgrading the tourism offer across all economies.

Inequality remains an important challenge

- Over the past two decades, **incomes per capita and living standards have improved** across all the WB6 economies. Nevertheless, the gap between the WB6 and the average EU and OECD economies remains relatively large. The WB6 average GDP per capita (PPP adjusted) is less than 40% of the EU and OECD averages – and inequality remains a considerable challenge. The level of income inequality, as measured by the Gini coefficient, is relatively high. And there are also considerable regional and ethnic inequalities in access to education, and other public services, employment, etc. (Sachs et al, 2021^[8]). For example, these inequalities disproportionately affect ethnic minorities such as the Roma, while regional disparities are also significant, with citizens living in large cities benefitting from higher incomes, better employment opportunities, better infrastructure and services than their rural counterparts. Fostering more inclusive growth is thus a critical challenge for the WB6 economies going forward.

Covid-19 has exacerbated structural challenges

The COVID-19 pandemic has had a significant impact on the Western Balkan economies in 2020, with the regional GDP estimated to have declined by 3.3% on the back of falling domestic demand and exports (European Commission, 2021^[4]). The biggest impact was felt in the second quarter (Q2) of 2020, when lockdown measures, disruptions to global value chains and travel restrictions strongly affected critical service and manufacturing sectors, including retail and wholesale trade, transport as well as tourism and hospitality. Despite some recovery in Q3 and Q4 as travel restrictions and lockdowns were lifted, it was relatively subdued due to high uncertainty in the midst of recurrent waves of the pandemic. As a result, in most regional economies GDP growth remained negative on a year-on-year basis in the second half of 2020.

The degree to which each economy has been affected by the crisis has depended on key economic fundamentals, the strength of the fiscal response as well as the relative strength of the pandemic wave. Montenegro was by far the most badly affected WB6 economy due to its high dependence on tourism, as well as its limited scope for a proportional fiscal response in light of the already high level of public debt. As a result, Montenegro's annual GDP declined by 15.2% in 2020. In Albania, meanwhile, the strong impact on the tourism sector and on domestic demand was mitigated by the recovery from the 2019 earthquake, resulting in a year-on-year GDP decline of 3.3% in 2020. Serbia's economy declined by just 1% in 2020 thanks to its more diversified economic base and the strong fiscal stimulus implemented to combat the economic fallout of the crisis. Meanwhile, the economies of Bosnia and Herzegovina and North Macedonia were more strongly affected by the second wave of the pandemic; this impact could not be lessened despite the additional stimulus measures implemented in the second half of 2020 (World Bank, 2021^[22]).

The impact on the labour market was mitigated by government measures aimed at supporting employment and the liquidity of companies in the most critically affected sectors of the economy. Montenegro and

Bosnia and Herzegovina saw the highest increase in unemployment: in Montenegro by 3% (from 15.4% in 2019 to 18.4% in 2020) and in Bosnia and Herzegovina by 2.3% (from 15.7% in 2019 to 18% in 2020). In Albania, unemployment remained relatively unchanged (12% in 2019 to 12.2% in 2020), while in the other three economies the decline in unemployment continued despite the pandemic (European Commission, 2021^[41]).

Many of the structural challenges described above have played a role in either amplifying the impact of the COVID-19 epidemic or limiting the scope of the policy responses to lessen its impact. The crisis has, therefore, provided important lessons on how to build more resilient economies and institutions:

