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Article

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Economic trends in the Western Balkans

Relative resilience in the face of post-pandemic and war-implied challenges, but pockets of vulnerabilities call for continued vigilance[1]

Economic slowdown caused by global and domestic factors

Following a relatively robust recovery from the pandemic in 2021, the economic performance in the Western Balkans[2] (WB) slowed down significantly in 2022, particularly in the second half of the year (table 1). Hence, after 7.7% in 2021, average GDP-weighted real economic growth in the region dropped to just above 3% last year. It ranged between about 2% in North Macedonia and 6% in Montenegro. It is worth noting that half of the WB countries experienced real GDP growth in 2022 at or below the EU average (3.5%) thus setting back real convergence. Russia's war against Ukraine and its repercussions have put a significant, although mainly indirect, drag on the Western Balkan economies. The slackening of economic activity was thus predominantly brought about by the global macroeconomic environment, which had clouded because of post-pandemic supply chain frictions and an ubiquitous surge in (commodity) prices that had not been seen in a long time, among other factors. The situation has been exacerbated by Russia's war in Ukraine, resulting in a simultaneous tightening of financial conditions. On the external side, the small and rather open WB economies have suffered from weak foreign demand, particularly from the EU, which accounts for some 35% to 80% of WB exports. In contrast, the direct trade exposure of the Western Balkans to Russia, Ukraine and Belarus is rather limited. In addition, some idiosyncratic domestic factors affected economic performance in the region last year. For example, the summer drought hampered the relatively important agricultural sector in Serbia and, via lower hydropower generation, it impaired industrial production in

Table 1

Real GDP growth

	2020	2021	2022	Q3 21	Q4 21	Q1 22	Q2 22	Q3 22	Q4 22
	Annual real change in %								
Gross domestic product									
Albania	–3.3	8.9	4.8	6.9	5.1	7.0	3.1	4.9	4.7
Bosnia and Herzegovina[1]	–3.0	7.4	3.9	7.6	7.8	5.9	5.8	2.6	1.7
Kosovo	–5.3	10.7	3.5	14.5	7.9	2.2	0.7	3.9	6.8
Montenegro	–15.3	13.0	6.1	27.9	9.3	4.7	13.6	2.8	4.7
North Macedonia	–4.7	3.9	2.1	1.4	1.2	2.2	4.0	2.0	0.6
Serbia	–0.9	7.5	2.3	7.8	7.2	4.1	3.8	1.0	0.4
WB average[2]	–3.0	7.8	3.2	8.3	6.5	4.5	4.3	2.2	1.9

Source: Eurostat.

[1] *Expenditure-side data.*
[2] *Average weighted with GDP at PPP.*

[1] *Compiled by Tomáš Slačík.*

[2] *The Western Balkans comprise the EU candidate countries Albania, Bosnia and Herzegovina, Montenegro, North Macedonia and Serbia as well as the potential candidate Kosovo. The designation "Kosovo" is used without prejudice to positions on status and in line with UNSC 1244 and the opinion on the Kosovo Declaration of Independence.*

some countries. In Serbia, in particular the drought aggravated disturbances in electricity production owed to damages in the major power station. Industrial production thus declined by as much as 43% in Q2 in an annual comparison.

Domestic demand drove moderate economic growth while net exports lagged behind

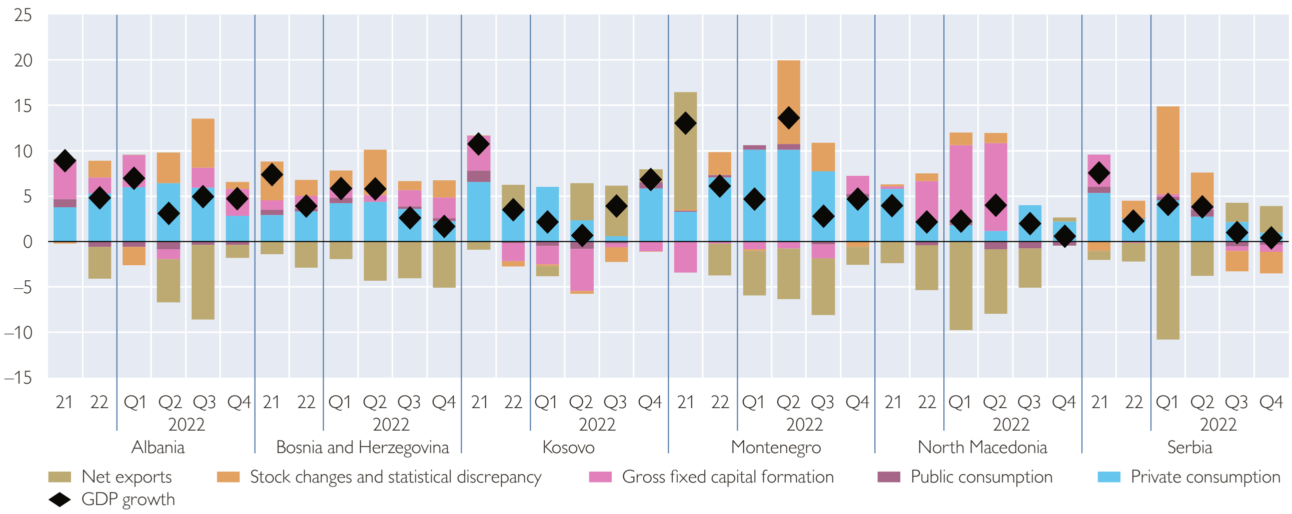
On the expenditure side, economic growth in the WB region in 2022 was driven by domestic demand while net exports made a negative contribution to GDP growth in all countries but Kosovo. Among the domestic demand components, household consumption played a dominant role, especially in the first half of the year, benefiting from rather buoyant wage growth and improving labor market conditions (table 2). Household consumption was also bolstered to some extent by various government support measures to mitigate the increase in cost of living, strong credit growth (especially in Kosovo), resilient inflows of remittances and the arrival of (well-off) residents in the wake of Russia's invasion to Ukraine (especially in Montenegro and Serbia). However, these nominal boosts to disposable incomes have been increasingly counteracted in real terms by accelerated inflation.

Investment made a positive contribution to economic growth in Albania, Bosnia and Herzegovina and North Macedonia. In Albania, it was particularly fixed investment which benefited from a booming construction sector and strong FDI inflows heading into the real estate and tourism industry. In Bosnia and Herzegovina, capital formation profited from favorable lending activity and stock-piling of inventories. Similarly, an accumulation of inventories was the predominant driver of capital formation in North Macedonia. This was brought about by an increase in the import of intermediary goods, raw materials, energy products, machinery and equipment, among others. Yet barring this special case, gross investment was rather muted in general, suffering from elevated input costs and

Chart 1

GDP growth and growth contributions in the Western Balkans

Percentage points, year-on-year GDP growth in %



Source: Eurostat, wiiw, national statistical institutes.

Note: Gross capital formation for North Macedonia.

geopolitical uncertainty, subdued foreign demand and contracting industrial production (Montenegro).

The contribution of public consumption to growth was rather insignificant in most instances or it was slightly negative as earlier pandemic support measures were phased out. While exports of services in the tourism strongholds benefited from a strong tourism season, overall net exports remained subdued in most of the region in 2022, some recovery in Kosovo and Serbia in the second half of the year notwithstanding. This was owed to muted foreign demand in the EU, which is the region's most important trading partner by far, as well as to the fact that export growth was outpaced by increases in imports (including those of services, e.g. in Albania due to outbound tourism).

Continued labor market tightening, exacerbated by migration and demographic trends

While official labor market figures might not provide an entirely accurate picture due to high levels of informality and data (availability) limitations, the readings suggest that labor markets tightened further in 2022. Unemployment, whose solid long-lasting downward trend was partially interrupted during the pandemic, resumed its decline in 2022 (table 2) in all countries in the region[3]. At end-2022, the unemployment rate thus ranged between nearly 10% in Serbia and just above 15% in Bosnia and Herzegovina. Employment also somewhat improved in the entire region so that at end-2022 between one-third (Kosovo) and two-thirds (Albania) of the potential working population were employed. Despite continued improvements, formal employment, in most cases, remains well below the EU average (about 70%), suggesting not only persistent structural mismatches between labor demand and supply but also a comparably large informal sector.

Labor shortages have become more severe in the face of tightening (formal) labor markets exacerbated by outward migration and adverse demographic trends. Labor shortages have been exerting mounting pressure on wages (table 2), especially in the booming sectors. Nominal wage growth accelerated in all WB economies throughout 2022, largely driven by wage hikes in the private sector and amplified by increases in minimum wages. Shortages of skilled labor are increasingly becoming a binding constraint for firms' ability to do business. Nonetheless, nominal wage hikes mostly did not keep up with accelerated inflation in 2022 so that real wage growth ended up in negative territory except for Serbia and to a lesser extent Albania.

[3] *We expect that this also holds true for Kosovo. Even though Labor Force Survey data provided by the Kosovo Agency of Statistics is available only until 2021, more recent data from the Tax Administration of Kosovo indicate a further improvement in labor market indicators.*

Table 2

Labor market

	2020	2021	2022	Q3 21	Q4 21	Q1 22	Q2 22	Q3 22	Q4 22
	Annual change in %								
Average gross wages – total economy									
Albania	2.7	6.3	8.2	6.9	8.4	5.8	7.0	9.2	10.8
Bosnia and Herzegovina	4.0	4.4	11.7	4.5	5.1	8.2	10.7	13.4	14.4
Kosovo	–2.3	3.9	19.8	. .	. .	. .	. .	. .	. .
Montenegro	1.3	1.4	11.3	1.7	1.9	11.3	10.6	11.4	11.8
North Macedonia	8.3	5.7	11.1	4.8	5.4	7.7	10.4	12.0	14.1
Serbia	9.5	9.4	13.8	9.0	11.8	13.4	13.6	14.8	13.4
	%								
Unemployment rate[1]									
Albania	12.2	12.1	11.3	11.6	11.9	11.7	11.5	10.8	11.0
Bosnia and Herzegovina	16.2	17.5	15.5	. .	. .	. .	. .	. .	. .
Kosovo	26.0	20.8	0.0	17.7	19.0	16.6	0.0	0.0	0.0
Montenegro	18.4	16.9	15.1	15.0	15.7	17.0	14.9	13.4	14.9
North Macedonia	16.6	15.8	14.6	15.9	15.3	14.9	14.7	14.4	14.2
Serbia	9.5	11.4	9.7	10.8	10.2	11.0	9.2	9.3	9.4

Source: Eurostat, Macrobond, national statistical offices, wiiw.