- **Fiscal policy:** As noted above, all WB6 governments introduced fiscal policy measures to stave off the economic and social impact of the crisis. The packages ranged in size and composition, but most included measures to stimulate employment retention (wage and social security subsidies) and firm liquidity (deferred tax payments, reduced VAT rates for specific goods and services, SME credit guarantee schemes, etc.) and boost support for the poorest and most vulnerable households (cash transfers).
- The fiscal response has been critical for avoiding significant economic fallout from COVID-19, especially on labour market outcomes. However, it has resulted in a significant narrowing of the fiscal space. In Montenegro, for example, the fiscal deficit plunged to 11% in 2020 and public and publicly guaranteed debt rose to 109.2% of GDP. In Albania, a deficit of 6.7% resulted in a further increase in public and publicly guaranteed debt to 77.4% of GDP. In North Macedonia, public and publicly guaranteed debt increased by more than 10% in 2020, from 49.4% to 60% of GDP (World Bank, 2021^[22]).
- In the context of weaker prospective revenues in the wake of the crisis, particularly if the recovery is slow, improving the efficiency of public spending will be critical over the coming months. Expenditures that can support the recovery and promote productivity growth and structural transformation must be prioritised to ensure stronger and more resilient long-term growth. This includes increasing public investment, which has suffered significantly due to high and rising current expenditures. The crisis has also highlighted the importance of rebuilding fiscal buffers in the post-crisis period. In addition to managing expenditures better, achieving this will also require tackling some of the structural constraints that undermine revenue performance.
- **Innovation and technology adoption:** The COVID-19 crisis has starkly demonstrated the importance of firm adaptability in meeting new challenges and changing circumstances. It has also revealed the advantages that firms which have embraced digitalisation and modern practices have over others. The resilience of the post-COVID recovery will therefore depend on addressing structural issues limiting firm innovation and technology (see Structural economic challenges section) and mainstreaming digitalisation and digital skills.
- **Access to finance:** The crisis highlights the significance of having a well-developed and diversified financial sector that can respond to the financing needs of enterprises – not only in times of crisis, but also during the recovery phase. As in the rest of the region, the main instruments for providing additional liquidity for enterprises during the crisis were government support for subsidised lending or lending guarantees. But a robust financial sector made up of diversified financial institutions that can provide financing for riskier and innovative ventures, and not just established enterprises, will be very important in the recovery phase and beyond.
- **Informality:** The large size of the informal sector, and the significant share of informal employment even within the formal sector, have limited the scope of the measures to protect the income and employment of people in the worst-affected sectors. Informality is widespread in the sectors most affected by the crisis, including retail trade and tourism. For example, a study in North Macedonia found that there were 33 000 informal jobs in the nine most vulnerable sectors to the COVID-19 pandemic, accounting for around 26% of total informal employment in the economy (ILO, 2020^[23]).

This segment has not been able to benefit from government subsidies, favourable loan terms and loan guarantees or other support measures. Developing a more resilient economy will also depend on improving the incentives for formalisation of businesses and improving the oversight and sanctioning of non-compliance.

- **Health sector:** The pandemic has exposed some of the critical challenges that the WB6 health sectors were already facing. Some of these include lower government spending on health care than in EU and OECD countries, resulting in lower quality and poor access. Citizens' high out-of-pocket expenditures are another important challenge for the health systems in the region, with important implications for equality of access as well as quality of care (World Bank, 2021^[11]). For example, during the pandemic the high cost of testing for the virus resulted in low propensity for testing, underestimation of the number of cases and more rapid contagion (EURACTIV, 2020^[24]).

EU accession process

All of the WB6 economies are committed to pursuing EU accession, and the approximation process has been an important anchor for reforms in the region over the past two decades. Of the WB6 economies, four (Albania, Montenegro, North Macedonia and Serbia) are candidates for EU accession and two (Bosnia and Herzegovina and Kosovo) are potential candidates. Since 2010, citizens of all the WB economies except for Kosovo have been able to travel visa-free to all EU Member States that are part of the Schengen area.

The importance of advancing on the socio-economic reform agenda remains a critical priority on the Western Balkan economies' journey to EU membership. The findings of this Competitiveness Outlook (CO) 2021 offer monitoring relevant to a number of critical chapters of the *acquis*, while its recommendations provide the guidance needed to meet the accession requirements. The Competitiveness Outlook also provides a good basis for assessing the critical challenges that the economies face as a starting point for developing their Economic Reform Programmes (Box 1.1)

Box 1.1. Economic Reform Programmes

Since 2015, all EU candidate countries and potential candidates prepare Economic Reform Programmes (ERPs) which play a key role in improving economic policy planning and steering reforms to sustain macroeconomic stability, boost competitiveness, and improve conditions for inclusive growth and job creation. The ERPs contain medium-term macroeconomic projections (including for GDP growth, inflation, trade balance and capital flows), budgetary plans for the next three years and a structural reform agenda.