[1] *Labor force survey.*

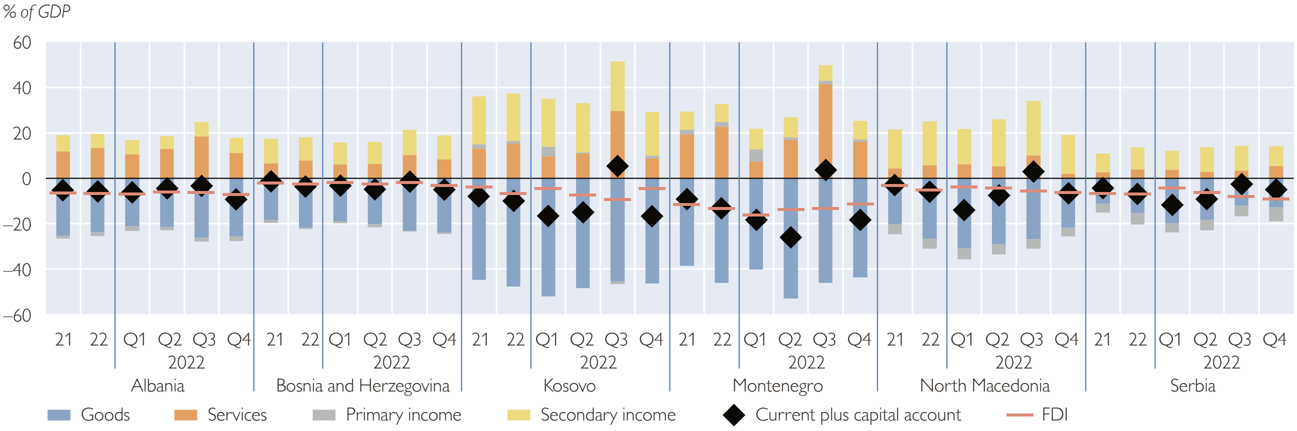
Widening external deficits do not appear a major cause for concern

External deficits relative to GDP widened in all countries but Albania in 2022, primarily on account of higher trade deficits. These were brought about mainly by elevated import prices of commodities and comparably weaker export performance attributable to moderated foreign demand. The goods trade deficit thus widened by between 2.9 (Kosovo) and 7.5 (Montenegro) percentage points of GDP in the twelve months to December 2022 while it improved by 2.6 percentage points of GDP in Albania. The deteriorations in the goods trade deficits were partially offset by higher surpluses in the services balance. The latter's improvement was particularly strong in Albania (more than 6 percentage points of GDP), Montenegro (3.5 percentage points) and Kosovo (2.5 percentage points) thanks to the recovery in tourism. The influx of remittances recorded in the secondary income balance remained robust. Hence, overall, the combined current and capital account deficit widened by 2 (Kosovo) to 4 (Montenegro) percentage points of GDP during 2022. Albania was the only country where it slightly improved. The combined current and capital account deficits thus ranged between some 4.4% of GDP in Bosnia and Herzegovina and 13% in Montenegro. Yet, these imbalances were (almost) fully covered by FDI inflows in Albania, Montenegro and Serbia and to a large extent in the remaining countries (chart 2).

The development of external accounts was inversely reflected by the level of reserves relative to GDP. It declined in all countries in the region (apart from Serbia), reflecting the strong increase in the value of imports (relative to exports) among other factors (table 3). In Serbia, in contrast, international reserves recovered to record highs in absolute terms (more than EUR 21 billion by end-February 2023) thanks to strong FDI inflows and higher external borrowing. The latter increased particularly after Serbia had sought help from both the IMF and the

Chart 2

External accounts in the Western Balkans



Source: National central banks, national statistical offices, wiiw.

Note: FDI: + = net accumulation of assets larger than net accumulation of liabilities (net outflow of capital).
– = net accumulation of assets smaller than net accumulation of liabilities (net inflow of capital).

Table 3

Reserve assets excluding gold

	2020	2021	2022	Q3 21	Q4 21	Q1 22	Q2 22	Q3 22	Q4 22
	End of period, % of GDP								
Albania	28.6	31.9	26.6	19.1	21.8	21.0	20.0	19.6	18.5
Bosnia and Herzegovina	39.1	41.1	34.3	27.7	28.1	26.9	25.7	25.0	23.7
Kosovo[1]	13.3	13.8	13.1	11.1	9.5	9.8	10.7	11.6	8.8
Montenegro	41.5	35.3	31.4	23.4	23.9	23.6	22.4	23.1	20.9
North Macedonia	27.8	28.1	27.0	20.1	18.7	16.5	15.6	18.6	18.3
Serbia	25.1	27.2	28.7	20.3	18.6	15.4	15.6	16.9	19.4

Source: National central banks, IMF.

[1] *Reserve assets (including gold).*

United Arab Emirates (UAE) in the second half of 2022 to handle its soaring market debt costs. As a result, Serbia turned to the IMF and concluded a Stand-by Arrangement (SBA) and obtained a loan at preferential conditions from the UAE.

Despite mostly prudent fiscal stance in the region, pockets of fiscal vulnerability remain and need to be addressed

Except for Montenegro, where the general government deficit widened significantly and contributed to the inflationary pressure, the fiscal stance in the WB region was rather prudent in 2022 and added only marginally to aggregate demand. The fiscal deficit relative to GDP remained broadly unchanged in North Macedonia while Bosnia and Herzegovina recorded a slight increase, yet at a rather low level (table 4). By contrast, the fiscal deficit decreased in Albania and Kosovo, and also marginally in Serbia – despite 2.5% of GDP spent on subsidies and loans to energy state-owned enterprises. Before Serbia managed to successfully return to the international capital market in January 2023, the SBA from the IMF and the loan from the UAE helped cover the large extra costs resulting from the energy crisis.

In general, while the revenue side was aided by the still – relatively – robust economic activity in the region, it was particularly driven up by high inflation. To some extent also tax collection improved, most notably in Kosovo, inter alia thanks to the progressing formalization of the economy. Expenditures also increased in nominal terms. On the one hand, this was predominantly attributable to measures aiming to mitigate inflationary pressures on households and firms such as, inter alia, price caps, (energy) subsidies, bonuses, additional pensions and transfers. On the other hand, in most countries, government expenses such as public sector wages and investment costs increased in response to inflationary pressures. In contrast, however, in some instances (e.g. in Albania, Kosovo, Montenegro) low execution of public investment plans dampened the expenditure side and thus contributed to a better fiscal outcome.

General government debt relative to GDP declined in most cases, most significantly in Montenegro. In the latter country, this was – despite the highest fiscal deficit in the region – due to strong nominal GDP growth on the one hand and some debt repayment on the other. Yet, the reduction of public debt in Montenegro notwithstanding, it remains the country with the highest debt among its peers. Moreover, from the current budgetary perspective, the expansionary fiscal stance is envisaged to continue in the medium term[4]. This does not only elevate the fiscal risk but also adds to inflationary pressure, especially in a country with no autonomous monetary policy. Notable fiscal vulnerabilities persist – despite some progress – also in Albania, primarily due to high refinancing requirements and exposure to interest and exchange rate risks amid tightening financial conditions as well as energy price volatility. Against this background, it is key to restore fiscal buffers to be able to cope with future shocks. Rather quick and decisive fiscal consolidation is also in the cards for Serbia and North Macedonia, in the former under the auspices of the IMF.

Table 4

Fiscal policy indicators

	2020	2021	2022f	2020	2021	2022f
	General government balance			General government debt		
	End of period, % of GDP					
Albania	–6.7	–4.5	–3.5	74.5	73.2	69.4
Bosnia and Herzegovina	–5.2	–0.3	–1.0	36.1	34.0	34.0
Kosovo	–7.6	–1.3	–0.5	22.0	21.1	19.6
Montenegro	–11.1	–1.9	–5.6	105.3	82.5	75.5
North Macedonia	–8.3	–5.4	–5.4	51.9	51.8	51.4
Serbia	–8.0	–4.1	–3.9	58.6	57.1	55.2
Ukraine	–5.3	–3.4	–17.0	60.4	49.0	85.0

Source: European Commission (Ameco), Macrobond, national central banks, wiiw.

[4] *According to the latest Economic Reform Programme, the Montenegrin authorities plan a fiscal deficit of 5.9% of GDP in 2023 and 6.2% in 2024 and 2025 on the basis of the continuation of existing legislation. While the authorities recognize the need for fiscal consolidation, recent measures will lower revenues and at the same time imply higher mandatory expenditures on public wages, social transfers, pensions and the Health Insurance Fund.*

Gradually moderating yet still high inflation deserves continued vigilance

In all WB economies inflation started soaring in mid-2021, although to different extents. Yet after still relatively moderate increases in 2021, consumer price inflation climbed sharply in 2022, averaging between 6.7% in Albania and about 14% in Bosnia and Herzegovina as well as North Macedonia (chart 3). Such high readings had not been seen for a very long time or, in some countries, not ever in recorded history. However, while still high, inflation seems to have mostly culminated in October and November 2022 and has somewhat eased since then in all WB countries but Serbia. A combination of supply- and demand-side factors has contributed to price pressures. Supply constraints have driven food and energy prices to record highs and they have been amplified by the war in Ukraine. On the demand side, lingering demand-supply imbalances brought about by the pandemic have continued to weigh on prices. The surge in prices has thus been driven particularly by food items followed by housing and transportation. Food prices have contributed between 50% and 60% to headline inflation in the WB (compared to about 30% in the euro area). This primarily echoes the fact that the weight of food items is roughly twice as high in the region's consumer basket compared to the euro area. The markedly lower acceleration of inflation (remaining in single-digit levels) in Albania is notable not only in comparison to its regional peers but also to other countries in Central and Eastern Europe. This is attributable to a relatively high share of administered prices, energy tariff controls, almost exclusive electricity production in domestic hydropower plants and, last but not least, rather robust currency appreciation for most of 2022. In the two other countries with flexible exchange rates the currencies have remained broadly stable vis-à-vis the euro (chart 4). Increases in core inflation[5] have been relatively subdued in the region so far. Yet, most recently, core inflation has also accelerated up to 11% in Serbia and Montenegro, suggesting that the pass-through of cost-push factors is becoming more broad-based.