The structural reform agenda includes reforms to boost competitiveness and improve conditions for inclusive growth and job creation in the following areas:

1. Public Financial Management
2. Green transition
3. Digital transformation
4. Business environment and reduction of the informal economy
5. Research, development and innovation
6. Economic integration reforms
7. Energy market reforms
8. Transport market reforms
9. Agriculture, industry and services

10. Education and skills
11. Employment and labour market
12. Social protection and inclusion
13. Healthcare systems

The structural reforms part of the ERPs is organised in two parts:

- A first part identifies and analyses the three key challenges across those 13 areas. The identification and prioritisation of key challenges imply a clear political commitment at the highest level to address them and the ERPs should propose a relevant number of reform measures to decisively tackle each of them in the next three years.
- A second part provides an analysis of the remaining areas (not included as key challenges) and may propose additional reforms to address them.

The European Commission and the European Central Bank then assess these programmes, which form the basis for a multilateral economic policy dialogue involving the enlargement economies, EU Member States, the Commission and the European Central Bank. The dialogue culminates in a high-level meeting during which participants adopt joint conclusions that include economy-specific policy guidance reflecting the most pressing economic reform needs. The findings of the Competitiveness Outlook provide guidance to the six Western Balkans EU candidates and potential candidates in identifying the key obstacles to competitiveness and economic growth, and in developing structural reform measures to overcome them.

Source: (European Commission, 2021^[25]), Guidance for the Economic Reform Programmes 2022-2024 of the Western Balkans and Turkey, https://ec.europa.eu/neighbourhood-enlargement/sites/default/files/erp_2022-2024_guidance_note.pdf; (European Commission, 2018^[26]), Economic Reform Programmes: Western Balkans and Turkey, <https://ec.europa.eu/neighbourhood-enlargement/sites/near/files/20180417-erp-factsheet.pdf>.

EU financial and development support

The EU is the largest provider of external financial assistance to the Western Balkan economies. Since 2007, the EU has provided over EUR 12 billion in pre-accession funds aimed at strengthening democracy and the rule of law, strengthening competitiveness, boosting innovation in agriculture and rural development, reforming the public administration, improving energy and transport infrastructure and policies and fostering climate action. A further EUR 10.2 billion of financing has been provided through the European Investment Bank (EIB) since 1999, while financing of EUR 1.14 billion through the Western Balkans Investment Framework (WBIF) has leveraged additional investment worth an estimated EUR 16.4 billion. Finally, the EU has provided significant grant financing to support disaster relief and reconstruction in the aftermath of the floods that have affected many regional economies, as well as the disastrous earthquake that struck Albania in 2019 (European Commission, 2021^[27]).

In addition to the grant funding and lending, the EU also provides important support through guarantees for public and private investment to reduce the risks and costs associated with those investments. The new Western Balkans Guarantee Facility is expected to mobilise up to EUR 20 billion in investment over the coming decade (European Commission, 2020^[28]).

The Connectivity Agenda seeks to support investments in sustainable transport and clean energy. Set up under the WBIF, the latest package, which was presented at the Western Balkans Summit in Sofia on 10 November 2020, completes the delivery of the EU's 2015 pledge to finance EUR 1 billion of investment to support better connectivity in the WB region. It also represents the first step in implanting the flagship projects under the Economic and Investment Plan for the region (European Commission, 2021^[29]).

The EU has also been instrumental in supporting the Western Balkan economies in their response to the COVID pandemic. This included more than EUR 500 million in repurposed IPA 2014-2020 financing to cover the urgent needs of the health sector, support economic and social recovery in the aftermath of the crisis, and to help WB countries gain access to COVID-19 vaccines through a EUR 70 million package adopted in December 2020. In addition, in February 2021, a joint EU/WHO project provided assistance of EUR 7 million to support vaccination readiness and health sector resilience in the region (European Commission, 2021^[29]). The WB economies have also been recipients of the EU's regional economic reactivation package of EUR 385 million. A further EUR 500 million was provided in macro-financial assistance to support the economic recovery in Albania, Kosovo, Montenegro and North Macedonia, while the European Investment Bank mobilised EUR 1.7 billion, bringing the EU financial response to COVID-19 in the Western Balkans to more than EUR 3.3 billion in total.

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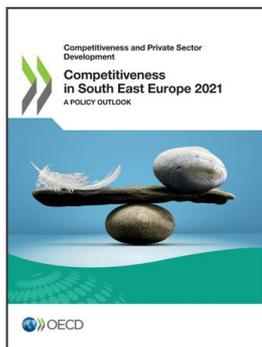
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Notes

¹ The 11 Central and Eastern European countries (CEECs) joining the European Union: Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic and Slovenia.



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