To prevent a de-anchoring of inflation expectations and to bring inflation back on a downward trajectory, the respective central banks in the three countries with autonomous monetary policy started their monetary policy tightening in March (Albania) and April 2022 (North Macedonia and Serbia), respectively. Since then, key policy rates have been raised in 6 steps (25 or 50 basis points each) from 0.5% to 3% in Albania, in 10 steps (25–75 basis points each) from 1.25% to 5.5% in North Macedonia and in 13 steps (i.e. every month since the start of the cycle, 25–50 basis points each) from 1% to 6% in Serbia (chart 5)[6]. In addition, according to the National Bank of Serbia (NBS), it has intervened in the FX market to keep the dinar exchange rate vis-à-vis the euro relatively stable to help contain the spillover of rising import prices on domestic prices[7]. In the three countries without autonomous monetary policy – Bosnia and Herzegovina, Kosovo and Montenegro – the tools to combat inflation are mostly limited to minimum reserve requirements

[5] *Subject to the varying country-specific definitions of core inflation.*

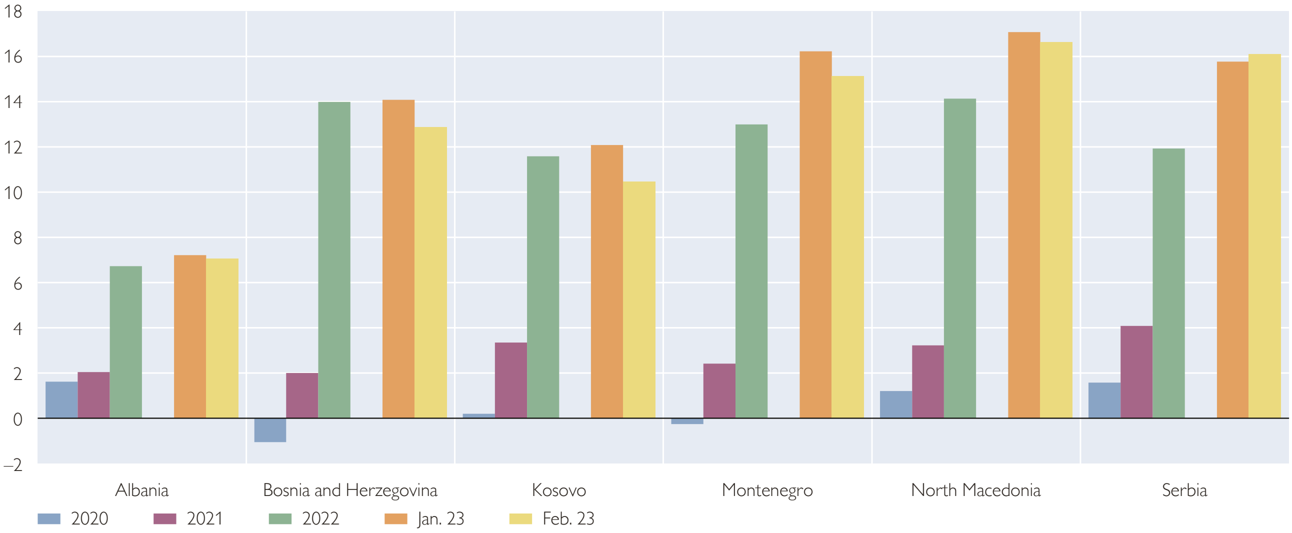
[6] *Monetary policy tightening has been less vigorous in Albania thanks to more contained inflation rises, steady currency appreciation and stronger than expected transmission associated particularly with a strong increase of treasury bill yields.*

[7] *2022 was the 5th among the last 6 years that the NBS ended as a net FX buyer. The NBS's purchases in FX market interventions exceeded the sales by over EUR 700 million in 2022 (see NBS | Show news).*

Chart 3

Consumer price developments

Period average, annual change in %



Source: Macrobond, wiiw.

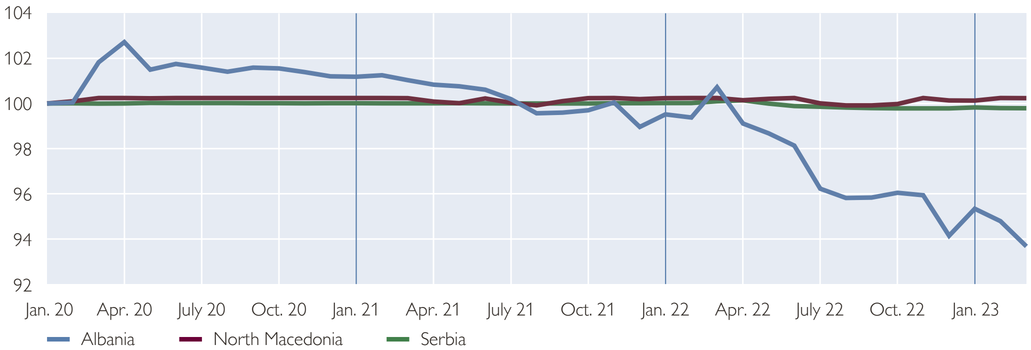
and macroprudential tools. Yet in the current inflationary period none of these tools have been actively used for monetary policy purposes so far. The central banks in the three mentioned WB countries have argued that the current inflation is mainly imported and/or that such instruments are predominantly employed for financial stability objectives. In this context, it is important to again stress the crucial role of prudent fiscal policy also in the monetary policy context, especially in countries without autonomous monetary policy.

Looking ahead, inflation is projected to soon start falling noticeably in the entire region, including in Serbia, where it has not yet plateaued so far. The slowdown is expected to be brought about by weakening global cost-push factors

Chart 4

Exchange rate vis-à-vis the euro

National currency per EUR, period average, January 2020 = 100



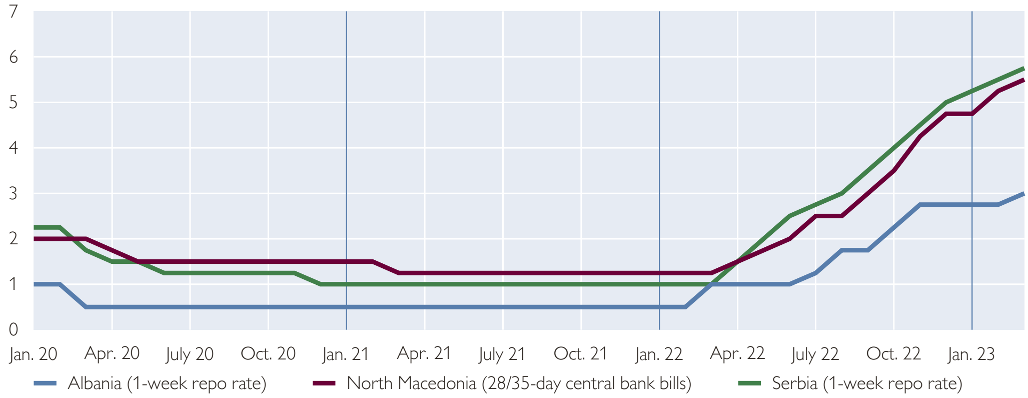
Source: Macrobond.

Note: Upward movement = depreciation; downward movement = appreciation.

Chart 5

Key interest rates

End of period, %



Source: National central banks.

Note: No policy rate available for Bosnia and Herzegovina, Kosovo and Montenegro due to unilateral euroization or currency board.

on the back of easing energy and commodity prices as well as global supply chain frictions, among other factors. Moreover, on the domestic front, the impact of tighter monetary policies will take hold and the base effect will start to kick in. Nonetheless, a watchful eye is warranted in light of the persisting geopolitical tensions, rising core inflation, considerably increased inflation expectations in all countries as well as tight labor markets. The risk of potential second-round effects and particularly of wage-price spirals thus needs to be closely monitored[8].

Financial sector appears resilient to recent external shocks

The WB financial sector, which is mostly dominated by foreign-owned banks, remains resilient even after the shocks triggered by the pandemic and the war. Bank lending to the nonbank private sector has kept on expanding at a robust pace in the entire region, despite some significant counterweighing factors such as a weakening of the business environment and economic sentiment as well as global and national political uncertainty. Compared to 2021, nominal credit growth accelerated in 2022 in four WB economies and cooled down in Albania and Serbia (table 5) owing to tighter credit conditions and the slowdown of the economy. Nonetheless, real credit expansion was negative in the WB countries barring Kosovo and Albania. The pattern behind the nominal credit expansion was not homogenous either. Hence, whereas in Albania and Bosnia and Herzegovina, it was predominantly loans to households that recorded strong growth (in Albania largely for real estate purposes), in the other countries lending to both businesses and households expanded quite vigorously. As for the currency decomposition, in Serbia and Albania, and to a lesser extent in North Macedonia, credit growth was driven mainly by foreign currency-denominated lending. This was spurred mainly by lower interest rates of euro loans and, on the supply side, by a shift toward foreign currency deposits, especially after the outbreak of the war. In contrast, in

[8] *For instance, following the adoption of the draft law on salary reform, the average monthly salary in Albania will rise from the current EUR 563 to EUR 900 within a year.*

Bosnia and Herzegovina, lending in foreign currency had been contracting since 2018, increasingly so in 2022, so that loans in domestic currency dominated. As a result, the share of foreign currency loans dropped to just above 40% in Bosnia and Herzegovina, almost 20 percentage points less than in 2018. In contrast, it has increased somewhat in Albania, North Macedonia and Serbia (table 5). Hence, the de-euroization process in the affected WB countries and particularly the relatively significant dinarization trend observed in recent years in Serbia have been interrupted. However, this has been mainly due to external factors. Data from the OeNB Euro Survey suggest that trust in domestic currencies has somewhat declined (except for Albania). However, this decline affected not only national

Table 5

Banking sector indicators

	2020	2021	2022	Q3 21	Q4 21	Q1 22	Q2 22	Q3 22	Q4 22
	End of period, annual change in %								
Bank loans to the domestic nonbank private sector									
Albania[1]	5.9	9.4	8.9	8.4	9.4	10.7	11.3	11.7	8.9
Bosnia and Herzegovina[1]	–2.5	3.7	5.3	2.7	3.7	4.6	4.9	4.7	5.3
Kosovo	7.1	15.5	16.0	13.5	15.5	18.4	17.4	18.4	16.0
Montenegro	3.0	3.2	8.7	1.1	3.2	6.5	8.9	8.9	8.7
North Macedonia[1]	4.3	7.3	8.4	6.2	7.3	8.1	7.8	7.3	8.4
Serbia[1]	10.9	8.5	5.3	6.8	8.5	9.6	9.8	7.4	5.3
	End of period, %								
Share of foreign currency loans[2]									
Albania	48.3	48.8	49.3	47.5	48.8	49.3	49.0	49.6	49.3
Bosnia and Herzegovina	52.2	47.8	41.2	49.1	47.8	45.9	43.9	42.8	41.2
Kosovo	. .	. .	. .	. .	. .	. .	. .	. .	. .
Montenegro[3]	2.9	3.2		3.1	3.2	3.4	2.7	4.0	
North Macedonia	41.5	40.7	42.6	41.3	40.7	40.9	41.4	42.3	42.6
Serbia[4]	62.8	61.7	65.2	61.4	61.7	62.4	63.1	64.4	65.2
	%								
NPL ratio									
Albania	8.1	5.7	5.0	6.5	5.7	5.2	5.3	5.1	5.0
Bosnia and Herzegovina	6.1	5.8	4.5	5.5	5.8	5.4	5.2	4.9	4.5
Kosovo	2.7	2.3	2.0	2.4	2.3	2.1	2.1	2.1	2.0
Montenegro	5.5	6.2	5.7	5.6	6.2	6.5	6.3	5.9	5.7
North Macedonia	3.2	3.2	3.1	3.6	3.2	3.3	3.4	3.3	3.1
Serbia	3.7	3.6	3.0	3.6	3.6	3.4	3.3	3.2	3.0
	%								
Tier 1 capital ratio									
Albania	17.2	16.9	16.9	17.2	16.9	16.7	17.8	18.1	16.9
Bosnia and Herzegovina	18.1	18.7	18.7	18.4	18.7	18.6	18.6	18.4	18.7
Kosovo[5]	16.5	15.3	14.8	17.9	15.3	15.1	15.1	15.8	14.8
Montenegro[5]	18.5	18.5	19.3	18.5	18.5	19.2	18.9	18.4	19.3
North Macedonia	15.3	15.8	16.6	15.9	15.8	15.5	15.9	16.3	16.6
Serbia	21.6	19.7	18.8	20.6	19.7	18.9	18.2	18.2	18.8

Source: National central banks.

[1] *Foreign currency component at constant exchange rates.*
[2] *In total loans to the nonbank private sector. As far as available, including loans indexed to foreign currencies.*
[3] *Share in total loans to all sectors.*
[4] *Including securities.*
[5] *Overall capital adequacy ratio.*

currencies but also the euro. Naturally, depreciation fears were ignited immediately after the Russian invasion of Ukraine.

Banks in the region remain liquid and well capitalized (table 5) while their profitability has improved in most instances on the back of higher interest rates and lower noninterest costs. The concern that asset quality could noticeably deteriorate after a removal of the pandemic-triggered support measures has not materialized so far. The share of nonperforming loans (NPLs) to total loans decreased in all countries in 2022 (table 5). However, in some instances this was the result of a relatively stronger growth of the credit volume in the denominator since the NPL stock increased somewhat in half of the WB economies. While these figures appear encouraging at first glance, it is warranted to keep a close eye on future asset quality developments, especially in light of potentially mounting credit, exchange and interest rate risks. Apart from the fragile geopolitical situation and challenging macroeconomic environment, the microeconomic perspective also calls for caution. According to the most recent OeNB Euro Survey data, about 20% of interviewed household borrowers in Bosnia and Herzegovina and up to 60% in Albania report that they are unlikely or very unlikely to repay their debt over the next 12 months. The need for a watchful eye is corroborated also from the banks' view. According to the EIB Bank Lending Survey conducted in September 2022, banks in all WB economies expected deteriorating NPLs in the short to medium term. What is more, if credit risks materialize, structural obstacles continue to complicate NPL resolution in the region. In particular, collateral execution remains a difficult task as protection of property rights keeps on lagging behind[9].

Some notable political and institutional breakthroughs?

At present, the European Union is engaged in accession negotiations with Montenegro and Serbia. Both countries accepted the revised enlargement methodology endorsed in June 2021, which they continue to apply[10]. According to the European Commission's 2022 Enlargement Package, which provides a detailed assessment of the state of play and progress made by (potential) candidates on their respective paths toward the EU, Serbia has opened 22 out of 35 chapters since the start of accession negotiations in January 2014. These include all chapters in cluster 1 on the fundamentals and all chapters in cluster 4 on the green agenda and sustainable connectivity. Two chapters have been provisionally closed. Accession negotiations with Montenegro were opened in June 2012. To date, 33 chapters have been opened, three of which have been provisionally closed. The other WB countries will be subject to the revised enlargement methodology in its entirety. In July 2022,

[9] *In 2022, a score provided by The Heritage Foundation that captures the level of property right protection and is normalized between 0 (worst) and 100 (best) ranged between less than 50 in Kosovo and just above 60 in Montenegro. For comparison, the Central and Eastern European region scores between more than 70 in Poland and 90 in Slovenia.*

[10] *The dissatisfaction of some EU countries with the quality of reforms in candidate countries has prompted changes in the methodology of enlargement. The new methodology is based on four principles: credibility, predictability, dynamism and greater political governance. One of the key novelties is the establishment of six negotiation clusters: (1) fundamentals; (2) internal market; (3) competitiveness and inclusive growth; (4) green agenda and sustainable connectivity; (5) resources, agriculture and cohesion and (6) external relations. The new methodology is expected to increase the dynamics and thus the speed of the process if the countries implement the reforms on time. While a greater involvement of the EU in monitoring the process is envisaged the new procedure also allows for reversibility in case of no progress or backsliding.*

the Council of the European Union decided to commence long-awaited accession talks with Albania and North Macedonia. Both countries are currently undergoing the screening process to acquaint themselves with the acquis, establish the level of alignment with EU legislation and to outline plans for further alignment. Additionally, in December 2022, Bosnia and Herzegovina was granted the EU candidate status while the potential candidate Kosovo officially applied for EU membership. In the meantime, in April 2023, the European Parliament agreed a long-awaited removal of visa requirements for Kosovo citizens to enter the Schengen area from 2024 on. In a similar vein, through the implementation of the SAAs[11] as well as other EU programs (e.g. the Economic and Investment Plan), agreements or cooperation frameworks, the EU is keen to accelerate the integration of the WB region prior to full EU membership. In this context and in light of the current energy crisis, the EU is for instance opening its electricity market to the Western Balkans, subject to regulatory reforms. In May 2022, the European Commission thus launched the so-called REPowerEU Plan to help reduce the EU's and the Western Balkans' dependence on Russian gas.

Yet, the integration progress toward the EU is significantly intertwined with domestic political developments. At end-March 2023, presidential elections took place in Montenegro after a year of political deadlock that had threatened the country's advancement in EU accession negotiations. The incumbent Milo Đukanović, who has served the country as president for more than 20 years (and, taken together with the Prime Minister post, for more than three decades) lost the presidential election to the contender Jakov Milatović. The candidate of the Europe Now Movement, who advocates closer ties with both the European Union and Serbia won in a close runoff. Further, general elections scheduled for June 2023 could definitely end the long period of political stalemate and instability after two governments did not survive the no-confidence vote in the parliament during 2022. Another noteworthy parliamentary election was held in Bosnia and Herzegovina last October. A new, state-level government was formed in late January 2023. For the EU prospects of Kosovo and Serbia in the period ahead, the so-called Ohrid Agreement will be of utmost importance (see box 1).

With respect to other important institutional relations, in late 2022, the IMF approved a two-year SBA for Serbia amounting to about EUR 2.4 billion (equivalent to a 290% of quota). The SBA replaced the previous Policy Coordination Instrument and builds on its reform agenda with appropriate modifications to address new policy challenges. In particular, in the context of the energy crisis, the SBA focuses on addressing external and fiscal financing needs, maintaining macroeconomic and financial stability, and fostering structural reforms, especially in the energy sector. In a similar vein, in April 2023, IMF staff and Kosovo authorities reached a staff-level agreement on Kosovo's economic policies to be supported by a precautionary 24-month SBA worth around EUR 100 million (97% of quota), and an arrangement under the Resilience and Sustainability Facility (RSF) of about EUR 78 million (75% of quota). These requests are subject to the approval of the IMF's Executive Board, whose considerations about these arrangements are expected to be

[11] *All WB countries have established Stabilization and Association Agreements (SAAs) with the EU which, inter alia, define the terms and mechanisms for implementing reforms that will bring the respective countries progressively closer to EU policy standards.*

concluded in late May. According to the IMF, the SBA would provide liquidity in case downside risks – including those arising from Russia's war in Ukraine – materialize. In contrast, the RSF is supposed to provide affordable financing to support Kosovo's climate change mitigation and adaptation efforts, greener electricity production, and long-run growth prospects. Moreover, it is expected to catalyze other climate financing. Kosovo's RSF is the first in Europe.

Box 1

The Ohrid Agreement

Mediated by the EU, on March 18, 2023, Serbia and Kosovo reached a verbal agreement on the Implementation Annex of the "Agreement on the path to normalization of relations" between the two countries, informally known as the Ohrid Agreement. This agreement, along with the Implementation Annex, will be integral to the EU accession process for both Serbia and Kosovo. The agreement stipulates particularly the following provisions for the two parties:

- *Development of normal, good-neighborly relations;*
- *Mutual recognition of their respective documents and national symbols;*
- *Respecting each other's independence, autonomy and territorial integrity and the right of self-determination;*
- *Any disputes are to be settled exclusively by peaceful means;*
- *Neither party can represent the other in the international sphere;*
- *Serbia will not object to Kosovo's membership in any international organization;*
- *Neither party will block, nor encourage others to block, the other party's progress on its EU path;*
- *Kosovo will ensure the security of the properties of the Serbian Orthodox Church;*
- *Both parties will exchange permanent missions to be established in each other's capitals.*

In addition, as part of the agreement, Kosovo committed to immediately commence negotiations within the EU-facilitated dialog on establishing specific arrangements and guarantees to ensure an appropriate level of self-management for the Serbian community in Kosovo, in compliance with previous agreements determined by the EU facilitator. Furthermore, Serbia and Kosovo agreed to establish, within 30 days, a Joint Monitoring Committee, chaired by the EU[12] *and tasked with supervising the implementation of all provisions. Within 150 days, the EU will organize a donor conference to establish an investment and financial aid package for Serbia and Kosovo. However, disbursement will not occur until the EU confirms that all provisions of the agreement have been fully met. The document also stipulated that any failure to meet obligations stemming from the agreement may result in direct negative consequences for the EU accession paths of Serbia and Kosovo, as well as the financial aid they receive from the EU.*

The fact that the agreement is verbal and was not signed has allowed Serbia's President Vučić to later question his acceptance of the pact and/or present alternative interpretations. In Serbia, the agreement was met with fierce opposition and protests by parts of the political spectrum; it remains to be seen how the country's president and government will walk the line between the country's commitments vis-à-vis the EU and the Ohrid Agreement on the one hand and domestic political pressures on the other.

[12] *The committee is chaired by EU Special Representative for the Belgrade-Pristina Dialogue and other Western Balkan regional issues, Miroslav Lajčák.*